

Illinois Real Estate Broker **Pre-License Topics**

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4140 Executive Parkway
Westerville, Ohio 43081
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Published 2020. Printed in the United States of America

22 21 20 1 2 3
978-1-59844-395-0

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PREFACE

Illinois Real Estate Broker Pre-License Topics

The *Illinois Real Estate Broker Pre-License Topics* course is designed to meet the 75-hour prelicensing curriculum requirements for real estate brokers as set forth by the State of Illinois. The course covers topic areas such as Illinois license law, agency, state and federal law, relationships with employing brokers, working with sellers and buyers, real property, fair housing, ownership, contracts, real estate valuation, environmental issues, construction, real estate closings, advertising, property management, and commercial real estate. The book includes additional topics as referenced by the outline for the state real estate broker licensing examination.

Highlights include:

- Sample forms and contracts
- Chapter review questions on key points to help you assess your new knowledge
- Real-life scenarios to illustrate the topics being taught
- Illinois law citations for quick reference
- Comprehensive real estate glossary, including Illinois-specific terms
- Math formulas and practice calculations

Acknowledgements

This edition of the Illinois Real Estate Broker Pre-License Topics textbook would not have been possible without the aid and assistance of many people. A special thank you to the following for their comments, suggestions, and expertise:

Bill Alston: Realty USA

Patrick J Carmody: Certified Mortgage Training Instructor, Illinois Licensed Real Estate Broker

Timothy Detty: Certified General Appraiser

John Dilanni: Associate Broker, Realty USA

Lisa Durand: Mortgage Originator, Albany Funding Inc.

Laura Farrell: Broker, L. Newman Real Estate

Chip Francek: Polley Associates

J. Chris Jones: B.S. Accounting

Dave McGowan: Inland Real Estate School, Inc.

Bill O'Donnell: TMF Career Solutions; IL Licensed Real Estate Broker and Instructor

Wayne Paprocki: DREI-GRI-CNE, Real Estate Negotiation Institute Certified Trainer

Bill Plunkett: New York Real Estate Institute

Leo Schwartz: President, Schwartz & Brannin Real Estate; Illinois Licensed Instructor

Erin Sheridan: Associate Broker, Pro Realty of N.Y. Inc.

Joseph Sullivan: Broker, Prudential Manor Homes

Jeanne Warzek: Associate Broker, Coldwell Banker Prime Properties

Linda Randolph: Editor

Exam Outline

Illinois Real Estate Broker Licensing Examination

The licensing examination for Illinois Real Estate Broker applicants consists of a national portion and a state portion. The following detailed content outlines are from the **Illinois Broker Candidate's Handbook**, effective August, 2019. This list indicates chapters where the topics can be found in this textbook. The Candidate's Handbook is essential and can be downloaded from this website:

http://documents.goamp.com/Publications/candidateHandbooks/ILREP-handbook.pdf

National Examination Outline

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UNIT 1

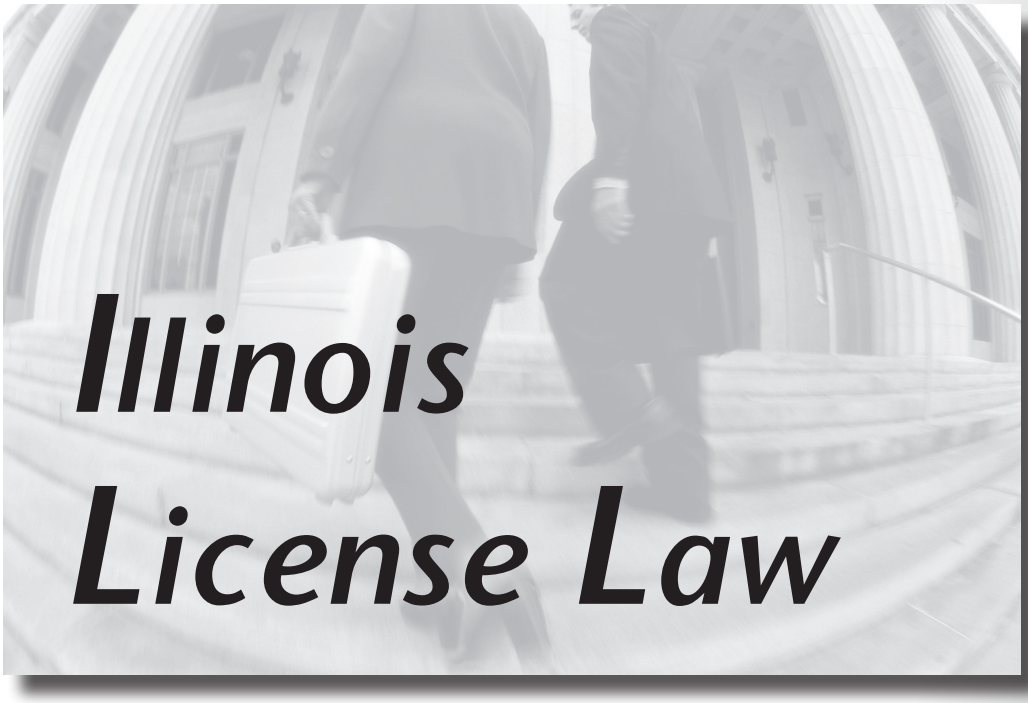
REAL ESTATE LAW

Chapter 1 - Illinois License Law

Chapter 2 - Illinois Grounds for Discipline

Chapter 3 - Human Rights and Fair Housing

Chapter 4 - Federal Business Law



1

Illinois License Law

In this chapter, you'll learn about real estate licensing law in general and the Illinois State agencies that regulate real estate licensees. You'll understand why a license is necessary and who must be licensed, and you'll also be able to distinguish between brokers and managing brokers. The information in this chapter is the foundation for your new career.

You will learn:

- The activities that require a real estate license.
- Who is exempt from the licensure requirements of the Illinois Real Estate License Act.
- The legal authority for license laws in the State of Illinois.
- The requirements set forth by the State of Illinois to apply for a real estate license.
- The requirements necessary to renew a license, including continuing education.
- Provisions for transferring a licensee's sponsorship.
- The definition of each license status.

Key Terms

Broker
Coordinator
Designated Managing Broker
Inactive Status
License
Licensee
Managing Broker
Reciprocity
Renewal Period
Residential Leasing Agent
Sponsoring Broker
Sponsorship

License Law

Every state has its own real estate license laws, and all of the state laws share a common purpose: *To protect the health, safety, and welfare of the public by ensuring a consistent level of competence, ethics, and professionalism by real estate licensees.* Therefore, it's important to remember that a license is a **privilege** that is not conferred on just anyone. The authority for the creation of Illinois real estate license law is located in the Civil Administrative Code of Illinois (20 ILCS 2105/). As a licensed real estate professional, you are obligated to uphold and follow the laws and regulations established by the State of Illinois.

The task of regulating real estate activity in Illinois ultimately belongs to the **Illinois Department of Financial and Professional Regulation** (IDFPR), whose chief executive is the **Secretary of Financial and Professional Regulation**. The Secretary of Financial and Professional Regulation has the authority to issues rules and regulations as necessary to administer and enforce the provisions of Illinois license law.

Illinois Statutes and Rules

The **Illinois Compiled Statutes** (ILCS) are a cumulative organization of Public Acts—bills that have become law—compiled into a coherent framework and divided into related Chapters. Most, but not all, Public Acts are incorporated into the most current ILCS. For a real estate licensee, these are the most critical Chapters of the ILCS:

- 225 Professions and Occupations
- 765 Property

The Chapters are organized by Act. Acts are divided into Articles and then Sections and Subsections. If you see a law referenced as ***225 ILCS 454/5-20***, for example, you know that it can be found in:

- Chapter ***225*** of the Illinois Compiled Statutes
- Act ***454*** (which is the Real Estate License Act)
- Article ***5***
- Section ***20***

Note, however, that sometimes instead of referencing the Article, the number after the slash may be referencing the Section and Subsection instead.



You can access the ILCS online from the State General Assembly website:
www.ilga.gov/legislation/ilcs/ilcs.asp

The **Illinois Administrative Code** is the collection of rules and regulations passed to support and enforce the law. While the rules generally mirror the actual statutes, they often provide clarification or more detail. Rules carry the same governing authority as the actual laws. Rules are divided into Titles, then Chapters, then Parts and Subparts, and finally, into Sections and Subsections. Administrative rules related to the real estate profession are found in the **Rules of the Department of Financial and Professional Regulation**, **Part 1450 Real Estate License Act** of **Title 68: Professions and Occupations**. Rules and regulations are generally referenced only by the Part and Section, so if you see a rule referenced as Rules: Section ***1450.180***, you know that it can be found in:

- Part ***1450*** of Title 68
- Section ***180***

The Illinois Real Estate License Act (RELA)

The **Illinois Real Estate License Act**:

- Regulates persons and entities engaged in real estate business for the protection of the public.
- Establishes the **Real Estate Administration and Disciplinary Board**.
- Provides for appointment of a **Real Estate Coordinator** to serve as a liaison and point of contact between Department and licensees for information, education, advice, and assistance.

- Defines terms, licensing requirements, agency relationships, disciplinary provisions, law administration procedures, and transition rules.

Major updates to the Real Estate License Act were signed into law in August of 2019. The changes are intended to better reflect modern-day real estate practices by addressing various practices such as the use of teams and the role of technology in the profession. Age and education requirements for licensure were also updated. While the updates to the Real Estate License Act legally became effective immediately, the specific details related to rules, the updated educational curricula, or the transition of existing students to the revised educational requirements will be implemented through administrative rules to be issued by IDFPR.

Organization of the Real Estate License Act

Of most interest to real estate licensees are the following Articles of the Illinois Real Estate License Act:

- **Article 1.** Provides general provisions and definitions.
- **Article 5.** Defines the licensing and education requirements for brokers, managing brokers, and residential leasing agents.
- **Article 10.** Discusses compensation and other business practices.
- **Article 15.** Defines agency relationships and a licensee's statutory obligations to clients.
- **Article 20.** Lists activities that can lead to disciplinary action and describes the consequences.
- **Article 25.** Establishes the authority of boards and personnel tasked with administering real estate licensees.
- **Article 30.** Defines the criteria for approval and administration of real estate education providers.

Division of Real Estate

The Illinois Real Estate License Act is administered and enforced by the Division of Real Estate (DRE). The Division also has oversight of the Real Estate Administration and Disciplinary Board.

The Division administers four separate funds:

- **Real Estate Recovery Fund**, which compensates the public for harmful actions by licensees
- **Real Estate License Administration Fund**, which uses licensing fees to fund the administration of the Department
- **Real Estate Research and Education Fund**, which is used for research and education at state institutions of higher education or other organizations for research and the advancement of education in the real estate industry
- **Real Estate Audit Fund**, which provides for investigatory audits of brokers' special accounts

The Division also oversees other real estate professions such as appraisal, home inspection, auctions, and timeshare/land sales.

Real Estate Administration and Disciplinary Board *225 ILCS 454/25-10*

Article 25 of the Illinois Real Estate License Act creates the **Real Estate Administration and Disciplinary Board**. The Board provides recommendations to the Secretary of Financial and Professional Regulation on questions involving standards of professional conduct, discipline, and examination of candidates for licensure.

The provisions for membership are as follows:

- The Board is composed of nine (9) persons appointed by the Governor.
- All members have been citizens of Illinois for at least six (6) years prior to appointment date.
- Six (6) members have been managing brokers/brokers for 10 years prior to appointment date.

- Three (3) members are public members who represent common interests (excluding licensees, spouse or family member of licensee, any person with ownership interest in real estate brokerage business, or any person with affiliation to a real estate brokerage business or licensee).
- The member's term will be four (4) years or until a successor is appointed.
- No member may be reappointed for a term of service of longer than 12 years.
- The membership should reflect geographic distribution of licensee population.
- The Governor may terminate membership for just cause.
- Five (5) members of the board constitute a quorum.

Real Estate Coordinator

225 ILCS 454/25-15

Article 25 of the Illinois Real Estate License Act also creates the position of a **Real Estate Coordinator**, who is appointed by Secretary of the Real Estate Administration and Disciplinary Board. The Real Estate Coordinator must hold a currently valid broker license, which must be **transferred to inactive status** during the appointment.

The duties and responsibilities of the Real Estate Coordinator are as follows:

- Act as Chairperson of the Board, without vote
- Serve as the direct liaison between the Department, the profession, real estate organizations, and associations
- Prepare and circulate educational and information materials to licensees
- Appoint any necessary committees
- Subject to administrative approval of the Secretary, supervise all real estate activities

Requirements for Licensure

225 ILCS 454/1-10

According to the Illinois Real Estate License Act, any individual, partnership, limited liability company, corporation, or registered limited liability partnership (*other than a residential leasing agent*) who, whether in person or through any media or technology, performs any of the following activities **for another** and **for compensation**, or with the intention or expectation of compensation directly or indirectly, is required to be licensed as a broker or managing broker:

- Sell, exchange, purchase, rent, or lease real estate; or offers to do so.
- Negotiate the sale, exchange, purchase, rental or leasing of real estate; or offer or agree to do so.
- List, offer, attempt or agree to list real estate for sale, lease, or exchange.
- Whether for another or for themselves, engage in a **pattern of business** of buying, selling, offering to buy or sell, market for sale, exchange, or otherwise deal in contracts, including assignable contracts for the purchase or sale of options on real estate or improvements thereon. A pattern of business involves one or more of these practices on **two or more occasions in a 12-month period**.
- Supervise the collection, offer, attempt, or agreement to collect of rent for the use of real estate.
- Advertise or represent oneself as engaging in the business of buying, selling, exchanging, renting, or leasing real estate.
- Assist or direct in procuring or referring leads or prospects intended to result in the sale, exchange, lease, or rental of real estate.
- Assist or direct in the negotiation of any transaction intended to result in the sale, exchange, lease, or rental of real estate.
- Open real estate to the public for marketing purposes.
- Sell, lease, or offer for sale or lease real estate at auction.
- Prepare or provide a broker price opinion or comparative market analysis.

All active participants in a partnership (partners) or corporation (officers) must hold a broker's license or sign an **affidavit of non-participation** if not licensed.

Exemptions

Although the list of activities for which licensure is required under the Illinois Real Estate License Act is broad, there are some exemptions. For this discussion, these exemptions have been organized into some categories to help clarify the purpose or reason for the exemption. (The subdivision under 775 ILCS 454/5-20 is indicated in parentheses after each point for reference.)

When Acting as an Owner or On Behalf of an Owner

A **residential leasing agent** acting on behalf of an owner is exempt from licensure as a broker (although a broker's license is required for leasing commercial properties). These are other specific exemptions that relate to owners and ownership:

- Any person, partnership, or corporation that as **owner** or **lessor** performs any of the acts described in the definition of "broker" under Section 1-10 of the Act with reference to property owned or leased by it, or to the **regular employees** thereof with respect to the property so owned or leased, where such acts are performed in the regular course of or as an incident to the management, sale, or other disposition of such property and the investment therein, provided that such regular employees do not perform any of the acts described in the definition of "broker" under Section 1-10 of the Act in connection with a vocation of selling or leasing any real estate or the improvements thereon not so owned or leased. (1)
- Any person acting as a **resident manager** for the owner or any employee acting as the resident manager for a broker managing an apartment building, duplex, or apartment complex, when the resident manager resides on the premises, the premises is his or her primary residence, and the resident manager is engaged in the leasing of the property of which he or she is the resident manager. (4)
- Any **resident lessee** of a residential dwelling unit who refers for compensation to the owner of the dwelling unit, or to the owner's agent, prospective lessees of dwelling units in the same building or complex as the resident lessee's unit, but only if the resident lessee (i) refers no more than 3 prospective lessees in any 12-month period, (ii) receives compensation of no more than $5,000 or the equivalent of two month's rent, whichever is less, in any 12-month period, and (iii) limits his or her activities to referring prospective lessees to the owner, or the owner's agent, and does not show a residential dwelling unit to a prospective lessee, discuss terms or conditions of leasing a dwelling unit with a prospective lessee, or otherwise participate in the negotiation of the leasing of a dwelling unit. (10)
- An existing **timeshare owner** who, for compensation, refers prospective purchasers, but only if the existing timeshare owner (i) refers no more than 20 prospective purchasers in any calendar year, (ii) receives no more than $1,000, or its equivalent, for referrals in any calendar year and (iii) limits his or her activities to referring prospective purchasers of timeshare interests to the developer or the developer's employees or agents, and does not show, discuss terms or conditions of purchase or otherwise participate in negotiations with regard to timeshare interests. (12)

When Acting in a Professional or Regulated Capacity

Specific exemptions for individuals who perform certain activities while in the course of doing business in a professional or regulated capacity are as follows:

- An **attorney in fact** acting under a duly executed and recorded power of attorney to convey real estate from the owner or lessor or the services rendered by an attorney at law in the performance of the attorney's duty as an attorney at law. (2)
- Any person acting as receiver, trustee in bankruptcy, administrator, executor, or guardian or while acting **under a court order** or under the authority of a will or testamentary trust. (3)
- Any officer or employee of a **federal agency** in the conduct of official duties. (5)
- Any officer or employee of the **State government** or any political subdivision thereof performing official duties. (6)
- Railroads and other **public utilities** regulated by the State of Illinois, or the officers or full time employees thereof, unless the performance of any licensed activities is in connection with the sale, purchase, lease, or other disposition of real estate or investment therein not needing the approval of the appropriate State regulatory authority. (8)

- An **exchange company** registered under the Real Estate Timeshare Act of 1999 and the regular employees of that registered exchange company but only when conducting an exchange program as defined in that Act. (11)
- Any person who is licensed without examination under Section 10-25 (now repealed) of the Auction License Act is exempt from holding a broker's license under this Act for the limited purpose of selling or leasing real estate at auction, so long as: (A) that person has made application for said exemption by July 1, 2000; (B) that person verifies to the Department that he or she has sold real estate at auction for a period of 5 years prior to licensure as an auctioneer; (C) the person has had no lapse in his or her license as an auctioneer; and (D) the license issued under the Auction License Act has not been disciplined for violation of those provisions of Article 20 of the Auction License Act dealing with or related to the sale or lease of real estate at auction. (13)
- A **hotel operator** who is registered with the Illinois Department of Revenue and pays taxes under the Hotel Operators' Occupation Tax Act and rents a room or rooms in a hotel as defined in the Hotel Operators' Occupation Tax Act for a period of not more than 30 consecutive days and not more than 60 days in a calendar year. This exemption also extends to those who participate in online rental platforms for their own residences. (14)

When Involved in Information Collection and Dissemination Only *775 ILCS 454/5-20*

Additional exemptions are related to information collection and dissemination when no other licensed activities are performed:

- Any **Multiple Listing Service** or other similar information exchange that is engaged in the collection and dissemination of information concerning real estate available for sale, purchase, lease, or exchange for the purpose of providing licensees with a system by which licensees may cooperatively share information, along with which no other licensed activities as defined in Section 1-10 of the Act are provided. (7)
- Any **medium of advertising** in the routine course of selling or publishing advertising, along with which no other licensed activities as defined in Section 1-10 of the Act are provided. (9)

Illinois Real Estate Licenses

The State of Illinois issues three different types of real estate licenses to individuals—broker, managing broker, and residential leasing agent—and also issues licenses to business entities.

Broker *225 ILCS 454/5-27, 35, 70*

A **broker** is an individual licensee who performs or assists a sponsoring broker in performing the activities requiring licensure, but who may work only *under the name and supervision of a sponsoring licensed broker.* A broker cannot operate independently and can be compensated only by his or her sponsoring broker.

Every broker's license issued under the Illinois Real Estate License Act expires on **April 30** of each **even-numbered year**.

Broker License Application Requirements

Under the 2019 updates of the Real Estate License Act, licensing requirements for a first time broker applicant are as follows:

- At least 18 years old (previously, the age limit was 21 but waived for anyone who is at least 18 years old and can provide evidence of the successful completion of at least four semesters of post-secondary school study as a full-time student or the equivalent, with major emphasis on real estate courses, in a school approved by the Department).
- Certification of graduation from a four-year high school or its equivalent
- Be of good moral character
- Registered sponsorship with a licensed sponsoring broker

- Submission of a signed and completed application
- Proof of successful completion of the examination authorized by the Division
- Payment of the required non-refundable fee

Applicants must also submit proof of one of the following:

- Current admittance to practice law by the Supreme Court of Illinois, or
- Completion of the required prelicensing education.

Prelicensing Education Requirements

For prelicensing education, a broker is required to complete a total of **75 hours** of prelicensing education for entry-level licensure (previously, the requirement was for a total of 90 hours):

- A **60-hour** course in the classroom or through distance learning (previously, 75 hours)
- A **15-hour** course completed in a classroom or interactive setting applying the concepts and facts learned in the 60-hour course

Both courses require a proctored final examination with a minimum passing score of **75%**.

Educational transcripts are good for **two years** after the completion of the required education.

Licensing Examination

Applicants for a broker license must take the licensing examination authorized by the Division that consists of two parts: One on general/national topics and one on Illinois-specific topics. Applicants will have **one year** from the date they passed the exam to meet all of the requirements for licensure and to file an application with the Division.

An applicant who has failed the examination **four consecutive times** must repeat the prelicensure education in order to be readmitted to sit for the exam.

Post-License Education Requirements

Under the provisions of the 2019 updates to the Real Estate License Act, prior to the first renewal of their licenses, brokers are required to complete a **45-hour post-license course** (30 hours for licenses first issued before January 31, 2020) consisting of three 15-hour courses that address applied brokerage principles, risk management and discipline, and transactional issues.

If one's first broker license is issued within **180 days** preceding the next broker renewal deadline, the licensee will have until the **second broker renewal deadline** following receipt of their license to complete the 45 hours of post-license education.

Those who take the 30-hour post-licensure broker course during their first renewal cycle will *not* be required to complete any other continuing education during that pre-renewal cycle.

Continuing Education Requirements

In order to renew a real estate license, a broker must complete a total of **12 hours** of approved continuing education during every **two-year licensing period**. At least four hours for each two-year licensing period is required to be completed in the core curriculum as established by the Real Estate Education Advisory Council with eight hours of approved electives. Brokers may be able to apply CE credit earned in a reciprocal state to their Illinois CE requirement.

To meet the CE requirement, all real estate licensees must complete a one-hour approved CE course in sexual harassment prevention training. This course will be required for every renewal or after January 1, 2020. For real estate licensees, this mandatory course may be included within the required CE hours.

A renewal applicant is not required to complete CE for the first current licensing period following licensure if the initial license was issued **less than 90 days** prior to the expiration date (i.e., on or after February 1 of an even-numbered year).

Good Moral Character

One of the requirements for licensure in Illinois is that the candidate must be of "good moral character." According to the Illinois Real Estate License Act (225 ILCS 454/5-25), that means that the candidate cannot have:

- Had a license revoked on a prior occasion.
- Been found to have committed any of the practices that are grounds for discipline under the Act.
- Been convicted of or entered a plea of guilty or nolo contendre to forgery, embezzlement, obtaining money under false pretenses, larceny, extortion, conspiracy to defraud, or any other similar offense.
- Been convicted of a felony involving moral turpitude in any court of competent jurisdiction in Illinois or any other state, district, or territory of the U.S., or a foreign country.

The Board may consider the prior revocation, conduct, or conviction in its determination of the applicant's moral character and whether to grant the applicant a license. In its consideration, the Board will take into account the nature of the conduct, any aggravating or extenuating circumstances, the time elapsed since the revocation, conduct, or conviction, the rehabilitation or restitution performed by the applicant, and any other mitigating factors deemed relevant, for example, whether the offenses have any relationship to the duties and function of a real estate licensee or the person's age at the time of the offense. The Board also considers **financial responsibility** as further evidence of an applicant's good moral character, for example, has she defaulted on a State-sponsored student loan, is he more than 30 days delinquent on court-ordered child support?

When an applicant has made a false statement of material fact on his or her application, the false statement may in itself be sufficient grounds to revoke or refuse to issue a license. Note, however, that applicants are not required to report arrest records when there was no charge or conviction or if charges were dismissed or overturned by a higher court. Nor is it necessary to report juvenile adjudications unless the nature of the offense required the applicant to be tried as an adult.

Managing Broker

225 ILCS 454/5-28, 35, 70

A **managing broker** is a broker who may have supervisory responsibilities for licensees in one, or in the case of a multi-office company, more than one office. A **designated managing broker** is a licensee who has been appointed as such by the sponsoring broker registered with the Department. A managing broker may act as his or her own sponsor.

Every managing broker's license issued under the Illinois Real Estate License Act after 2011 expires on **April 30** of each **odd-numbered year**.



A licensee doing business as a **sole proprietor** must have a managing broker license.

Managing Broker License Application Requirements

Licensing requirements for an initial managing broker license are as follows:

- At least 20 years old (previously 21 years old)
- Be of good moral character
- Certification of graduation from a four-year high school or its equivalent
- Licensure for at least two consecutive years of the preceding three years as a real estate broker
- Proof of successful completion of the examination authorized by the Division
- Payment of the required non-refundable fee
- Submission of a signed and completed application
- If a sponsoring broker, a properly completed consent to audit and examine special accounts form

Applicants must also submit proof of one of the following:

- Current admittance to practice law by the Supreme Court of Illinois, or
- Completion of the required prelicensing education.

Prelicensing Education Requirements

To obtain a managing broker license, an applicant is required to complete a total of **165 hours** of education:

- **120 hours** of required prelicensing and post-licensing education courses needed to obtain a broker license
- A **30-hour managing broker** prelicensing course in the classroom or through distance learning on brokerage administration and management (must be completed within the one-year period prior to submitting the managing broker application)
- A **15-hour managing broker** prelicensing interactive course completed in a classroom or interactive setting applying concepts and facts in the practice of real estate

Each prelicensing course requires a proctored final examination with a minimum passing score of **75%**. The three courses that make up the broker post-licensing curriculum require one comprehensive final examination, also with a minimum passing score of **75%**.

Educational transcripts are good for **four years**.

Examination

Applicants for a managing broker license must also take a licensing examination authorized by the Division. Applicants will have **one year** from the date they passed the exam to meet all of the requirements for licensure and to file an application with the Division.

An applicant who has failed the examination **four times** must repeat the prelicensure education in order to be readmitted to sit for the exam.

Continuing Education Requirements

A managing broker is required to have a total of **24 hours** of continuing education for every two-year licensing period, which must include:

- 12 hours of approved continuing education courses during the two-year licensing (including the one-hour mandatory sexual harassment training course).
- 12-hour approved Broker Management course during the two-year licensing period.

Business Entity Licenses

The Illinois Department of Financial and Professional Regulation will issue broker licenses to the following business entities.

- **Corporation**. All corporate officers of the corporation who actively participate in the real estate activities of the corporation must be licensed as a managing broker or broker. Furthermore, every employee acting as a broker or leasing agent must be licensed accordingly.
- **Limited liability company (LLC) or limited liability partnership (LLP)**. Every manager or member in a member-managed LLC must be licensed as a managing broker or broker. Furthermore, every employee acting as a broker or leasing agent on behalf of the LLC or LLP must be licensed accordingly.
- **Partnership**. Every general partner in a partnership or partner in a limited liability partnership must hold a license as a managing broker or broker. Furthermore, every employee acting as a broker or leasing agent must be licensed accordingly.

A license would not be granted to a business entity if an owner, partner, member, or officer has previously been publicly disciplined by the IDFPR resulting in that licensee being currently barred from practicing real estate because of a suspension or revocation.



The license of any business entity that is not in good standing with the Illinois Secretary of State or is not authorized to conduct business in Illinois is immediately inactive and is prohibited from engaging in any licensed activities.

Reciprocity

225 ILCS 454/5-60

Reciprocity is the *practice of allowing a license in one jurisdiction to be valid in another jurisdiction*. A reciprocal arrangement means that licensees from a state that has a reciprocal agreement with Illinois may apply for an Illinois broker license or managing broker license without any additional training, education, or experience. To qualify as a reciprocal state, the standards for licensing must be substantially equal or greater than the minimum standards in Illinois.

When applying for an Illinois broker or managing broker license, someone who has an active equivalent license in a state that has a reciprocal agreement with Illinois and maintains a definite place of business in that state of licensure must submit a statement with a seal of the licensing authority showing:

- The applicant's license in that state is current.
- The license is in good standing.
- Any disciplinary action taken against the broker.

The applicant must also:

- Pass an approved test on Illinois-specific real estate brokerage laws.
- Agree, in writing, to abide by all the provisions of the Illinois Real Estate License Act.
- Submit to the jurisdiction of the Illinois Department of Financial and Professional Regulation (IDFPR).
- File written statements with the Department appointing the Secretary to act as the broker's agent upon whom all judicial and other process or legal notices directed to the licensee may be served, agreeing that any lawful process against the licensee that is served upon the agent will be of the same legal force and validity as if served upon the licensee.

Any person who holds a valid reciprocal license is eligible to obtain a resident managing broker's license or a broker's license without examination should that person change their state of residence to Illinois and otherwise meets the qualifications for licensure. As of 2020, there are eight states with which Illinois has real estate license reciprocity agreements: Colorado, Connecticut, Florida, Georgia, Indiana, Iowa, Nebraska, and Wisconsin.

A list of states with which Illinois has reciprocity can be found on the website for the Division of Real Estate.



Those holding reciprocal licenses are required to meet the Illinois continuing education requirements to renew. A renewal applicant who earns CE hours in another state or territory may apply to claim credit toward full compliance in Illinois. The Department may choose to grant such credit if it is determined that the course meets the basic requirements for CE under the Illinois Real Estate License Act. CE credit is rarely granted for classes taken out-of-state, however.

Residential Leasing Agent

225 ILCS 454/5-10

A **residential leasing agent** is a person who is employed by a real estate broker to engage in licensed activities limited to leasing residential real estate.

Residential Leasing Agent License Application Requirements

Licensing requirements for a residential leasing agent are as follows:

- At least 18 years old
- Certification of graduation from a four-year high school or its equivalent
- Be of good moral character
- Submission of a properly completed sponsor form
- Submission of a signed and completed application
- Proof of successful completion of the examination authorized by the Division
- Payment of the required non-refundable fee

Prelicensing Education Requirements

For prelicensing education, a residential leasing agent is required to complete **15 hours** of instruction in an approved course of study related to the leasing of residential real property on topics including fair housing and human rights, advertising, leases, credit reports, criminal background, owner-tenant relationships, handling of funds, and environmental issues.

A residential leasing agent who has completed course work to meet leasing agent prelicensing requirements may **apply those credits** toward the course work needed to obtain a broker or managing broker license.

Continuing Education Requirements

Residential leasing agents are required to complete an 8-hour core curriculum continuing education course for every two-year licensing period. This includes the requirement for the one-hour mandatory sexual harassment training.

License Maintenance

225 ILCS 454/5-50(e)

Once the requirements are met and a broker or managing broker license is issued, the licensee must meet requirements to maintain and renew the license.

Evidence of Licensee Status

Prior to the 2019 revisions to the Real Estate License Act, each licensee who met all the licensing requirements for the current period and has paid all applicable fees was issued a pocket card by the Illinois Department of Financial and Professional Regulation (IDFPR). A licensee was required to carry the pocket card at all times and be prepared to show it upon request as evidence of being authorized to conduct real estate activities. Now, the IDFPR no longer issues pocket cards. Instead, licensees must carry a copy of their license or an electronic version of their license, for example, on a phone or tablet.

Licensees must inform the Department in writing of any change of address, email address, telephone number, or office location **within 24 hours** of such change.

Fees

225 ILCS 454/5-65 ***Rules: Section 1450.130***

The Illinois Department of Financial and Professional Regulation (IDFPR) establishes, by rule, fees to be paid by broker and managing broker applicants and licensees. These include the following:

- Initial application fee
- Renewal fees, e.g., non-expired license, late renewal, expired license (2+ years)
- Initial license application or renewal fee for partnership, limited liability company, or corporation
- Prelicensing school, instructor, course fee
- Testing fee

All licensing fees charged pursuant to the Illinois Real Estate License Act are **nonrefundable**. The Department also charges administrative fees to cover reasonable expenses for such things as requests for additional processing, duplicate copies, certifications, waivers, and transcripts.

Continuing Education

225 ILCS 454/5-70, 75, 80, 85

Continuing education (CE) requirements will consist of a core curriculum and elective courses that are recommended by the Board and approved by the Department. Subject areas of approved continuing education courses may include, but are not limited to, the following topics:

- License law and escrow
- Antitrust
- Fair housing
- Agency
- Appraisal
- Property management
- Residential brokerage
- Farm property management
- Transaction management rights and duties of parties to a transaction
- Commercial brokerage and leasing
- Real estate financing
- Broker supervision and managing broker responsibility
- Disclosures
- Professional conduct
- Use of technology

The following offerings do *not* meet the continuing education requirements:

- Examination preparation offerings (with some exceptions for transitional licensees)
- Offerings in mechanical office and business skills such as typing, speed reading, memory improvement, advertising, or psychology of sales
- Sales promotion or other meetings held in conjunction with the general business of the attendee or his or her employer
- Meetings that are a normal part of in-house staff or employee training

About Continuing Education

Key points about continuing education:

- Education credit may be earned for serving as the licensed instructor for an approved continuing education course.
- A licensee may earn credit for a particular continuing education course only once during the licensing period.
- No more than twelve hours of CE credit may be taken or earned in one calendar day.
- The Department must review any CE credits a licensee has earned in another state to determine whether the instruction meets the requirements for CE credit in Illinois and will make a decision to approve or disapprove the out-of-state credits.
- The following offerings do not meet approved CE requirements in Illinois: Exam preparation products; business or office skills courses such as typing, speed reading, and advertising, etc.; and sales promotion or staff meetings.

Citations

225 ILCS 454/20-20.1

The Department may issue a **citation** to any licensee who fails to comply with the continuing education requirements. The citation indicates the number of required CE hours that the licensee has not successfully completed as well as any penalty to be imposed up to a maximum of **$2,000**. A copy of the citation will be sent to the licensee's designated managing broker.

Licensees may choose to **dispute** a citation by requesting a hearing before the Department within 30 days. The issuance of a citation and the payment of a penalty, however, does not excuse a licensee from completing the required continuing education hours.

Payment of such a fine does not constitute disciplinary action that would be reported on the Department's website unless a licensee has received two or more citations and paid two or more fines.

Renewal

225 ILCS 454/5-27 ***Rules: Section 1450.140, 400-450, 700***

Sponsoring brokers will receive an emailed notice of renewal from the Division of Real Estate for the licensees they supervise or who are employed by their sponsoring broker. The designated managing broker must then notify the licensee:

- Personally within seven (7) days, or
- By certified or registered mail or other signature restricted delivery service within 10 days.

The notice must inform the licensee that the designated managing broker will return any unprocessed renewal form to the Division. If a designated managing broker receives a renewal application from the Division for a licensee not supervised by the designated managing broker or employed by his or her sponsoring broker, the renewal form must immediately be returned to the Division. Such a license will remain in good standing until the new licenses are issued and in the possession of the licensee.

The **license renewal period** begins **90 days prior to the expiration date** of a license.

If the license has been expired for more than two years but less than five years, it may be restored by applying to IDFPR, paying the required fee, completing the required CE courses, and filing proof of fitness to have his or her license restored.

Any licensee whose license expired under the following conditions may have the license renewed, reinstated, or restored without paying any lapsed renewal fees (if within two years), training or education with satisfactory evidence of service:

- On active duty with the Armed Forces of the United States or called into service or training by the state militia
- Engaged in training or education under the supervision of the United States preliminary to induction in the military service
- Serving as an employee of the Department or as the Coordinator or Real Estate

Any licensee whose license has been **expired** for **more than five years** is **not eligible** to renew or restore that license, but instead must meet all of the requirements for a new license.

What's in a Name?

Other common terms heard in the real estate profession are ***agent***, ***salesperson,*** and REALTOR®. Salesperson is no longer an actual license category in Illinois, but you may hear it in reference to a broker associated with a sponsoring broker, especially when discussing a particular task being performed or the role played. The term ***agent*** is generic and could refer to either a broker or a managing broker. The term REALTOR® refers specifically to a real estate licensee who is a member of the National Association of REALTORS® (NAR) and affiliated state and local boards. Only NAR members may use the term REALTOR®.

Licensee Sponsorship

A **sponsoring broker** is the broker who certifies to the Department that the named licensed broker, managing broker, or residential leasing agent is employed or associated by written agreement with the sponsoring broker. The Department **registers** this sponsorship.

Points about sponsorship:

- A sponsoring broker **registers** a licensee's sponsorship with the Department.
- A licensee can be associated with only one sponsoring broker at any one time.
- A licensee can receive compensation only from his or her sponsoring broker.
- A sponsoring broker can be a person or a legal entity, such as corporation.

Transfer of Sponsorship

225 ILCS 454/5-40

When a licensee accepts employment or association with a new sponsoring broker, **within 24 hours**, the new sponsoring broker must update the online sponsorship registration details with the Illinois Department of Professional Regulation and pay any appropriate fee to cover administrative expenses of changing the licensee's registration.

The license will immediately be assigned **inactive** status until the licensee becomes officially associated with a new sponsoring broker and the required change of registration is completed.

A sponsoring broker is *not* permitted to hold a surrendered license or refuse to update the sponsorship details online in order to collect debts owed or equipment/materials that must be returned to the sponsoring broker.

Termination of Sponsorship

225 ILCS 454/5-40(b) Rules: Section 1450.11(8)

When a licensee terminates his or her employment or association with a sponsoring broker OR the employment is terminated by the sponsoring broker, the party initiating the termination must notify the IDFPR within 24 hours. As with a transfer, the license will immediately be considered inactive until a new valid sponsorship is registered.

License Status Types

The license status for a broker's license may be classified as follows:

- **Active.** A licensee has met all the requirements and holds a valid, current license and may conduct all licensed activities.
- **Denied.** A licensee's application has been refused because of failure to meet one or more of the requirements for issuance of an initial license or renewal of an existing license.
- **Expired.** A licensee has not met the renewal requirements prior to the expiration date or when the licensee has met the license renewal requirements but has **not** renewed the license.
- **Inactive.** A licensee who holds a current license but is prohibited from engaging in licensed activities because the license is **unsponsored** or the license of the licensee's sponsoring broker is expired, revoked, suspended, or otherwise invalid is also considered to be **inactive**.
- **Probationary.** A licensee is provided with a temporary license to continue engaging in licensed activities subject to certain terms and conditions.
- **Revoked.** A licensee's license has been terminated due to violation after notice and opportunity for hearing.
- **Suspended.** A licensee's license has been temporarily cancelled due to violation after notice and opportunity for hearing.

A licensee whose license status is classified as **inactive**, or placed in any other disciplinary status such as **denied** or **suspended**, would be in direct violation of the law to engage any licensed real estate business activities while not properly licensed.



A managing broker could submit a written request to the Department to irrevocably place his or her managing broker license on inactive status in exchange for a broker's license.

Summary

1. The purpose of license law is to protect the health, safety, and welfare of the public by ensuring a consistent level of competence, ethics, and professionalism by real estate licensees. Real estate activity in Illinois is regulated by the **Illinois Department of Financial and Professional Regulation** (IDFPR) under the Civil Administrative Code of Illinois (20 ILCS 2105/2105-15).
2. The **Illinois Real Estate License Act** establishes the **Real Estate Administration and Disciplinary Board**, and provides for the appointment of a **Real Estate Coordinator**. The Act defines terms, licensing requirements, agency relationships, disciplinary provisions, law administration procedures, and transition rules.3. A n y individual, partnership, limited liability company, corporation, or registered limited liability partnership who, whether in person or though any media or technology, performs real estate activity for another and for compensation, or the expectation of compensation, is required to be licensed as a broker or managing broker.
3. Any individual, partnership, limited liability company, corporation, or registered limited liability partnership who, whether in person or through any media or technology, performs real estate activity for another and for compensation, or the expectation of compensation, is required to be licensed as a broker or managing broker.
4. **Broker** license requirements under the RELA updated 2019: 18 years old , 75 hours of prelicensing education; 45 hours of post-licensure education; 12 hours of continuing education during every two-year licensing period (ends April 30 in even-numbered years). **Managing broker** license requirements: 20 years old, two years of verifiable real estate sales experience in the past three years, 165 hours of prelicensing education, 24 hours of continuing education during every two-year licensing period (ends April 30 in odd-numbered years). **Residential leasing agent** license requirements: 18 years old, 15 hours of approved coursework, 8 hours of core continuing education during every licensing period. The CE requirement for renewal includes a mandatory one-hour sexual harassment training course for all real estate licensees.
5. Brokers may only work for a **sponsoring broker**, from whom all their compensation must come. Brokers must be prepared to show proof of sponsorship, whether a printed copy of the license or an electronic copy.
6. When accepting a transfer, a sponsoring broker must update the online sponsorship information within 24 hours. When terminating an association with a sponsoring broker, the sponsoring broker must update the online sponsorship information within two days.
7. The license status for a broker's license may be classified as active, denied, expired, inactive, probationary, revoked, or suspended. Licensees may only practice real estate if their license status is active.

Quiz

1. ***The primary purpose of licensing law is to protect the***
   a. Division of Real Estate.
   b. general public.
   c. real estate licensees.
   d. State of Illinois.

2. ***Your broker asks you to review 225 ILCS 454/10. Where can you find this?***
   a. Illinois Administrative Code
   b. Illinois Compiled Statutes
   c. Illinois Public Acts
   d. Rules of the Department of Financial and Professional Regulation

3. ***A broker may work***
   a. as a sole proprietor of a brokerage.
   b. independently if licensed for at least two of the past three years.
   c. with another broker in a limited partnership.
   d. under the name and supervision of a licensed sponsoring managing broker only.

4. ***Which agency regulates real estate activity in the State of Illinois?***
   a. Attorney General's office
   b. Department of Financial and Professional Regulation
   c. Illinois State Board of Real Estate
   d. Illinois State Legislature

5. ***What are the age and education requirements to apply for a broker license?***
   a. 18 years old and a high school diploma or equivalent
   b. 18 years old and 75 hours of approved education
   c. 21 years old and 45 hours of approved education
   d. 21 years old and 90 hours of approved education

6. ***Broker David chooses to transfer to Tim's agency. As David's new sponsoring broker, what is Tim's deadline for updating the sponsorship registration online with IDFPR?***
   a. immediately
   b. 24 hours
   c. 2 days
   d. 30 days

7. ***Jason is in the process of transferring his license to a new sponsoring broker. Until the new sponsoring broker completes the change of registration, Jason's license is considered***
   a. in transit.
   b. expired.
   c. inactive.
   d. suspended.

8. ***Broker Adrian is holding an open house. To be sure he is in compliance with the Illinois Real Estate License Act, he should***
   a. always present his business card.
   b. disclose his commission rate to all interested buyers.
   c. be prepared to show a copy of his license.
   d. make sure the home is ready to show.

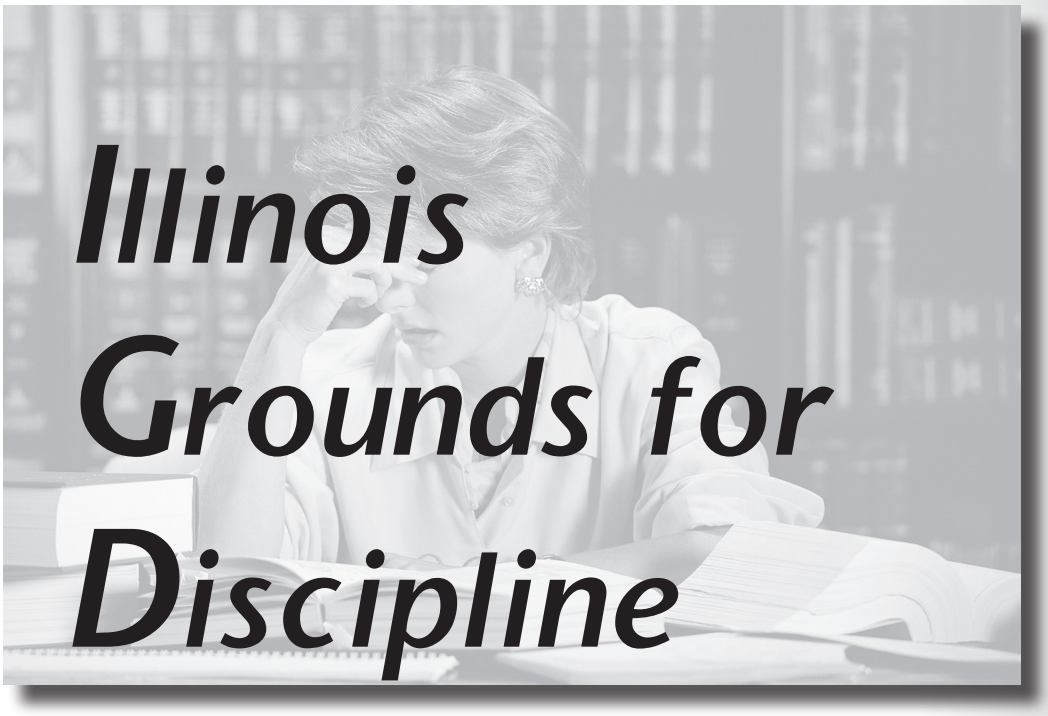
9. ***When does a broker license expire?***
   a. April 30 of each even-numbered year
   b. April 30 of each odd-numbered year
   c. December 31 of each even-numbered year
   d. December 31 of each odd-numbered year

10. ***Broker Nina, who has been caring for her sick mother, failed to renew her license. Nina's license status***
    a. has not changed.
    b. is classified as inactive and she cannot legally engage in real estate activities.
    c. is classified as inactive, but she can legally engage in real estate activities during the grace period.
    d. is classified as suspended and she cannot legally engage in real estate activities.

11. ***Who is NOT exempt from needing a real estate license?***
    a. Julie, who offers to help her neighbor find a buyer for his condo if he'll pay her association fees that month
    b. Lisa, who lives in a multi-unit apartment building and is paid one month's rent for referring two new tenants
    c. Matthew, who, as executor of his father's will, is getting paid by the estate to sell his father's house
    d. Paul, a county employee who is paid commission for finding and negotiating the lease of new office space

12. ***Who must be licensed as a broker under Illinois law?***
    a. Ethan, who has keys made for a sponsoring broker's company listing
    b. Juan, who holds open houses to market real estate to the public for a sponsoring broker
    c. Sam, who sets up for an open house at a sponsoring broker's property before it opens to the public
    d. Wallace, who places signs on properties for a sponsoring broker

13. ***Marty, an apartment manager, is unlicensed, but manages the building in which he lives. Marty may do all of the following EXCEPT***
    a. interview prospective tenants.
    b. move and continue to manage the building.
    c. sign leases on behalf of the owner.
    d. pay utility bills on behalf of the owner.



2 Illinois Grounds for Discipline

One thing you must always remember is that the purpose of license and agency laws is to **protect the consumer**. Licensing laws are intended to ensure an acceptable level of knowledge and aptitude within a specific industry, and violating that public trust is serious. In this chapter, you will look at violations of the rules and regulations found in Article 20 of the Illinois Real Estate License Act Law. You will also see how licensees are subject to the Administrative Rules of the ***Department of Financial and Professional Regulation***. We'll discuss some of the penalties that may be imposed, including license revocation or suspension, and look at the Illinois Real Estate Recovery Fund.

You will learn:

- Actions that constitute unprofessional conduct.
- Nature of and grounds for discipline against licensees.
- The impact of the Quinlan & Tyson ruling by the Illinois Supreme Court.
- The impact of license suspension and revocation.
- The procedure for conducting disciplinary hearings.
- The purpose and use of the Real Estate Recovery Fund.

Key Terms

Advisory Letter
Cease and Desist
Civil Penalty
Guaranteed Sales Plan
Peer Review Advisor
Real Estate Recovery Fund
Revocation
Suspension

Conduct and Character

Before looking at specific violations, it's helpful to discuss some of the broad expectations the State has for licensees.

Unprofessional Conduct

Rules: Section 1450.900

The Administrative Rules of the Department of Financial and Professional Regulation (IDFPR) define **unprofessional conduct as that which** constitutes dishonorable, unethical, or unprofessional conduct of a character likely to deceive, defraud, or harm the public. Such unprofessional conduct includes, but is not limited to, the following:

- Failure to act in the best interests of a client.
- Deliberately misleading a client as to the market value of the property.
- Failing to advertise the property as obligated by the listing agreement.
- Deliberately misrepresenting to prospective purchasers or their agents the condition of the property or the availability of access to show the property.
- Purchasing or transferring of the property through an intermediary in order to conceal the purchase by the licensee.
- Inducing a seller to list the property through false representations.
- Inducing a seller through false representations or false promises to transfer the property to the licensee.
- Taking unfair advantage of a client's or customer's age, disability, or lack of understanding of the English language.
- Engaging in conduct with the public or other real estate licensees in the practice of real estate in a manner that is abusive, harassing, or lewd.
- Representing oneself as a sponsoring broker or managing broker without providing the actual supervision and management of the real estate business.
- Failing to reasonably safeguard confidential information or improperly using confidential information.
- Obstructing an inspection, audit, investigation, examination, or disciplinary proceeding.
- Violations related to the handling of special accounts (escrow accounts).
- Assisting or inducing a licensee to violate the Illinois Real Estate License Act or the Administrative Rules.
- Any conduct that constitutes a breach of duty to the client, and caused, or is likely to cause, harm to the client in the future.

Nature of and Grounds for Discipline Under Article 20-20

Article 20-20 of the Illinois Real Estate License Act lists specific actions that are grounds for discipline. For the purposes of this discussion, the prohibited acts have been organized into the following categories to help you recall them more easily (the subdivision is indicated in parentheses after each point for reference):

- Misrepresentation and fraud
- Criminal conviction and personal disability
- Unlicensed and unlawful activities
- Contracts and compensation
- Escrow accounts
- Brokerage issues

The commission of a single action prohibited by the Illinois Real Estate License Act or by the Administrative Rules, or a violation of a disciplinary order issued under this Act, constitutes a violation that could result in discipline. According to 225 ILCS 454/20-115, the Illinois Department of Financial and Professional Regulation must commence action against someone for violating the terms of the Illinois Real Estate License Act or the Administrative Rules **within five years after the occurrence of the alleged violation.**

Prohibited Acts: Misrepresentation and Fraud

Grounds for discipline under the Act related to **misrepresentation** and/or **fraud** include:

- Committing fraud through action or omission during license application or renewal. (a)(1)
- Cheating on licensing or continuing education exams or assisting someone else in doing so. (a) (7) (8)
- Using misleading, inaccurate, or untruthful advertising including deceptive signage, blind advertisements, or free offers when conditions or obligations for receiving the free merchandise or services are not disclosed. (a) (9) (10) (26) (28) (35)
- Making false promises to influence, persuade, or induce. (a) (11)
- Making false promises through agents, salespeople, advertising, etc. (a) (12)
- Using trade name or insignia for an organization of which the licensee is not a member. (a) (13)
- Acting for more than one party in a transaction without providing written notice to all parties. (a) (14)
- Representing or attempting to represent or performing licensed activities for a broker other than the sponsoring broker. (a) (15)
- Engaging in dishonest dealings or dishonorable, unethical, or unprofessional conduct likely to deceive, defraud, or harm the public, including but not limited to any rules set forth by the Department. (a) (21) (25)

Prohibited Acts: Misconduct and Personal Disability

Grounds for discipline under the Act related to **criminal misconduct**, **disciplinary violations**, or **personal disability** by the licensee include**:**

- Conviction, plea of guilty, or plea of nolo contendre to a felony or misdemeanor involving dishonesty, fraud, larceny, embezzlement, or the like; committed in Illinois or any other state. (2)
- Inability to engage in licensed activities with reasonable judgment, skill, or safety as result of physical illness, including, but not limited to, deterioration through the aging process or loss of motor skill, or a mental illness or disability. (a) (3)
- Habitual or excessive use or addiction to alcohol, narcotics, stimulants, or any other chemical agent or drug that results in a managing broker, broker, salesperson, or residential leasing agent's inability to practice with reasonable skill or safety. (a) (42)
- Disciplinary action by another state, the District of Columbia, a territory, a foreign nation, a government agency, or any other entity authorized to impose discipline for a violation while acting as a managing broker, broker, or residential leasing agent in another state, which constitutes a violation of an equivalent law in Illinois. (a) (5)
- Violating the terms of a disciplinary order issued by the IDFPR. (a) (37)
- Failing to notify the Department of any criminal conviction that occurs during the licensee's term of licensure within 30 days after the conviction. (a) (45)

Prohibited Acts: Unlicensed and Unlawful Activities

Grounds for discipline under the Act related to **unlicensed** and/or **unlawful misconduct** by the licensee include**:**

- Active engagement in licensed activities related to real estate transactions without holding a valid license or after a license is inactive, revoked or suspended. (a) (6)
- Blockbusting or panic selling, which refers to influencing by any words or acts a prospective seller, purchaser, occupant, landlord, or tenant of real estate, in connection with viewing, buying, or leasing real estate, so as to promote the continuance of racially and/or religiously segregated housing or to retard, obstruct, or discourage racially integrated housing on or in any certain street, block, neighborhood, or community. (a) (30)
- Engaging in any act that constitutes a violation of any provision of Article 3 of the Illinois Humans Rights Act, whether or not a complaint has been made and adjudicated by the Illinois Human Rights Commission. (a) (31)

- Acting as the attorney for either the buyer or the seller in the same transaction in which the licensee has acted as a broker. (a) (34)
- Violating any provision of the Land Sales Registration Act, the Illinois Time-Share Act, or the rules in place to enforce these Acts. (a) (36)
- Disregarding or violating any provision of the Illinois Real Estate License Act or aiding and abetting another to do so. (a) (40)

Prohibited Acts: Contracts and Compensation

Grounds for discipline under the Act related to misconduct related to **contracts** and/or **compensation** include:

- Inducing any party to a contract of sale or lease or brokerage agreement to break the contract of sale or lease or brokerage agreement for the purpose of substituting, in lieu thereof, a new contract for sale or lease or brokerage agreement with a third party. (a) (32)
- Negotiating a sale, exchange, or lease of real estate directly with any person if the licensee knows that the person has a written exclusive brokerage agreement with another broker, unless specifically authorized by that broker. (a) (33)
- Paying compensation that violates Article 10 of the Illinois Real Estate License Act. (a) (38)

Prohibited Acts: Escrow Accounts

Grounds for discipline under the Act related to **mishandling of escrow accounts** include:

- Failing to account for or to remit any monies or documents belonging to others that come into the licensee's possession. (a) (16)
- Failing to properly maintain and deposit escrow monies in a separate account and/or disburse properly. (a) (17)
- Failing to make all escrow records maintained in connection with the practice of real estate available during normal business hours and within 24 hours of submitted request. (a) (18)
- Commingling the money or property of others with one's own. (a) (22)
- Requiring a party to a transaction who is not a client of the licensee to allow the licensee to retain a portion of the escrow monies for payment of commission or expenses as a condition for release of the escrow money to that party. (a) (39)

Prohibited Acts: Brokerage Issues

Grounds for discipline under the Act related to **issues of brokerage misconduct** include**:**

- Acting or attempting to act as a broker or salesperson in a retail sales establishment from an office, desk, or space that is not separated from the main retail business and located within a separate and distinct area within the establishment. (a) (4)
- Failing to provide appropriate information, documents, or copies related to a real estate transaction in a timely manner. (a) (19)
- Failing to timely provide sponsorship or termination of sponsorship information to the IDFPR. (a) (20)
- Employing any person on a purely temporary or single-deal basis as a means of evading the law regarding illegal payment of fees to non-licensees. (a) (23)
- Permitting the use of one's broker license by a residential leasing agent or any unlicensed person in order to operate a real estate office. (24)
- Failing to provide information requested within 30 days of a request from the IDFPR, as related to audits or complaints made against the licensee based on the Act. (a) (27)
- Failing to provide minimum services required when acting under an exclusive brokerage agreement. (a) (41)

- Enabling, aiding, or abetting an auctioneer to conduct real estate auction in a manner that violates the Real Estate License Act. (a) (43)
- Permitting any residential leasing agent or temporary residential leasing agent permit holder to engage in activities that require a broker's or managing broker's license. (a) (44)
- A designated managing broker's failing to provide an appropriate written company policy or failure to perform any of the required duties. (a) (46)

Other Violations

The following are among other specific violations and offenses that could result in discipline under the Illinois Real Estate License Act and the Rules of the Department of Financial and Professional Regulation.

Guaranteed Sales Plans

225 ILCS 454/10-50

A **guaranteed sales plan** is any real estate purchase or sales plan in which a licensee:

- Enters into one or more conditional or unconditional written contracts with a seller, one of which is a brokerage agreement.
- Agrees to purchase the seller's property within a specified period of time at a specific price.
- Purchases the property in the event it is not sold in accordance with the terms of the brokerage agreement entered into between the sponsoring broker and the seller.

A licensee offering a guaranteed sales plan:

- Must provide the details and conditions of the plan in writing, including the purchase price conditions **prior to entering into the brokerage agreement**.
- Must provide evidence of sufficient financial resources to satisfy the purchase commitment.
- Must market the property in the same manner he or she would market any other property, unless the agreement provides otherwise.
- Cannot purchase the property until the brokerage agreement has expired according to its terms or is otherwise ended.

Any licensee who fails to perform on a guaranteed sales plan will be subject to:

- All penalties provided in the Illinois Real Estate License Act.
- Civil fine payable to the party injured by the default in an amount up to $25,000.

Financial Irresponsibility

225 ILCS 454/20-20 (b) (c) (d)

Article 20-20 of the Illinois Real Estate License Act indicates various offenses related to a licensee's personal financial responsibility that could have a negative impact on an application for a new license or renewal.

Payment of Taxes. The Department may refuse to issue or renew or may suspend the license of any person who fails to file a return; pay the tax, penalty, or interest shown in a filed return; or pay any final assessment of tax, penalty, or interest as required by any tax Act administered by the Department of Revenue.

Default on Educational Loans. The Department will deny a license or renewal authorized by the Illinois Real Estate License Act to a person who has defaulted on an educational loan or scholarship provided or guaranteed by the Illinois Student Assistance Commission or any governmental agency of Illinois.

Child Support Delinquency. In cases where the Department of Healthcare and Family Services has previously determined that a licensee or a potential licensee is **more than 30 days delinquent** in the payment of child support and has subsequently certified the delinquency, the Department may:

- Refuse to issue or renew the license.
- Revoke or suspend that person's license.
- Take other disciplinary action against that person based solely upon the certification of delinquency made by the Department of Healthcare and Family Services.

Returned Checks and Fees

225 ILCS 454/20-25

Any person who delivers a check or other payment to the Department that is returned to the Department unpaid by the financial institution upon which it is drawn—or presents a declined, dishonored, or expired credit or debit card charge—must pay to the Department, in addition to the amount already owed to the Department, a fee of **$50.** The Department will notify the person that payment of fees and fines must be paid to the Department by certified check or money order **within 30 calendar days** of the notification.

If, after the expiration of 30 days from the date of the notification, the person has failed to submit the necessary remittance, the Department will, without hearing, automatically:

- Revoke the license, or
- Deny the application.

If, after revocation or denial, the person seeks a license, he or she must apply to the Department for **restoration** or **issuance** of the license and **pay all fees and fines** due to the Department. The Department may establish a fee for the processing of an application for restoration of a license to cover expenses. The Secretary may waive the fees due in individual cases where the Secretary finds that the fees would be unreasonable or unnecessarily burdensome.

Failure to Disclose Interest

225 ILCS 454/10-27 *Rules: Section 1450.765*

An **arm's-length transaction** is one in which *the transaction occurred between relative strangers where both of the parties were acting in their own best interests.* When an agent has a **personal interest** in the property being sold, it is no longer an arm's-length transaction, and therefore, he must disclose that fact. Illinois law requires every licensee to disclose, in writing, his or her **status as a licensee** to **all parties in a transaction** when the licensee is selling, leasing, or purchasing any interest, direct or indirect, in the real estate that is the subject of the transaction. In other words, the licensee:

- Is selling, leasing or seeking to purchase property as sole owner.
- Is selling or seeking to purchase property as a joint tenant or tenant by the entirety.
- Holds a beneficial interest in a land trust selling, leasing or seeking to purchase an interest in the subject property.
- Is a general partner in a partnership selling, leasing or seeking to purchase an interest in the subject property.
- Is an officer, director, majority, or controlling shareholder of a corporation selling, leasing or seeking to purchase an interest in the subject property.
- Is a manager or majority or controlling member of a limited liability company selling, leasing, or seeking to purchase an interest in the subject property.

Unlicensed Practice

225 ILCS 454/20-10, 20-22

The Illinois Department of Financial and Professional Regulation (IDFPR) has the authority and power to investigate any and all unlicensed activity. Any person who practices, offers to practice, attempts to practice, or holds oneself out to practice as a **real estate broker, managing broker**, or **residential leasing agent** without being licensed under the Illinois Real Estate License Act:

- Has committed a Class A misdemeanor (first offense).
- Has committed a Class 4 felony (for additional or subsequent offense).
- Is subject to an injunction order issued by the Department to stop further unlicensed activity.
- Is subject to a civil penalty fine of up to $25,000, which may be assessed by the Division after disciplinary hearing is held. The civil penalty will be assessed by the Department after a hearing is held in accordance with the provisions regarding the provision of a hearing for the discipline of a license and must be paid **within 60 days** after the effective date of the order imposing the civil penalty. Such an order by the Department constitutes a judgment and may be filed and executed in the same manner from any court of record.

The Department also has the authority to prosecute individuals who **aid and abet** others in the unlicensed practice of real estate.

Unauthorized Practice of Law

On a similar note, every real estate licensee must take great care to ensure that his or her activities do not stray beyond the scope of those permitted under the Illinois Real Estate License Act by providing unauthorized advice or assistance for activities that require a law or securities license.

Quinlan and Tyson

A landmark case for Illinois real estate licensees began when the **Chicago Bar Association** filed a complaint in the Circuit Court of Cook County to stop a real estate brokerage firm, **Quinlan and Tyson, Inc.**, from engaging in what the Bar Association considered to be the **unauthorized practice of law**. Like many real estate brokerages of the day, Quinlan and Tyson's agents were preparing such contracts and documents as offers to purchase real estate, deeds, and other property conveyance documents necessary to clear title. Generally, these were standardized "fill-in-the-blank" forms that had been created by attorneys. They did not charge a fee for these services and were compensated only on the basis of the negotiated brokerage commission.

The real estate brokerage argued that such services do not amount to the practice of law because their performance by real estate professionals was an established custom, incidental to the broker's role, and that no harm was shown to have resulted. They further argued that the filling in of these forms was a simple matter, for which ordinary business intelligence was sufficient. The Bar Association, on the other hand, contended that such services amounted to the practice of law.

The case eventually found its way to the **Illinois Supreme Court**, who ruled in the case of ***Chicago Bar Association, et al. v. Quinlan and Tyson*** in 1966 that real estate licensees could use acceptable pre-printed forms, but for **purchase agreements only**. Licensees are *not* permitted to prepare or complete any other legal documents relating to the sale (e.g., deeds, bills of sale, mortgages, promissory notes, and other legal instruments). These, according to the Supreme Court, require the particular skills of a licensed attorney.

Generally, an acceptable form is one that has been written and approved by local bar associations in conjunction with REALTOR® associations.

Advisory Letters

As indicated in Section 1450.955 of the Administrative Rules, licensees may request clarification or advice from the Division of Real Estate related to the Rules or Illinois Real Estate License Act. The Division may then issue an **advisory letter** in response, dealing with the interpretation and application of the Act or Rules.

The Division will provide some response to the licensee requesting the advisory letter **within 60 days** after receipt of the request:

- An advisory letter.
- An estimated time for providing an advisory letter.
- A request for clarification or additional information.
- A statement that the Division declines to issue an advisory letter as requested and why.

A licensee who seeks an advisory letter is entitled to rely upon an advisory letter from the Division and will not be disciplined for taking such actions. However, the Division may change its position prospectively, at which time the licensee who sought the advisory letter will have to meet the new position or policy of the Division.

Although not binding on the Division, other licensees may refer to an advisory letter issued by the Division as the reason for their acts or omissions in the event of disciplinary action. While the Division will consider these arguments, it will not be bound by the advisory letter to anyone other than the licensee who sought it originally.

Investigations and Hearings

An investigation of a possible violation of the Illinois Real Estate License Act or Administrative Rules may be initiated by the Real Estate Administration and Disciplinary Board:

- On its own initiative.
- On the motion of the Illinois Department of Financial and Professional Regulation.
- Upon the filing of a complaint by **any person**.

After determining the merit of the complaint, the Board will schedule a **hearing prior to imposing any disciplinary action**. All disciplinary hearings brought before the Real Estate Administration and Disciplinary Board must be conducted in accordance with the Rules of Practice in Administrative Hearings in 68 Ill. Adm. Code 1110.

Peer Review Advisors

In accordance with Section 25-21 of the Illinois Real Estate License Act, the Department may, at its discretion, contract with a qualified licensee to act as a paid **peer review advisor** to the Department regarding public complaints and alleged violations. The peer review advisor may only be referred matters that involve the actions of an unlicensed person or a licensee at the same or lower level of licensure and may not investigate a complaint from a marketplace in which he or she does business.

A peer review advisor is authorized to:

- Investigate the facts of a complaint, which may involve interviewing witnesses, the complainant, and any licensees involved in the alleged matter.
- Make a recommendation as to the findings of fact to the Department.

The Department is not bound by the recommendations of a peer review advisor and has **30 days** from receipt of the recommendation to accept, reject, or modify the recommended findings of fact.

Notice of Hearing

At least **30 days before the hearing date**, the Board must notify the accused and his or her designated managing broker in writing of the charges made and the time and place set for the hearing on the charges. It must direct the accused to file a written **answer to the charges** with the Board, under oath, **within 20 days** of the notice being served. The notification will also indicate whether the licensee's license has been temporarily suspended.

Failure to Respond

In case the person, after receiving the notice, fails to file an answer, his or her license may, at the discretion of the Department, be:

- Suspended,
- Revoked,
- Placed on probationary status.

The Department could also choose to take whatever disciplinary action considered proper, without a hearing, if the act or acts charged constitute sufficient grounds for that action, including:

- Limiting the scope, nature, or extent of the person's practice.
- The imposition of a fine.

At the Hearing

225 ILCS 454/20-60, 62, 63, 64, 66

At the time and place fixed in the notice, the Board will proceed to hear the charges. Any Board member may attend the hearing. The Board may continue the hearing from time to time.

The Secretary of the IDFPR has the authority to appoint any attorney licensed to practice law in the State of Illinois to serve as the **hearing officer** in any action for refusal to issue, restore, or renew a license; or to discipline a licensee. The hearing officer has full authority to conduct the hearing.

The Department has the power to subpoena documents, books, records, or other materials and to bring before it any person and to take testimony either orally or by deposition, or both. All parties or their counsel will be given ample opportunity to present any pertinent statements, testimony, evidence, and arguments.

The hearing officer will report his or her findings of fact, conclusions of law, and recommendations to the Board. The Board will then review the report of the hearing officer and present its findings of fact, conclusions of law, and recommendations to the Secretary and all parties to the proceeding. If the Secretary disagrees with a recommendation of the Board or of the hearing officer, then the Secretary may issue an order in contravention of the recommendation.

The Department will preserve a record of all proceedings at the formal hearing of any case. The notice of hearing, complaint, all other documents in the nature of pleadings, written motions filed in the proceedings, the transcripts of testimony, the report of the Board, and orders of the Department must be contained in the record of the proceeding.

At the conclusion of a hearing and following deliberation by the Board, the Department will serve a copy of the Board's report upon the applicant, licensee, or unlicensed person.

Rehearings

225 ILCS 454/20-64, 72

Within 20 days after service of the Board's report, the applicant or licensee may present, in writing, a **motion for a rehearing** to the Department. The motion must specify the particular grounds for rehearing. The Department may:

- Respond to the motion and order a rehearing.
- Deny the motion, in which case the Secretary may enter an order in accordance with the recommendations of the Board.

If the Secretary believes that substantial justice has not been done in any discipline of an applicant or licensee, however, then he or she may order a rehearing by the same or other examiners.

Judicial Review

225 ILCS 454/20-75

All final administrative decisions of the Department are subject to **judicial review** under the Administrative Review Law and its rules, found in the Illinois Code of Civil Procedure (735 ILCS 5/3-101).

Proceedings for judicial review are commenced in the Circuit Court of the county in which the party applying for review resides. A final decision, order, or judgment of the Circuit Court, entered in an action to review a decision of an Administrative Agency, is reviewable by an Appellate Court as in other civil cases.

Penalties

225 ILCS 454/20-20

A violation of the provisions of the Illinois Real Estate License Act or the Administrative Rules could result in the following actions by the Illinois Department of Financial and Professional Regulation:

- Denial of a new license application.
- Failure to renew an existing license.
- Probation, suspension, or revocation of a license.
- Any disciplinary or non-disciplinary action the Department may deem proper.
- A civil fine **not to exceed $25,000** (to be deposited into the Real Estate Recovery Fund).

Suspension and Revocation

225 ILCS 454/20-68, 69

Suspension means that a license is *withdrawn for a specified period of time and may call for the performance of a condition prior to restoration*. In the case of intentional violations or a repeated pattern or practice of violations, the licensee stands a strong possibility of **revocation** of license to practice real estate.

Upon the revocation or suspension of a license, the licensee must **immediately surrender** his or her license to the Department. If the licensee fails to do so, the Department has the right to seize the license. At any time after the successful completion of a term of suspension or revocation of a license, the Department may restore it to the licensee, upon the written recommendation of the **Real Estate Administration and Disciplinary Board**, unless after an investigation and a hearing the Board determines that restoration is not in the public interest.

Injunctions and Cease and Desist Orders

225 ILCS 454/20-21

If any person violates the provisions of the Illinois Real Estate License Act, the Secretary of the Department of Financial and Professional Regulation may, in the name of the people of the State of Illinois, through the Attorney General of the State of Illinois or the State's Attorney for any county in which the action is brought, petition for an order **enjoining the violation** or for an order **enforcing compliance** with the Act. Upon the filing of a verified petition in court, the court may issue a **temporary restraining order**, without notice or condition, and may preliminarily and permanently enjoin the violation. If it is established that the person has violated or is violating the injunction, the Court may punish the offender for **contempt of court**. Such proceedings would be **in addition to**, and not in lieu of, all other remedies and penalties provided by the Illinois Real Estate License Act.

Whenever, in the opinion of the Department, a person violates a provision of the Act, the Department may issue a ruling to that person to show cause why an order to cease and desist should not be entered against him or her. The rule shall clearly set forth the grounds relied upon by the Department and shall allow **at least seven days** from the date of the rule to file an answer to the satisfaction of the Department. Failure to answer to the satisfaction of the Department shall cause an order to cease and desist to be issued immediately.

Temporary Suspension

225 ILCS 454/20-65 *Rules: Section 1450.905*

The Secretary may **temporarily suspend** the license of a licensee **without a hearing**, though simultaneously with the institution of proceedings for a hearing, if the Secretary determines the **safety** or **welfare** of the public or another licensee imperatively requires **emergency action**.

A typical circumstance requiring emergency action would be if a licensee's conduct poses a threat that the public's or another licensee's money will be stolen or embezzled. For example, the licensee:

- Fails to account for or to remit any moneys or documents that belong to others.
- Fails to maintain and deposit in a special or escrow account, separate and apart from personal and other business accounts, all escrow moneys belonging to others entrusted to a licensee.
- Fails to make available to real estate enforcement personnel of the Division all escrow records and related documents as requested (this action in and of itself would not be sufficient grounds for a temporary suspension).
- Commingles money or property of others with the licensee's own.

Licensees must be given a **notice of temporary suspension** that:

- Recites the statutory basis for the action.
- Demands immediate surrender of the license.
- Sets a hearing date **within 30 days** after the date on which the order takes effect.
- Identifies the location where the hearing will take place.
- Provides information as to where the licensee may obtain the Division's rules for Practice in Administrative Hearings.

Non-Disciplinary Action

Rules: Section 1450.910

As indicated, the Division has the authority to impose other **non-disciplinary action** it deems reasonable. Non-disciplinary action may include, but is not limited to, the following:

- Restricting a licensee's access to escrow funds.
- Requiring the successful completion of any approved real estate course, including courses for those licensees who would otherwise not be required to complete continuing education.
- Requiring the licensee to provide any report, record, or document regarding real estate activity the Division deems relevant and appropriate.
- Imposition of an administrative fee.
- Requiring a mental or physical exam.

Mental and Physical Examinations

In enforcing Article 20-20 of the Illinois Real Estate License Act, the Department or Board, upon a showing of a possible violation, may compel a licensee or applicant to submit to a mental or physical examination, or both, at the Department's expense. Failure of an individual to submit to a **mental** or **physical examination**, when directed, may be grounds for **suspension** of his or her license.

If the Department or Board finds an individual unable to practice because of mental or physical disabilities set forth in Article 20-20, they may require that individual to submit to care, counseling, or treatment as a condition, term, or restriction for continued, reinstated, or renewed licensure to practice. If the individual refuses or fails to comply with ordered care, counseling, or treatment, the Department may file—with or without the Board's recommendation—a complaint to immediately **suspend**, **revoke**, or **otherwise discipline** that individual's license.

In instances in which the Secretary immediately suspends a person's license, the Department must convene a hearing **within 30 days** after the suspension, completing it without appreciable delay. The Department and Board have the authority to review the subject individual's record of treatment and counseling regarding the impairment to the extent permitted by applicable federal statutes and regulations safeguarding the confidentiality of medical records. A licensee will have the opportunity to demonstrate that he or she can resume practice in compliance with acceptable and prevailing standards under the provisions of his or her license.

Effect of Suspension or Revocation

As you can imagine, there could be a serious trickle-down effect when a broker has his or her license suspended. The suspension of a license to practice real estate for even a brief period of time could cost a broker multiple commissions that would otherwise be due. During a suspension period, buyers and sellers will not postpone or delay a potential real estate transaction in order to use a particular broker.

For all intents and purposes, when the license of a sponsoring broker is suspended, the whole company could shut down until the suspension is lifted. Since a broker is affiliated with a sponsoring broker and can only work under the supervision of a managing broker, it's important to understand what happens if the license of a sponsoring broker or managing broker is suspended or revoked.

Sponsoring Broker

Upon the effective date of a temporary or other suspension or revocation of the license of a sponsoring broker corporation, limited liability company, partnership, or sole proprietorship and their respective principal or sponsoring broker, unless an interim sponsoring broker or receiver is appointed by the real estate brokerage company or its representative, and subject to approval by the Division, the following are impacted:

Sponsored Licensees

The licenses of all respective sponsored licensees are automatically **inactive**. Each licensee may resume the practice of real estate only upon being **registered with the Department** by another active sponsoring broker.

Brokerage Agreements

All brokerage agreements with the sponsoring broker, including listing agreements, are deemed **expired** unless a new sponsoring broker is named **within seven business days**. Unless a new sponsoring broker is named within that timeframe, the suspended or revoked sponsoring broker must notify, in writing, all clients with whom the sponsoring broker has an active brokerage agreement, and advise that the brokerage agreement expired as of the date seven business days after the suspension or revocation. The notice must also inform clients that they are **legally authorized to enter into another brokerage agreement** with any active broker.

Pending Executed Real Estate Contracts

The suspension or revocation of a sponsoring broker will **not** have an effect on the enforceability of any pending, executed real estate contracts. The suspended or revoked sponsoring broker must send a **written notice** to all clients with a pending, executed real estate contract explaining the suspensions or revocations, and that the suspensions or revocations have no effect on the enforceability of the pending, executed real estate contracts. The notice must also identify the name, address, and telephone number of the person in control of the escrow money. To the extent that the clients require additional real estate services, the notice must provide that the clients may seek those services from another active broker.

Commissions

A suspension or revocation does **not** preclude the receipt of any commission or other compensation **earned** by the suspended or revoked sponsoring broker or other formerly sponsored licensee **prior to the effective date of a suspension or revocation of the sponsoring broker**.

A broker will **not be entitled** to compensation, however, if the suspension or revocation directly relates to the transaction **for which the compensation was earned**. If the broker has already received compensation related to the transaction leading to the suspension or revocation of the license, the Department or Board may consider that fact in issuing the discipline and/or fine.

Retirement or Dissolution

In the event of the voluntary **retirement** or the voluntary **dissolution** of a sponsoring broker, the sponsoring broker must, at a reasonable time prior to the voluntary retirement or voluntary dissolution, provide written notice to all:

- Sponsored licensees to allow the sponsored licensees to secure new sponsoring brokers.
- Active clients to allow the clients to secure brokerage agreements with new brokers.

Designated Managing Broker

Rules: Section 1450.915

In the event of a suspension or revocation of a **designated managing broker**, the office locations managed by that designated managing broker **may resume the practice of real estate upon securing a replacement** designated managing broker. If a replacement designated managing broker is unable to be secured immediately after a suspension or revocation of the designated managing broker, the entity may continue to practice real estate for the **first 15 days** after the suspension or revocation. If, after 15 days, a replacement designated managing broker has not been secured, the office may only continue to practice real estate upon securing the written authorization of the Division as provided for in Section 5-45(e) of the Act.

Associated Licensees

Rules: Section 1450.705

Any violation of the provisions of the Illinois Real Estate License Act or the Rules on the part of any licensees employed by a sponsoring broker or associated by written agreement with the sponsoring broker, or unlicensed employee of a sponsoring broker, would *not* be cause for suspension or revocation of the license of the sponsoring broker or a designated managing broker **unless the sponsoring broker or designated managing broker had knowledge of the violation**. However, failure to provide an appropriate company policy or failure to properly supervise would be cause for discipline, including suspension or revocation, of the license of the sponsoring broker or a designated managing broker.

Real Estate Recovery Fund

225 ILCS 454/25-35

The Illinois **Real Estate Recovery Fund** provides a means of compensating individuals for damages resulting from an act, representation, transaction, or conduct of a licensee or unlicensed employee that is in violation of the Illinois Real Estate License Act or Administrative Rules. Such actions, which must have occurred in the course of conducting business, include, but are not limited to, the following:

- Embezzlement of money or property.
- Actions that result in money or property being unlawfully obtained from any person by false pretenses, artifice, trickery, or forgery.
- Actions that result in a loss of actual cash money, as opposed to losses in market value, by reason of any fraud, misrepresentation, discrimination, or deceit.

The provisions related to the Real Estate Recovery Fund do **not apply to violations of the Illinois Real Estate Time-Share Act or the Land Sales Registration Act.**

The Recovery Fund is created in the **State Treasury** and funded primarily by the fines and penalties received by the Department as a result of disciplinary action. If, at any time, the balance remaining in the Real Estate Recovery Fund is less than $750,000, the State Treasurer will transfer moneys to it from the Real Estate License Administration Fund in an amount necessary to establish a balance of $800,000.

Collecting from the Recovery Fund

Before claimants can collect damages from the Recovery Fund, they must first obtain a valid judgment from a court of competent jurisdiction in an action in which the court has found the aggrieved person to be injured or otherwise damaged by any licensee or unlicensed employee of a licensee as a result of fraud, misrepresentation, deceit, or intentional violation of the Real Estate License Act. Such action to seek recovery funds must be started **no later than two years** from the date on which the aggrieved person knew, or should have known, of the intentional act of misconduct or omission.

When someone commences such a civil action for a judgment that may result in collection from the Real Estate Recovery Fund, that person must:

- Name as parties defendant to that action any and all individual licensees or their employees who allegedly committed or are responsible for acts or omissions giving rise to a right of recovery.
- Notify the Illinois Department of Financial and Professional Regulation in writing **within seven days** naming all alleged licensees of their employees responsible for the wrongful acts.

Failure to name defendants or notify the Department could preclude any collection from the Recovery Fund.

Once a judgment is obtained, in order to then recover from the Recovery Fund, the aggrieved person must submit in a **verified claim** and at an evidentiary hearing to be held by the court that he or she:

- Is not a spouse of the licensee or unlicensed employee named in the judgment, or the personal representative of such spouse.
- Has complied with all the legal requirements.
- Has obtained a judgment stating the amount of the judgment and the amount he or she is owed, not including interest, at the date of the application.

The aggrieved person is also required to prove the amount of attorney's fees sought to be recovered and the reasonableness of those fees up to the maximum allowed, such as with an affidavit.

The Department may enter an appearance, file an answer, appear at the court hearing, defend the action, or take whatever other action it deems appropriate on behalf and in the name of the defendant.

Judgment for Claimant

When a claimant recovers a valid judgment that qualifies for recovery under the Recovery Fund, the Department must receive written notice of the judgment within 30 days. The IDFPR is also entitled to a 20-day written notice of any supplementary proceedings to participate in efforts to collect on the judgment.

A claimant may be able to recover:

- An amount not more than the amount adopted by rule.
- Costs of the suit.
- Validated attorney's fees.

Licensee Liability

225 ILCS 454/20-85 through 20-110 ***Rules: Section 1450.945***

When a judgment amount is paid from the Recovery Fund on behalf of a licensee, the license is automatically **terminated**, until such time as the money is repaid to the Fund, plus interest. A licensee who desires to contest an automatic termination for payment out of the Real Estate Recovery Fund must file the appropriate motion or appeal with the Court that ordered the judgment.

The repayment in full of all obligations to the Real Estate Recovery Fund by any licensee does **not nullify or modify the effect of any other disciplinary proceeding resulting from violations of the Illinois Real Estate License Act or Administrative Rules.**

Bankruptcy of the licensee does **not** discharge liability to the Fund.

The maximum liability against the Recovery Fund arising out of multiple acts by any one licensee or one unlicensed employee of a licensee in any one transaction or set of facts that formed the basis for a post-judgment order is adopted by rule.

Records of Disciplinary Action

Violations of the Illinois Real Estate License Act are taken very seriously and strictly enforced. The Illinois Department of Financial and Professional Regulation publishes a monthly public **Discipline Report** detailing disciplinary action they have taken. The report includes:

- Names of the disciplined licensees and unlicensed employees.
- City where they were practicing at the time of action.
- Discipline imposed.

The Department also maintains an **index of formal decisions** taken under the Illinois Real Estate License Act (on or after December 31, 1999) regarding the following:

- The issuance and renewal of licenses.
- The refusal to issue or renew licenses.
- The revocation and suspension of licenses.
- Probationary or other disciplinary action taken.

The index is available to the public during regular business hours.

Discipline Report

The following are examples of violations and the penalty summarized from a recent IDFPR Discipline Report:

- Licensee reprimanded for sending a profane and harassing e-mail to another licensee.
- License revoked and fined $10,000 for having a total of 18 criminal convictions that were not disclosed on three separate license applications.
- License placed in refuse to renew status for failure to negotiate a real estate contract on behalf of a client.
- License indefinitely suspended for a minimum of two years and fined $10,000 for failure to return a security deposit to a lessee.
- License revoked for being more than 30 days delinquent in the payment of child support.
- License placed in refuse to renew status for failure to maintain records and for failure to respond to requests for information from the Department.
- License revoked and licensee barred from being an owner of any licensed real estate entity in the state of Illinois due to the wrongful withholding of escrow funds and failure to comply with the Department's request for documentation.
- License indefinitely suspended for failure to release the license of an employee who resigned and requested the release of said license; failure to cooperate with the Department investigator and for placing signage on private property without the permission of the property owner.
- Licensee fined $800 and ordered to complete 12 hours of outstanding continuing education that were not completed during the renewal period.
- License placed in refuse to renew status for failure to complete required continuing education for renewal and for misrepresenting the completion of the continued education credits.
- License placed in refuse to renew status after licensee broke an exclusive listing agreement, acted as a dual agent in a transaction in which the licensee owned the property for sale, and advertised real estate services on an inoperative license.

Summary

1. Real estate licensees must be of **good moral character** in order to receive and renew a license. **Unprofessional conduct** may include such actions as failing to act in the best interests of a client; deliberate misrepresentations and false representations; taking advantage of clients and customers; acting in a manner that is abusive, harassing, or lewd; mishandling accounts; obstructing investigations; or any conduct that could cause harm. **Negligence** is an unintentional breach of a legal duty.
2. The **Illinois Department of Financial and Professional Regulation** has the authority to investigate all unlicensed activity that takes place in the State of Illinois. Anyone who practices or attempts to practice without a license may be subject to a civil fine of **up to $25,000** in addition to an injunction to cease.
3. **Article 20-20** of the Illinois Real Estate License Act documents grounds for disciplinary action related to misrepresentation and fraud, criminal conviction and personal disability, unlicensed and unlawful activities, contracts and compensation, escrow accounts, brokerage issues, financial irresponsibility, issues related to guaranteed sales plans. Disciplinary action against a licensee for violations of the Act or the Administrative Rules must be brought by the Illinois Department of Financial and Professional Regulation **within five years** of the alleged violation.
4. Illinois law requires every licensee to disclose, in writing, his or her **status as a licensee** to **all parties in a transaction** when the licensee is selling, leasing, or purchasing any interest, direct or indirect, in the real estate that is the subject of the transaction.
5. A **guaranteed sales plan** is a real estate purchase or sales plan where the licensee enters in a contract to purchase the property within a specific time and for a specific price in the event it is not sold in accordance with the terms of the subsequent brokerage agreement. All details must be in writing and the licensee must be able to show the financial resources to satisfy the purchase agreement. The property cannot be purchased until after the brokerage agreement expires or is otherwise terminated.
6. As a result of the 1966 decision by the Illinois Supreme Court in the case of **Chicago Bar Association, et al. v. Quinlan and Tyson** real estate licensees are allowed to use acceptable pre-printed "fill-in-the-blank" purchase agreements.
7. Licensees may request clarification on points of law or administrative rule from the IDFPR in the form of **advisory letters**. The requesting licensee may rely on the advisory letter as a defense against disciplinary action, unless the Division changes its position on the issue at a later date. Other licensees may refer to advisory letters in defense of disciplinary action, but advisory letters are binding between the Department and the requesting licensee only.
8. The **Real Estate Administration and Disciplinary Board** may begin an investigation on its own initiative, on the motion of the Illinois Department of Financial and Professional Regulation, or upon the filing of a complaint by any person. A **peer review advisor** is a qualified licensee contracted by the Department to investigate the facts of a complaint against another licensee and make a recommendation to the Department. After determining the merit of the compliant, the Board will schedule a hearing prior to imposing any disciplinary action. The Board must notify the accused in writing at least **30 days before the hearing date** of the charges made and the time and place set for the hearing on the charges. The accused then has **20 days** to file a written response to the charges. Failure to respond may result in license suspension, revocation, or placement on probationary status.
9. The IDFPR Secretary may appoint a **hearing officer**. The Department has the power of subpoena and the power to compel testimony. All parties or their counsel will be given ample opportunity to present any pertinent statements, testimony, evidence, and arguments at the hearing. The hearing officer will report findings and recommendations to the Board, who will review the file and present its findings and recommendations to the Secretary and all parties. The Secretary may overturn the Board's findings. A licensee has **20 days to file a motion for a rehearing**. All final administrative decisions are subject to judicial review first through the Circuit Court, then through an Appellate Court.

10. Penalties for violating the Illinois Real Estate License Act and Administrative Rules include: Denial of license application or renewal; probation, suspension, or revocation or a license; civil fines up to **$25,000**; other disciplinary or non-disciplinary action the Department may deem proper, for example, restricting access to escrow funds, requiring education, requiring a mental or physical examination. The Secretary may petition for a court order **enforcing compliance** or **enjoining the violation** (cease and desist) either temporarily or permanently. Licensees have at least seven days to respond. The Secretary **may temporarily suspend** a license as an emergency action without benefit of a hearing when the safety or welfare of the public or another licensee is at stake, for example if there's a threat that money belonging to the public or another licensee may be stolen or embezzled.

11. Upon **revocation** or **suspension**, the license must be **surrendered immediately**. If it is the license of a **sponsoring broker**, the licensees of all sponsored licensees are automatically **inoperative** and sponsored licensees must secure a properly completed 45-day sponsor card from another qualified sponsoring broker in order to resume practice. If a new sponsoring broker is not named, all current brokerage agreements expire within **seven business days**. Pending sales contracts are **not** affected, nor are commissions earned prior to the date or suspension or revocation (unless the disciplinary action arose out of that transaction). If it is the license of a **managing broker**, the sponsoring broker has **15 days** to replace the managing broker without consequence.

12. The **Real Estate Recovery Fund** compensates people for damages resulting from the business conduct of a licensee or an unlicensed employee in violation of the Illinois Real Estate License Act or Administrative Rules. Claimants must file a civil suit in the county's Circuit Court within **two years**, naming the defendants, and notifying IDFPR in writing within **seven days**; failure to do either precludes collection from the Fund. A claimant with a valid judgment from the court may be able to recover the damages award, plus court costs and reasonable attorney's fees. When payment is made from the Fund, the licensee's license is **terminated** until the money is repaid, plus interest; repayment does not nullify any disciplinary action resulting from the violations.

Quiz

1. ***The Department must commence action against a licensee for violating the Real Estate License Act within _____ of the alleged violation.***
   a. 180 days
   b. 1 year
   c. 2 years
   d. 5 years

2. ***The civil fines and penalties that licensees pay for violating the Illinois Real Estate Act or the Administrative Rules are deposited into the***
   a. general fund of the Illinois Department of Financial and Professional Regulation.
   b. general fund of the Real Estate Administration and Disciplinary Board.
   c. Real Estate Recovery Fund.
   d. sponsoring broker's escrow account.

3. ***A consumer files a written complaint with the Real Estate Administration and Disciplinary Board against Parker, a real estate broker, accusing him of incompetence and revealing confidential information. What is the next step?***
   a. the filing of criminal charges
   b. a hearing before the appointed hearing officer
   c. an informal arbitration hearing between the complainant and the respondent
   d. an investigation to determine the merits of the complaint

4. ***Of these violations, which is most likely to result in a temporary license suspension prior to a hearing?***
   a. Broker Anne allowed her unlicensed assistant to open a house for a scheduled showing because she was running late.
   b. Broker Bob used money from his escrow account to pay the rent on his office for a month when things were a little tight.
   c. Broker Chris omitted the fact that his license in Missouri was suspended when he submitted his license renewal in Illinois.
   d. Broker Dawn, who's not a member of the National Association of REALTORS®, used the NAR® logo on her business card.

5. ***When offering a guaranteed sales plan, a broker must***
   a. enter into a written contract with the seller prior to entering into a brokerage agreement.
   b. offer financing concessions to the buyer to meet the asking price.
   c. pay the seller the difference between the asking price and the purchase price.
   d. purchase the property before the listing agreement expires.

6. ***Broker Annie shared confidential information about her client Carl with another broker, which resulted in Carl getting less for his house than he really believed to be appropriate. What is NOT an action that Annie may face?***
   a. Carl could file a complaint with the IDFPR.
   b. Carl could sue Annie in civil court.
   c. The IDFPR could bring Annie up on criminal charges.
   d. The IDFPR could suspend Annie's license.

7. ***Kevin's license expired when he did not complete his required CE. He had a contract pending, so he went ahead and closed that deal so that he could collect the commission he had earned. If he's found guilty of practicing real estate without a license, what is the maximum penalty that could be imposed?***
   a. $2,500
   b. $5,000
   c. $10,000
   d. $25,000

8. ***Of these, which is the most serious offense that could lead to the revocation of an Illinois broker license?***
   a. being more than 30 days delinquent on court-ordered child support payments
   b. defaulting on a student loan provided by a state agency
   c. failing to file a state income tax return
   d. paying an unlicensed assistant to assemble documents for a closing

9. ***The Board must notify an accused licensee at least _____ days before a hearing date.***
   a. 21
   b. 30
   c. 45
   d. 60

10. ***Under what circumstances might the Department issue a citation?***
    a. The licensee violates the Fair Housing Act.
    b. The licensee is practicing under a suspended license.
    c. The licensee betrays the confidence of a client.
    d. The licensee does not complete the required CE.

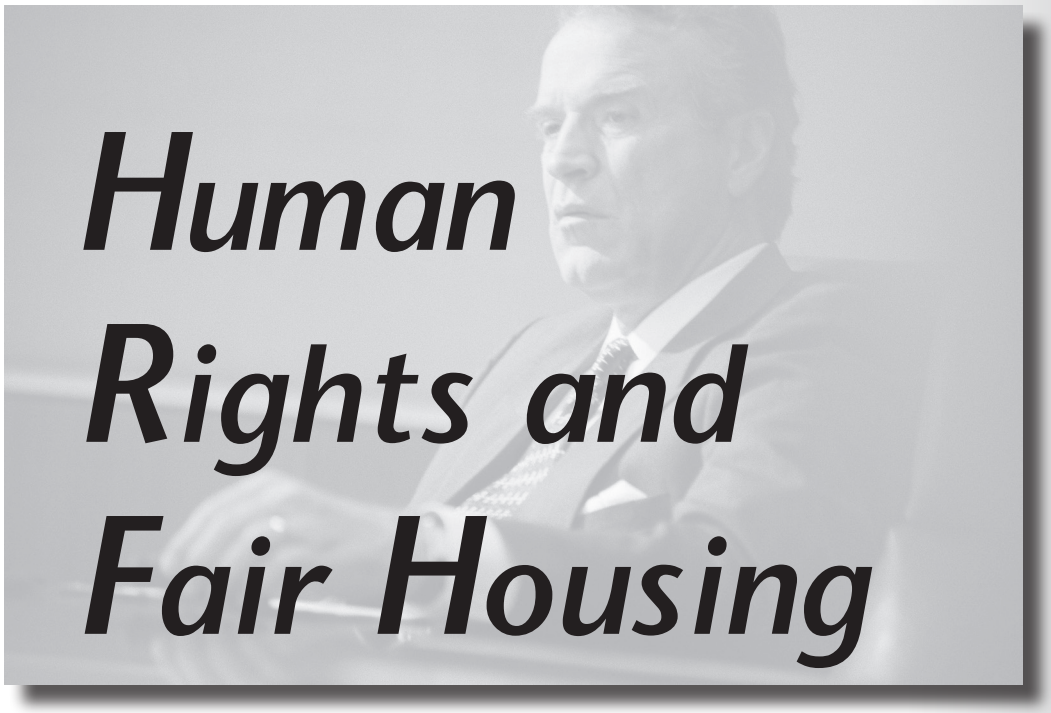
11. ***Of these, which would NOT be considered an action that the Department could impose on a licensee?***
    a. issue a cease and desist order
    b. require a broker to complete an educational course
    c. require a broker to have a medical examination
    d. restrict a broker's access to an escrow account

12. ***Seller Harvey recovered $12,000 in damages from the Real Estate Recovery Fund because of negligence on the part of his broker, Jane. Jane's license is***
    a. suspended until a disciplinary hearing can be held.
    b. revoked until the current renewal period ends.
    c. terminated until she repays the money.
    d. unaffected.

13. ***Who has the authority to investigate individuals who are illegally practicing real estate in Illinois?***
    a. Department of Financial and Professional Regulation
    b. Department of Housing and Urban Development
    c. Real Estate Coordinator
    d. Supreme Court

14. ***Illinois law requires licensees to disclose***
    a. any pending disciplinary action against them.
    b. the name of the law firm or real estate board that drafted their contracts.
    c. the names of all unlicensed assistants.
    d. their status as a licensee to parties in the transaction in which they have an interest.

15. ***The Illinois Supreme Court ruling in Quinlan and Tyson determined that real estate licensees***
    a. cannot pay unlicensed assistants for brokerage activities.
    b. can use acceptable pre-printed sales agreements.
    c. do not have to disclose that a murder took place on a property.
    d. must maintain earnest money is a separate escrow account.



3 Human Rights and Fair Housing

Fair and equitable treatment in housing and real estate transactions is a right by law. In this chapter, we focus on the mandatory fair housing issues that real estate licensees must understand and follow. The United States Congress, the U.S. Supreme Court, and your state legislature have made it clear that everyone needs to have equal access to housing. This mandate is ***not an option***. Real estate agents must know what conduct violates anti-discrimination laws to avoid potential liability.

You will learn:

- How fair housing laws have evolved.
- Federal laws addressing fair housing and anti-discrimination.
- Protections granted by the Illinois Human Rights Act.
- How to identify examples of discrimination.
- The implications of violating fair housing mandates.
- Your duties and responsibilities to treat all of your clients and customers fairly and equally under the law.

Key Terms

Americans with Disabilities Act (ADA)
Blockbusting
Civil Rights
Civil Rights Act of 1866
Civil Union
Department of Housing and Urban Development (HUD)
Disability
Discrimination
Fair Housing Act of 1968
Familial Status
Order of Protection Status
Public Accommodation
Reasonable Accommodation
Reasonable Modification
Redlining
Sexual Orientation
Steering
Testers

Federal Fair Housing

The **Civil Rights Act of 1866** was *the **first** major legislation to directly affect equal rights to ownership of personal and real property, and to guarantee equal housing opportunities*. The Act declared that all citizens of the United States:

> *… shall have the same right, in every State and Territory in the United States, to make and enforce contracts, to sue, be parties, and give evidence, to inherit, purchase, lease, sell, hold, and convey real and personal property, and to full and equal benefit of all laws and proceedings for the security of person and property, as is enjoyed by white citizens…*

Because of the reference to "white citizens," the 1866 Act was interpreted to prohibit only **racial** discrimination (as opposed to religious or sex discrimination, for example). This definition was later extended to include **color.**

There are no exceptions to the Civil Rights Act of 1866.

Relevant Supreme Court Decisions

Because the Civil Rights Act of 1866 did not include any provisions for enforcement, the reality was that not all citizens were treated equally. Several landmark U.S. Supreme Court decisions have addressed civil rights issues over the years.

Plessy v. Ferguson (1896) – This ruling introduced the doctrine of ***separate but equal***. The majority opinion of the Supreme Court held that a Louisiana statute segregating along racial lines did not deprive African Americans equal protection, as long as they were furnished accommodations equal to those of white people.

Buchanan v. Warley (1917) – Though the Supreme Court did not overturn ***Plessy***, it established a significant precedent against residential discrimination by declaring residential ordinances unconstitutional. However, it did not address private restrictive covenants.

Brown v. Board of Education (1954) – The U.S. Supreme Court ruled that the separate but equal doctrine introduced in ***Plessy v. Ferguson*** was in fact unconstitutional. ***Brown v. Board of Education*** involved segregating schoolchildren in the public school system based on color. The Supreme Court concluded that the separate educational facilities were inherently unequal. It further ruled that the segregation did violate the due protection clause of the Constitution.

Jones v. Alfred H. Mayer Co. (1968) – The constitutionality of the 1866 Civil Rights Act was upheld in this ruling that reiterated that the 1866 Act prohibited **racial** discrimination by the state ***and*** by any private organization. It stated that when it came to race with regard to sale or rental of housing, there were **no exceptions or exemptions.**

Fair Housing Act of 1968

The federal government passed a series of acts that extended the Civil Rights Act of 1866 and identified additional protected classes. These acts and amendments are collectively known as the federal Fair Housing Act. The federal **Fair Housing Act of 1968**, also referred to as Title VIII of the Civil Rights Act of 1968, *upheld earlier prohibitions against discrimination based on race or color when selling or leasing residential property, and added **religion** and **national origin** as protected classes*. This Act further prohibits discrimination:

- In advertising, real estate brokerage, lending, and some other services associated with residential transactions.
- Against individuals associated with persons in these protected classes.

The **Housing and Community Development Act of 1974** reinforced the federal Fair Housing Act by adding **sex** to the list of protected classes.

1988 Fair Housing Amendments

Title VIII was amended in 1988 to prohibit discrimination based on **familial status** or **disability.** In addition, these amendments imposed new requirements for certain buildings and greatly expanded the enforcement role of the Department of Housing and Urban Development (HUD).

Familial Status

The familial status clause makes it illegal to discriminate against a person because he or she is a *parent or guardian with custody of a child under 18 years old.* This protection also extends to *pregnant women* or any person in the *process of obtaining legal custody of a child under the age of 18.* The familial status clause also provides provisions to real estate licensees who suffer retaliation or financial losses because they:

- Sold (or offered to sell) or rented housing to a family with children under the age of 18.
- Negotiated (or attempted to negotiate) housing for a family with children under the age of 18.

Familial Status Exemptions

Familial status protection does *not* apply to **housing for older persons**. Exempt senior housing facilities and communities can lawfully refuse to sell or rent dwellings to families with minor children or may impose different terms and conditions of residency. The Act defines "housing for older persons" as any housing that meets one of these conditions:

- It is provided under a state or federal program designed to assist the elderly.
- It is intended for and solely occupied by persons 62 or older.
- It is designed to meet the physical and social needs of older persons, if management publishes and follows policies and procedures demonstrating an intent to provide housing for those who are 55 or older, at least 80 percent of the units are occupied by at least one person 55 or older, and the facility or community provides HUD with surveys and affidavits confirming the ages of residents.

Senior housing facilities may not discriminate based on race, color, religion, sex, disability, and national origin. In addition, in communities where families with minor children are permitted, those families may not be segregated in a particular section, building, or portion of a building.

Disability

A **disability** is *any physical or mental impairment that substantially limits or curtails one or more major life activities.* The federal Fair Housing Act defines this further:

- **Major Life Activities.** Functions such as caring for one's self, performing manual tasks, walking, seeing, hearing, speaking, breathing, learning, and working.
- **Physical Impairment.** Any physiological disorder or condition, cosmetic disfigurement, or anatomical loss, for example, blindness, hearing impairment, mobility impairment, HIV infection, alcoholism, or drug addiction. (This does *not* include those who are illegally addicted or who have been convicted of distributing or manufacturing a controlled substance.)
- **Mental Impairment.** Any mental or psychological disorder such as mental retardation, organic brain syndrome, emotional or mental illness, and specific learning disabilities.

If a tenant or someone associated with them has a disability, under the federal Fair Housing Act, the housing provider may *not* discriminate and must:

- Make *reasonable accommodations* in rules, policies, practices, or services, if necessary, for the disabled person to use the housing on an equal basis with non-disabled persons. For example, a landlord must allow a blind tenant to have a guide dog in a building with a no-pet policy.
- Allow the tenant to make *reasonable* modifications to a dwelling or common use areas, at their expense, which would permit them to fully use the housing. Where reasonable, the housing provider can require the tenant to restore the property to its original condition upon moving. For example, a landlord must allow a hearing-impaired tenant to install a flashing light in place of a doorbell, and can require the tenant to remove it when his lease is up.

Accessibility Requirements

Under the 1988 amendments, new multi-family buildings consisting of *four or more units that have an elevator* and were built for first occupancy on or after **March 13, 1991,** must provide:

- Wheelchair-width doors and hallways.
- Accessible public and common areas.
- Accessible routes into and through the unit.
- Accessible light switches, electrical outlets, thermostats, and other environmental controls.
- Reinforced bathroom walls to allow later installation of grab bars.
- Kitchens and bathrooms that can be used by people in wheelchairs.

In buildings without elevators, these standards apply only to ground floor units.

Real Success

Here's a little memory trick. Remember this sentence:

"**R**ealtors® **C**an **R**eally **S**ell **H**ouses **F**ast **N**ow."

The first letter of each word in this sentence is the first letter of each of the protected classes covered by the Fair Housing Act: **R**ace, **C**olor, **R**eligion, **S**ex, **H**andicap (disability), **F**amilial status, **N**ationality.

Federal Fair Housing Exemptions

The federal Fair Housing Act covers the majority of residential transactions in the U.S., although there are specific exemptions. Remember that these exemptions *never* apply to discrimination based on race or color, however. Also, a transaction that involves a real estate licensee through ownership or employment is *never* exempt.

One- to Four-Family Owner-Occupied Buildings

Fair housing laws do not apply to the rental of a room or unit in a dwelling with no more than four independent units provided that:

- The owner occupies one unit as a residence (unless the owner is a real estate licensee).
- No discriminatory advertising is used.
- No real estate broker or agent is used to facilitate the transaction.

This exemption may be referred to as "the Mrs. Murphy exemption."

When state law is more restrictive, the state law takes precedence.

Single-Family Housing

Fair housing laws do not apply to a single-family home sold or rented by a private owner provided that:

- The owner owns no more than three such homes at one time.
- No discriminatory advertising is used.
- No real estate broker or agent is used to facilitate the transaction.

To qualify for this exemption, the owner must meet all three requirements. An owner who is not the occupant or most recent occupant may use this exemption only once every 24 months.

Housing Operated by Organizations

In dealing with their own property in noncommercial transactions, religious organizations or affiliated nonprofit organizations may limit occupancy, or give preference to their own members provided membership is not restricted based on race, color, or national origin.

Housing Operated by Private Clubs

Private clubs with lodging not open to the public and not operated for commercial purposes may limit occupancy or give preference to members. Membership, however, may not be restricted based on race, color, or national origin.

Fair Housing Violations

The following discriminatory practices and activities violate the federal Fair Housing Act if they are based on a person's membership in a protected class:

Violation	Example
Refusing to rent or sell residential property after receiving a good faith offer.	A homeowner decides not to accept the offer after learning that the buyer is Jewish.
Refusing to negotiate for the sale or rental of residential property.	A listing agent follows his seller's instructions to not show the house to any Asians.
Taking any action that would otherwise make residential property unavailable or deny it to any person.	A minority couple tells an agent what they're looking for in a home. Six listings in the MLS match their criteria, but the agent tells them about only the three that are in neighborhoods with a high population of minorities.
Using discriminatory advertising or any other notice that indicates a limitation or preference or intent to make any limitation, preference, or discrimination.	A landlord includes the phrase "no children" in an advertisement for an apartment.
Making any representation that property is not available for inspection, sale, or rent when it is, in fact, available.	A landlord tells a potential tenant who has a Hispanic accent that the apartment is already rented, but shows the unit to a white man.
Denying access to a multiple listing service or any similar real estate brokers' organization or discriminating in terms or conditions for access to the organization.	A local broker's organization limits membership to suburban brokerages for the purpose of keeping minority inner city brokerages out.
Coercing, intimidating, threatening, or interfering with anyone because of his or her enjoyment, attempt to enjoy, or encouragement and assistance to others in their enjoyment of the rights granted by the federal Fair Housing Act.	A landlord threatens to evict a tenant who files a fair housing complaint.
Discriminating in the terms or conditions of any sale or rental of residential property or in providing any services or facilities in connection with such property.	A landlord requires applicants to include a deposit, but the property manager does not tell male applicants about the requirement, so their applications are not processed.
Discriminating against anyone by a commercial lender in making a loan for buying, building, repairing, improving, or maintaining a dwelling, or in the terms of such financing.	A bank charges a higher interest rate to a credit-worthy borrower who wants to buy a house in a minority neighborhood than is charged for an equally credit-worthy borrower in a different neighborhood.

Steering

The federal Fair Housing Act prohibits **steering**, which relates to buyers or renters, and is *channeling prospective buyers or renters to or away from specific neighborhoods based on their race, religion, national origin, or other protected class to maintain or change the character of a neighborhood.* For instance, Caucasian customers might be shown homes only in traditionally Caucasian neighborhoods and Hispanic customers shown homes only in traditionally Hispanic neighborhoods.

Real Success

When real estate licensees make assumptions about the types of neighborhood clients would like to live in instead of showing them all available options, they are practicing steering. ***Never assume*** you know what is best for your client. Spend time talking about their preferences and requirements, and then show them a variety of options that meet those qualifications. **Steering is also prohibited even if requested by the buyer client.**

Blockbusting

Blockbusting is *inducing or attempting to induce, for profit, any person to sell or rent property based on representations made regarding entry into the neighborhood of persons of a particular race, color, religion, sex, or national origin* and it is prohibited under federal and state law. You may also hear blockbusting referred to as panic selling or panic peddling.

Before the federal Fair Housing Act, unscrupulous real estate licensees intimidated homeowners into selling their homes by suggesting the ethnic or racial composition of their neighborhood was changing. Homeowners were led to believe their property values would decline, the area would experience higher crime rates, and the quality of schools would suffer. The apparent motive of these licensees was profit. Through certain techniques, property owners listed or sold properties at a reduced price, and then the licensee turned around and resold the properties at a higher price.

Redlining

Redlining is *discriminating against anyone by a commercial lender in making a loan for buying, building, repairing, improving, or maintaining a dwelling, or in the terms of such financing*. As you can see from the definition, redlining relates to mortgage lending and insurance brokers.

In most instances, homeowners insurance and financing must be obtained in order to buy a house. Redlining is a refusal to make loans or provide insurance on property located in particular neighborhoods for discriminatory reasons (effectively, drawing a red line around an area).

In the past, many lenders assumed an integrated or predominantly African American neighborhood was a place where property values were declining. Based on that assumption, they refused to make loans there. Since it was almost impossible to get purchase or renovation loans, it was extremely difficult to market, maintain, or improve homes in those neighborhoods, causing values to decline further, a process sometimes referred to as **filtering down**.

Combating Redlining

The practice of redlining was addressed in 1977 with the passage of the **Community Reinvestment Act**, also known as CRA. This law was designed to ensure that financial institutions take responsibility in meeting their respective communities' needs for low-income and moderate-income housing. Financial institutions are subject to periodic review by federal agencies and must demonstrate how they are in compliance with this legislation within their communities. Lenders may still deny loans in neighborhoods where property values are declining, but this ***must*** be based on objective criteria regarding the condition and value of the property or area. A lender may ***not*** simply equate integrated or minority neighborhoods with declining property values.

Enforcement of Federal Fair Housing Laws

The 1988 amendments to the federal Fair Housing Act greatly increased the enforcement role of the **Department of Housing and Urban Development (HUD)** beyond investigation and conciliation and into mandatory enforcement. The Department of Housing and Urban Development's mission is *to increase homeownership, support community development, and increase access to affordable housing free from discrimination.* One of HUD's main responsibilities is fair housing education and enforcement. The federal Fair Housing Act also requires HUD to develop voluntary programs to achieve fair housing goals.

The **Office of Fair Housing and Equal Opportunity** (FHEO), a division of HUD, is responsible for the administration and enforcement of federal fair housing laws. The FHEO also establishes policies that ensure equal access to housing for all Americans.

Testing

In 1991, the Civil Rights Division of the Department of Justice established a fair housing testing program to *objectively compare access and treatment of prospective homebuyers or renters*. The method typically involves two teams of **testers** (also known as checkers) *posing as customers or clients with similar housing needs and economic qualifications, but with obvious differences due to inclusion or exclusion from a protected class*. After both attempt to secure the same real estate services, the teams can compare notes on specific treatment, for example, which properties were shown, the list price or rent quoted, the manner of the real estate licensee, etc.

Testing may be initiated because HUD or some other fair housing agency receives a specific complaint from an individual who believes he has been unlawfully treated. It could also occur as part of an ongoing program of enforcement when a fair housing agency randomly selects a geographic area to test. The federal Fair Housing Act also contains provisions that encourage businesses and organizations to self-test for compliance.

Fair housing compliance agencies believe the importance of providing equitable treatment to all home seekers outweighs the brief inconvenience of a test. Testing can occur at any time and as many times as it takes to investigate a complaint.

Enforcing the Fair Housing Act

Violations of the federal Fair Housing Act may be handled a number of ways:

HUD Complaint. An individual who believes he has been discriminated against can file a *complaint* through HUD's Office of Fair Housing and Equal Opportunity (FHEO) *within one year* after the alleged discrimination. HUD may also institute its own investigation. If an investigation reveals evidence of a violation, the agency attempts negotiation and conciliation in an effort to obtain voluntary compliance with the Act. If these strategies are unsuccessful, HUD generally refers the matter to an *administrative law judge (ALJ).* The judge can impose civil penalties ranging from $10,000 for the first offense to $50,000 for a third offense within 7 years.

Civil Lawsuit. An individual can file a civil lawsuit in federal district court within one year of the incident (or within two years if the individual also filed a complaint with HUD). If the court determines that there was a violation, it could issue an injunction, which is a court order requiring a defendant to do something or refrain from doing something, for example, a court might order the respondent to rent an apartment to the complainant, attend educational programs about discrimination, etc. Additionally, the court could award actual and punitive damages with no limits.

U.S. Attorney General Action. The U.S. Attorney General, under the Department of Justice (DOJ), may bring a *civil suit* in federal district court against anyone engaged in an ongoing pattern or practice of discriminatory activities. The court could issue injunctions or impose fines of up to $50,000 for a first violation. The DOJ may also bring *criminal charges* against anyone who uses force or threats of force to deny or interfere with fair housing rights.

Filing a Civil Lawsuit

Generally a civil lawsuit may be brought only by someone who has been personally injured by the defendant's actions. For the purposes of the federal Fair Housing Act, however, the U.S. Supreme Court has interpreted the concept of standing to sue quite broadly. The Court held it is not only the actual buyers and renters who can sue for violation of the Act, but in some cases, a fair housing organization or individual testers may also have standing to sue, since it is said the whole community is injured by housing discrimination. And, almost everyone connected with the violation can be held liable, because of their actions or because they are legally responsible for the actions of their agents.

Who Can Sue for Violations of Anti-Discrimination Laws	Who Can Be Held Liable for Unlawful Discrimination
Prospective Buyer/Tenant	Seller/Landlord
Checker/Tester	Property Manager
Fair Housing Organization	Resident Manager
Community Groups	Residential Leasing Agent
State Attorney General	Real Estate Broker
State Civil Rights Commission	Multiple Listing Service
HUD	Lender
U.S. Attorney General	Mortgage Broker
	Homeowners Association/Board

Other Federal Anti-Discrimination Laws

Americans with Disabilities Act

Although the federal Fair Housing Act prohibits discrimination in housing against the disabled, Congress further expanded protection with the more comprehensive **Americans with Disabilities Act** (ADA), which was signed into law in 1990. The ADA Amendments Act was signed in 2008 and prohibits discrimination against the disabled in employment, public transportation, public accommodations, and telecommunication. It also imposes consistent and enforceable standards, requiring that reasonable accommodations be made for the disabled. The ADA addresses five general areas or titles of service or operation:

- **Title I – Employment:** Employers engaged in interstate commerce having **15 or more employees**, including employment agencies, labor organizations, or joint labor-management committees. Title I ensures equal opportunity for qualified individuals with disabilities in the workplace in job application procedures and hiring; advancement and discharge of employees; compensation; training; other terms, conditions, and privileges of employment. Title I requires employers to *reasonable accommodations* to the known physical or mental limitations of an employee.
- **Title II – Public Services:** State and local services and public transportation.
- **Title III – Public Accommodations:** Private entities which own, lease, lease to, or operate a place of public accommodation (includes transportation provided by private entities).
- **Title IV – Telecommunications:** Common carriers engaged in interstate communication.
- **Title V – Miscellaneous Provisions:** This title provides miscellaneous provisions, including minimum guidelines and a technical assistance plan along with a number of other provisions.

Of the ADA titles, **Title III** has had the greatest affect on the lives of disabled persons. Title III prohibits discrimination against disability "with regards to the full and equal enjoyment of the goods, services, facilities, or accommodations." Essentially, this title requires *all public and commercial facilities to be accessible to the disabled*. A **public accommodation** is a facility that is owned, leased, leased to, or operated by a private entity, for example, bars or restaurants, schools, gyms and community centers, hotels, theaters, stadiums, museums, libraries, convention centers, retail and service establishments, social service establishments, public transportation terminals.

Under the ADA, existing buildings are required to remove barriers to the disabled, if feasible. All public and commercial facilities built after 1993 must be designed to be accessible to the disabled, for example, by including handicap parking spaces, ramps, lowered sinks, wider doors, Braille or raised letters on elevator controls, etc.

The primary enforcer of the Americans with Disabilities Act is the U.S. Attorney General. The goal of the ADA enforcement program is to work with wrongdoers towards *compliance*. However, if necessary, the Attorney General may impose a fine of **up to $50,000** for the first violation and up to $100,000 for subsequent violations.

Equal Credit Opportunity Act

The **Equal Credit Opportunity Act** (ECOA) was enacted in 1974 and is implemented as **Regulation B.** ECOA prohibits discrimination in granting credit to individuals and businesses based on the following:

- Sex
- Age
- Marital status
- Race
- Color
- Religion
- Ancestry
- Receipt of public assistance

The provisions of ECOA apply to any creditor who regularly extends credit and includes real estate brokers who arrange financing.

Illinois Human Rights Act

Fair treatment of all is a basic human right. The Administrative Rules of the Department of Financial and Professional Regulation make it clear that discrimination is illegal (Section 1450.710). No licensee may enter into a listing agreement that prohibits the sale or rental of real estate to any person on the basis of his or her membership in a protected class. Nor may a licensee act or undertake to act as a real estate broker with respect to any property where its disposition would be prohibited to any person on the basis of his or her membership in a protected class. Recall that the federal Fair Housing Act prohibits discrimination on the basis of race, color, national origin or ancestry, sex, religion or creed, physical or mental disability, or familial status (the presence of children under the age of 18 living with a parent or person with legal custody).

The **Illinois Human Rights Act** (IHRA) was signed into law in **1979** to promote freedom from unlawful discrimination in connection with employment, real estate transactions, access to financial credit, and the availability of public accommodations. The Act applies to real estate transactions involving both commercial and residential properties, which may include the following:

- Houses
- Apartments
- Condominiums
- Mobile homes
- Vacant land
- Offices
- Stores
- Industrial facilities

Those who are required to comply with the provisions of the Illinois Human Rights Act include owners, managers, brokers and managing brokers, leasing/rental agents/office personnel, advertisers, appraisers, and builders.

State Protected Classes

775 ILCS 5/1-102

The Illinois Human Rights Act extends the **protected classes** beyond those covered in the federal Fair Housing Act to include the following:

- **Marital Status.** The legal status of being married, single, separated, divorced, or widowed.
- **Age.** The chronological age of a person who is at least 40 years old.
- **Military Status.** Refers to active duty in any of the armed forces of the United States, reserve member of any of the armed forces of the United States, or current member of the Illinois Army National Guard or Air National Guard. The definition also includes some **unfavorable military discharge** from the armed forces of the United States, reserve components of any National Guard or Navy Militia (classified RE-3); it does *not* include discharges characterized as RE-4 or dishonorable.
- **Ancestry.** Expands the federal protected class of national origin to include the place in which the ancestors or relatives of a person were born.
- **Sexual Orientation or Gender Identity.** Refers to actual or perceived heterosexuality, homosexuality, bisexuality, or gender-related identity, whether or not traditionally associated with the person's designated sex at birth.
- **Order of Protection Status.** A person who has an order of protection against someone can not be discriminated against in their real estate transactions. For example, if a woman has an order that her ex-husband must stay at least 500 feet away, a landlord cannot refuse to renew her lease based on that condition. This provision was added in 2010.

While the federal Fair Housing Act includes **sex** as a protected class, which refers to the status of being male or female, this definition is clarified in the Illinois Human Rights Act to include acts of **sexual harassment** or **stereotyping**, such as:

- Telling racial/ethnic/sexual jokes.
- Making derogatory remarks related to a protected class.

Real Success

Here's a little memory trick:

MAMAS OOPS

Each letter represents the first letter of each of the additional protected classes covered by the Illinois Human Rights Act: **M**arital status, **A**ge, **M**ilitary status/unfavorable military discharge, **A**ncestry, **S**exual orientation, **O**rder **O**f **P**rotection **S**tatus

Violations in Real Estate Transactions

It is a civil rights violation for an owner or any other person engaging in a real estate transaction, or for a real estate broker, to unlawfully discriminate on the following basis:

- **Transactions**. Refuse to engage in a real estate transaction with a person or to discriminate in making available such a transaction.
- **Terms**. Alter the terms, conditions, or privileges of a real estate transaction or the furnishing of facilities or services.
- **Offers**. Refuse to receive or to fail to transmit a bona fide offer to engage in a real estate transaction from a person.
- **Negotiations**. Refuse to negotiate for a real estate transaction with a person.
- **Representations**. Represent to a person that real property is not available for inspection, sale, rental, or lease when in fact it is so available, or to fail to bring a property listing to his or her attention, or to refuse to permit him or her to inspect real property.

- **Publication of Intent**. Print, circulate, post, mail, publish, or cause to be so published a written or oral statement, advertisement or sign, or to use a form of application for a real estate transaction, or to make a record or inquiry in connection with a prospective real estate transaction, which expresses any limitation founded upon, or indicates, directly or indirectly, an intent to engage in unlawful discrimination.
- **Listings**. Offer, solicit, accept, use, or retain a listing of real property with knowledge that unlawful discrimination or discrimination on the basis of familial status in a real estate transaction is intended.

Blockbusting

775 ILCS 5/3-102 through 103

As with federal law, **blockbusting** is prohibited by the Illinois Human Rights Act, including these specific practices:

- Distributing or causing to be distributed written material or statements designed to induce such a sale.
- Intentionally creating alarm among residents of any community, by transmitting communications in any manner, including a telephone call—whether or not conversation thereby ensues—with a design to inducing such a sale.

Accommodating Disabilities

775 ILCS 5/3-102.1

Disability is a protected class. When discussing real estate transactions, it refers to the disability of:

- The person involved in the transaction.
- Any person residing or intending to reside in that dwelling after it is sold, rented, or made available.
- Any person associated with that person.

It is a civil rights violation to refuse to:

- Sell or rent or to otherwise make unavailable or deny a dwelling to any buyer or renter because of a disability.
- Permit, at the expense of the person with a disability, reasonable modifications of existing premises occupied or to be occupied by such person if such modifications may be necessary to afford such person full enjoyment of the premises (with some conditions)
- Make reasonable accommodations in rules, policies, practices, or services, when such accommodations may be necessary to afford such person equal opportunity to use and enjoy a dwelling.

Additional provisions apply to compliance with the Illinois Accessibility Code for multi-family dwellings.

Other Violations

The Illinois Human Rights Act also addresses the following as it relates to real estate transactions:

Guide, Hearing, Support Dogs

It is a civil rights violation for the owner or agent of any housing accommodation to discriminate against any blind, hearing impaired, or physically disabled person in the terms, conditions, or privileges of sale or rental property, or in the provision of services or facilities, because he has a guide, hearing, or support dog. This includes:

- Refusing to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny property.
- Requiring an extra charge in a lease, rental agreement, or contract of purchase or sale, other than for actual damage done to the premises by the dog.

Restrictive Covenants

775 ILCS 5/3-104.1 though 105

It is a civil rights violation to insert into a written instrument relating to real property, such as a deed, any of the following provisions that are void. It is also a violation to honor or attempt to honor such a provision in the chain of title.

- Every provision in an **oral agreement** or a **written instrument** relating to real property which purports to forbid or restrict the conveyance, encumbrance, occupancy or lease thereof on the basis of race, color, religion, or national origin.
- Every condition, restriction or prohibition, including a right of entry or possibility of reverter, which directly or indirectly limits the use or occupancy of real property on the basis of race, color, religion, or national origin.

This does not apply to limitations of use based on religion where real property is held, operated, supervised, and controlled by a religious institution, organization, or charitable organization and used for religious or charitable purposes.

Exemptions Under State Law

775 ILCS 5/3-106

Exemptions to the Illinois Human Rights Act with respect to real transactions are similar to the federal Fair Housing Act. Note that the following exemptions apply only if the transaction occurs **without** the use in any manner of **any real estate broker** (or of any employee or agent of any real estate broker) or **without** the publication, posting or mailing, after notice, of any **advertisement** or **written notice** that would violate other provisions of the Illinois Human Rights Act.

Private Sales of Single-Family Homes. Any sale of a single-family home by its owner is exempt so long as the following criteria are met:

- The owner does not own or have a beneficial interest in more than **three single-family homes** at the time of the sale.
- The owner or a member of his or her family was the **last current resident** of the home.

Resident Owners in Apartments. Rental of a housing accommodation in a building which contains housing accommodations for not more than four families living independently of each other, if the owner resides in one of the housing accommodations is exempt.

Private Rooms. Rental of a room or rooms in a private home by an owner is exempt if he or she or a member of his or her family resides there, or, while absent for a period of not more than 12 months, if he or she or a member of his or her family intends to return to reside there.

Religious Organizations. A religious organization, association, or society, or any nonprofit institution or organization operated, supervised, or controlled by or in conjunction with a religious organization, association, or society, may:

- Limit the sale, rental, or occupancy of a dwelling which it owns or operates for other than a commercial purpose to persons of the same religion.
- Give preference to such persons, unless membership in such religion is restricted on account of race, color, or national origin.

Housing for Older Persons. The provisions related to familial status do not apply with respect to housing for older persons, which is defined as housing that is:

- Provided under any State or Federal program that the Illinois Department of Human Rights determines is specifically designed and operated to assist elderly persons.
- Intended for, and solely occupied by, persons 62 years of age or older.
- Intended and operated for occupancy by persons 55 years of age or older and at least 80% of the occupied units are occupied by at least one person who is 55 years of age or older (if meeting state requirements for verification).

Occupancy. Exemptions may be allowed for reasonable local, State, or Federal restrictions regarding the maximum number of occupants permitted to occupy a dwelling.

Sex and Sexual Orientation. Restricting the rental of rooms in a housing accommodation to persons of one sex is allowed, as is the owner of an owner-occupied residential building with four or fewer units (including the unit in which the owner resides) making decisions regarding whether to rent to a person based upon that person's sexual orientation.

Persons Convicted of Drug Related Offenses. It is allowable to discriminate against a person who has been convicted by any court of competent jurisdiction of the illegal manufacture or distribution of a controlled substance.

The Illinois Department of Human Rights

The state agency responsible for administering and enforcing the Illinois Human Rights Act (IHRA) is the **Illinois Department of Human Rights** (IDHR). The IDHR:

- Accepts discrimination complaints.
- Initiates charges against unlawful acts of discrimination.
- Conducts investigations.

Consequences of Illegal Discrimination

225 ILCS 454/20-50

When there has been an adjudication in a **civil** or **criminal proceeding** or an order in an **administrative proceeding** that a licensee has illegally discriminated while engaged in any activity for which a license is required, the Department, upon the recommendation of the Board as to the extent of the suspension or revocation, will **suspend** or **revoke** the license of that licensee in a timely manner, unless an appeal is currently underway.

Illinois Religious Freedom Protection and Civil Union Act

The **Illinois Religious Freedom Protection and Civil Union Act** became effective June 1, 2011. Under the act, a **civil union** is defined as *a legal relationship between two persons, either of the same or opposite sex.* The law ensures that any party to a civil union is entitled to the same legal obligations, responsibilities, protections, and benefits that are recognized under Illinois law to spouses, such as the right to:

- Make critical and emergency medical care decisions.
- Make funeral arrangements and control disposition of remains.
- Share a nursing home or hospital room.
- Protect spousal pension benefits.
- Receive employee benefits.

When considering real estate, the law allows couples in civil unions to hold title to **homestead property** (the principal residence) as **tenants by the entirety**, a right that previously was available only to legally married spouses. This method of holding title to property includes the **right of survivorship**, so that in the event of one partner's death, ownership automatically passes to the surviving partner in the relationship without having to go through probate. Another benefit of this particular method of holding title to homestead property is that it offers some **protection from creditors**. If one partner is individually liable for a debt or judgment, for example, property owned as joint tenants by the entirety cannot be used to satisfy the debt or judgment.

The Responsibility of Licensees

It is not only your duty as a licensee to provide non-biased service to all customers and clients, it is your legal responsibility. Making sure that you understand federal, state, and local fair housing laws is critical. Your sponsoring broker will likely have procedures in place to ensure compliance with these laws. If you do not comply with fair housing laws, you—and your broker—may be subject to fines, loss of license, and other legal action. But it's more than that: Equal access to housing is a basic human right.

Be aware that even innocent questions you may ask of customers or clients could be construed as a violation of fair housing laws, for example:

- Are you married?
- How many children do you have?
- You have an interesting accent; where are you from?
- What church do you attend?

As a real estate licensee, you should always be sensitive to the questions you ask and the words you use. And that advice works both ways. Your customers or clients may ask you pointed questions, such as:

- What's the racial makeup of this neighborhood?
- What's the dominant ethnicity at the local high school?
- Is there a mosque nearby?
- Is the guy who made an offer on my house an American?

Consider your responses very carefully. You may have no choice but to tell them that you are unable to answer their question. If appropriate, you can direct them to other resources, such as the local school district office.

Equal Service

Fair housing violations are serious, so much so that they are almost always *excluded* from errors and omissions insurance policies. To protect yourself against fair housing violations, treat everyone equally and fairly. Equal service is a basic tenet of the National Association of REALTORS® Code of Ethics, and it is good business.

While you may not be legally obligated to keep notes of every substantive conversation you have, it can be your strongest defense to establish that you gave equal professional service. Keep good records of all meetings, phone calls, appointments, and missed appointments. If you find yourself being questioned or end up in court, at least you can demonstrate a conscious effort to be fair, open, and honest with everyone. Some brokers require their agents to use a preprinted contact form, such as a "needs and wants" checklist and/or a prospect card, to document whom they spoke with, what they discussed, etc., as part of their fair housing compliance procedures to show that they provided equal service to all.

(Front of card)

PROSPECT INFORMATION CARD			
Name			Date
Address			Home Phone
			Bus. Phone
Income(s)		Occupation(s)	
Price Range	Taxes		Type of Financing
Down Payment	Monthly Payment		Estimated Expenses

PREFERRED HOME REQUIREMENTS			
Preferred Location	Style of Home		Preferred lot size Frontage Depth
# Bedrooms	# Baths	Type Heat	Garage
❑ Dining Room ❑ 1st Fl. Laundry ❑ 1st Fl. Family Room ❑ Eat-in Kitchen ❑ Fireplace List Other Features:			
Current Residence ❑ Own ❑ Rent	Referred to us by		Salesperson

(Back of card)

RECORD OF SHOWINGS			
DATE	**ADDRESS**	**BY**	**COMMENTS**

SAMPLE

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Disclosure

Licensed real estate professionals have the duty to disclose fair housing laws to clients, while being cautious not to practice law. In Illinois, contracts that create an agency relationship—a listing agreement with a seller or a buyer-broker agreement with a buyer—should carry a statement that indicates the broker and the client will conduct business in full compliance with local, state, and federal fair housing laws against discrimination on the basis of race, color, religion, sex, national origin, familial status, disability, age, marital status, sexual orientation, military status/discharge, or any other class protected by law.

After you properly disclose the laws governing fair housing to your clients, you have fulfilled your obligation of disclosure. If you later discover you are working with a seller who is not willing to abide by fair housing laws, you must inform your sponsoring broker. And you should inform the sellers that your sponsoring broker may want to terminate the relationship since both you *and* your broker could be held liable for violating fair housing laws. Note, however, that if your seller refuses to go through with a transaction because of the buyer's membership in a protected class, your sponsoring broker may sue for the commission anyway.

State and Federal Protected Classes			
Federal Housing	1866	Civil Rights Act	**Race, Color**
	1968	Fair Housing Act	Race, Color, **Religion, National Origin**
	1974	Fair Housing Development Act	Race, Color, Religion, National Origin, **Sex**
	1988	Fair Housing Amendment	Race, Color, Religion, National Origin, Sex, **Familial Status, Disability**
Illinois Housing	1979	Illinois Human Rights Act	Race, Color, Religion, National Origin, Sex, Familial Status, Disability, **Marital Status, Age (40+), Military Status/Unfavorable Discharge, Ancestry, Sexual Orientation/Gender Identity, Order of Protection Status**
Federal Credit	1974	Equal Credit Opportunity Act	Race, Color, Religion, National Origin, Sex, Marital Status, Age, **Receipt of Public Assistance**

Summary

1. The **Civil Rights Act of 1866** was the first federal anti-discrimination statute. It prohibited discrimination based on *race* (later interpreted to include *color*) in the purchase, lease, or transfer of real and personal property **without exception.**
2. The federal **Fair Housing Act of 1968** prohibits discrimination in the sale or lease of residential property for protected classes of *religion* or *national origin*. The **Housing and Community Development Act of 1974** added *sex* as a protected class. The **Fair Housing Amendments of 1988** added *familial status* (children under age 18) and *disability* as protected classes.
3. The Act also prohibits discrimination in advertising, real estate brokerage, lending, and some other services associated with residential transactions, as well as against individuals associated with persons in these protected classes.
4. Although the federal Fair Housing Act covers the majority of residential transactions in the U.S., there are several specific **exemptions**: Some single-family homes sold or rented by a private owner; rental of a unit in an owner-occupied building with no more than four units; religious and nonprofit organizations; private clubs. A property transaction involving a real estate licensee through ownership or employment, however, is *never exempt.*
5. The **Department of Housing and Urban Development** (HUD) is responsible for the enforcement of the federal Fair Housing Act. HUD utilizes **testers**, *fictitious potential buyers or renters*, to detect and combat discrimination of protected classes. Anyone can file a complaint of discrimination with HUD's Office of Fair Housing and Equal Opportunity (FHEO) within **one year** of the incident. They may also file a **civil lawsuit** in federal court. The U.S. Attorney General can bring a civil suit for actions that indicate a pattern of discrimination. The penalties for Fair Housing violations can be severe, including civil penalties **up to $10,000** for a first offense.
6. Key violations to remember are: **Steering**, *channeling prospective buyers or renters to or away from specific neighborhoods based on their membership in a protected class*; **redlining**, *discriminating against anyone by a commercial lender in making a loan for buying, building, repairing, improving, or maintaining a dwelling or in the terms of such financing*; and **blockbusting**, *inducing or attempting to induce, for profit, any person to sell or rent property based on representations made regarding entry into the neighborhood of persons of a particular race, color, religion, sex, or national origin*.
7. The **Americans with Disabilities Act (ADA)** was passed in 1990 and gives civil rights protection to individuals with disabilities. It guarantees equal opportunity for individuals with disabilities in public accommodations, employment, transportation, and telecommunications. **Title III** of the ADA requires all public and commercial facilities to be accessible to the disabled. The **Equal Credit Opportunity Act** (ECOA) was passed in 1974 and prohibits discrimination in lending based on sex, age (if at least 18), marital status, race, color, religion, national origin, receipt of public assistance, or exercised rights under the Consumer Credit Protection Act.
8. Licensees have an obligation to know and follow federal, state, and local fair housing and human rights laws. They must provide **equal service** to all, keep good records of their dealings with clients and customers, and **disclose** fair housing laws to their clients. When a real estate agent does not separate himself from a client's discriminatory behavior, the consequences can be serious for the agent *and* his broker.
9. The **Illinois Human Rights Act** was passed in 1979 and prohibits discrimination in employment, real estate transactions, access to financial credit, and the availability of public accommodations on the basis of **age** (at least 40), **ancestry, marital status, military status** (including some unfavorable discharges), **sexual orientation** (actual or perceived), or **order of protection status** (added in 2010). These are in addition to those protected under the federal Fair Housing Act (race, color, national original, sex, disability, religion, familial status). It also prohibits acts of **sexual harassment** or **stereotyping**. One may not unlawfully discriminate on the basis of transactions, terms, offers, negotiations, representations, publication of intent, or listings.

10. **Blockbusting** is specifically prohibited (also called panic-selling). Owners must make **reasonable accommodations** in rules, policies, and services to afford equal opportunity to the disabled; **support dogs** must be allowed. **Restrictive covenants** based on protected status are illegal. There are several **exemptions** to the Illinois Human Rights Act, including: Sales by **owners** (under certain conditions) or rental by **owner-occupants**; **religious organizations** (unless based on race, color, national origin); housing for **older persons** (under certain conditions); reasonable **occupancy** restrictions; persons convicted of **drug-related** crimes. The Act is administered and enforced by the Illinois **Department of Human Rights**.
11. The **Illinois Religious Freedom Protection and Civil Unions Act** provides couples in legal civil unions the same legal obligations, responsibilities, protections, and benefits that are recognized under Illinois law to spouses, including the right to own homestead property as **tenants by the entirety**.

Quiz

1. ***The federal Fair Housing Act prohibits discrimination based on race, color, religion, sex,***
   a. age, disability, or familial status.
   b. marital status, national origin, or familial status.
   c. national origin, familial status, or disability.
   d. sexual orientation, age, familial status, or disability.
2. ***Which of the following questions could NOT be construed as being discriminatory in nature when asked of a buyer?***
   a. Do you have children?
   b. How many bedrooms do you need?
   c. How many family members will be living with you?
   d. What church do you attend?
3. ***Which act defined familial status as a protected class?***
   a. Civil Rights Act of 1866
   b. Title VIII of the Civil Rights Act of 1968
   c. The Fair Housing Amendments Act of 1988
   d. The Housing and Community Development Act of 1974
4. ***A licensee who tells homeowners that property values are declining because the ethnic or racial makeup of the neighborhood is changing could be found guilty of***
   a. blockbusting.
   b. disclosure.
   c. steering.
   d. stigmatizing.
5. ***A disabled individual applies to rent an apartment and states that the property would need to be made handicap accessible. Which action would NOT be lawful in this situation?***
   a. The landlord makes the renovations, but requires the tenant to pay the actual cost of the materials.
   b. The landlord makes the renovations to the property at the landlord's expense.
   c. The landlord refuses to allow the individual to make the renovations to the apartment.
   d. The landlord requires the tenant to make the renovations at the tenant's own expense and requires the tenant also return the property to its original condition at the end of tenancy.
6. ***A mortgage lending company refuses to make loans for homes in a minority neighborhood. This is an illegal action called***
   a. blockbusting.
   b. coercion.
   c. redlining.
   d. steering.
7. ***Which Supreme Court decision overturned the concept of "separate but equal"?***
   a. Brown v. Board of Education
   b. Buchanan v. Warley
   c. Jones v. Alfred H. Mayer Co.
   d. Plessy v. Ferguson

8. ***Which is an example of steering?***
   a. Agent Tom tells homeowners that their property values will drop when a Puerto Rican family moves in.
   b. Mortgage banker Brad refuses to make loans for a particular inner city neighborhood.
   c. Property manager Amy suggests Jake would be happier in a more diverse building.
   d. Seller Oscar tells his listing agent to find only Caucasian buyer prospects.

9. ***Who is exempt from the federal Fair Housing Act?***
   a. an apartment property manager who rents only to fellow Mexicans
   b. a church that operates a boarding house for retired clergy only of its denomination
   c. a condominium that doesn't want the liability of children at its pool
   d. a landlord who does not allow dogs under any circumstances

10. ***Which individual is NOT protected under the disability clause of the federal Fair Housing Act?***
    a. hearing impaired individual
    b. individual in a wheelchair
    c. individual with AIDS
    d. individual who is addicted to illegal drugs

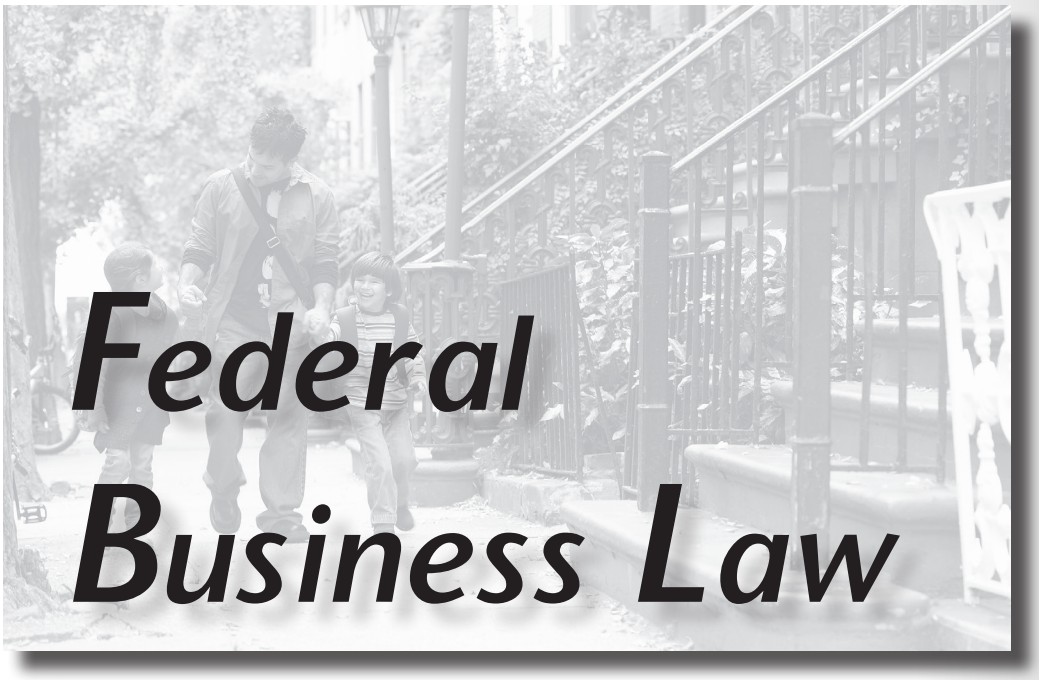
11. ***Which is NOT included as a protected class by the federal Fair Housing Act?***
    a. handicap
    b. national origin
    c. religion
    d. sexual orientation

12. ***When Gianna called landlord Steve about an apartment she saw advertised, he told her it was rented. A week later, the sign was still up in front of the building. Gina is convinced that Steve did not show her the apartment because she was a woman and she had a strong accent. If Gianna decided to file a complaint against Steve, she would have to do so within _____ of the incident.***
    a. 90 days
    b. 6 months
    c. 1 year
    d. 2 years

13. ***Which class is protected under the Illinois Human Rights Act but is NOT protected under the federal Fair Housing Act?***
    a. disability
    b. familial status
    c. religion
    d. sexual orientation

14. ***It would be a violation under Illinois Human Rights Act to***
    a. refuse to allow a blind tenant to have a guide dog in a pet-free building
    b. refuse to rent an apartment to someone who has been in jail for selling drugs
    c. refuse to rent a room in your private residence to a homosexual
    d. restrict the number of people living in a single apartment unit.

15. ***Which activity is NOT prohibited under the Illinois Human Rights Act?***
    a. inserting a provision in a deed limiting the transfer of ownership based on someone's race
    b. making lewd remarks about a client to a co-worker
    c. refusing to enter into a listing agreement with a 17-year-old Hispanic woman
    d. telling jokes about different religious beliefs in an employee meeting



4

Federal Business Law

Antitrust is a ***business activity that attempts to monopolize, contract, or conspire (or any of these things together) in a way that negatively impacts another's ability to do business.*** The earliest antitrust laws came from the Sherman Antitrust Act, followed later by the Federal Trade Commission Act and the Clayton Antitrust Act. These concepts continue to be address via the U.S. Department of Justice through court decisions. We'll also look at some provisions of the Real Estate Settlement Procedures Act (RESPA) related to business relationships and kickbacks.

You will learn:

- The origins of federal antitrust laws.
- How to recognize and avoid specific antitrust violations.
- Penalties for violating antitrust laws.
- What actions constitute an illegal kickback.
- Requirements for disclosing affiliated business relationships.

Key Terms

Affiliated Business Arrangement
Antitrust
Group Boycotting
Kickback
Market Allocation
Price-Fixing
RESPA
Tie-In Arrangement

Antitrust Laws

Antitrust laws regulate business activities in general, concluding that *any restraint* of trade practices are so injurious to competition that they could never be justified as anything but unreasonable and, therefore, *illegal*.

Sherman Antitrust Act

The **Sherman Antitrust Act** of 1890 was the first federal law outlawing practices considered harmful to consumers, such as monopolies. At the time, large corporations accused of anticompetitive practices were organized as trusts, hence the name. Of primary concern with this law is **collusion** between two or more persons or organizations to limit competition, set artificial price controls, or—through fraud or misrepresentation—attempt to gain an unfair advantage. Although it was a first step, the law was not robust and was difficult to enforce.

Clayton Antitrust Act

The **Clayton Antitrust Act** of 1914 was passed to enhance the Sherman Antitrust Act by prohibiting specific anticompetitive practices. For example, it bans mergers and acquisitions as well as price discrimination that lessens competition and creates a monopoly in any line of commerce. It also provides for more stringent penalties.

The Illinois Consumer Fraud and Deceptive Business Practices Act

815 ILCS 505/7

Patterned after Section 5 of the Federal Trade Commission Act, many states have Unfair or Deceptive Acts or Practices (UDAP) laws which address unethical or bad business practices and consumer complaints. Under the provisions of the Illinois Consumer Fraud and Deceptive Business Practices Act:

- Whenever the Attorney General or a State's Attorney has reason to believe a violation under the Act has occurred involving an unlawful method, act, or practice and that proceedings would be in the public interest, he or she may bring an action to **restrain by preliminary or permanent injunction** the use of such method, act, or practice.
- The Court, in its discretion, may exercise all powers necessary, including but not limited to: **Injunction; revocation, forfeiture** or **suspension** of any **license** or other evidence of authority of any person to do business in the State; and restitution.
- The Illinois Attorney General or State's Attorney may request and the Court may impose a civil penalty **up to $50,000** against any person found by the Court to have engaged in any unlawful method, act, or practice.
- If the victim of the unlawful method, act, or practice is age 65 or over, the Attorney General or State's Attorney may request and the Court may impose a civil penalty **up to $60,000.**
- Anyone who has suffered actual harm is allowed to recover actual damages and punitive damages, plus attorney's fees.

Antitrust Violations

An antitrust violation can occur in seemingly innocent situations. Often generating from a discussion or through conversation, the interchange can quickly spiral into a liability trap. Here are some common instances of antitrust violations a real estate licensee may encounter.

Price Fixing

Antitrust problems most frequently arise out of agreements—conspiracies, really—among competitors which have the purpose or effect of eliminating or restricting competition between the parties to the agreement. A common subject of such agreements is the price or fee each competitor charges its customers for its products or services. Real estate brokerage firms are no different, and in the real estate profession, that usually means commission rates.

The antitrust prohibition on **price fixing** means that *two or more real estate firms may not agree on the commission rate that each will charge.* Brokers must not agree with others on commission rates, and must take care to avoid even implying that they have discussed or reached agreement on fees. Licensees must exercise similar caution: Discussing (or even casually mentioning) commission rates among competitors is a violation of antitrust laws against price fixing.

Another common liability that could arise from the things licensees say is when a potential seller asks what a standard commission is for a particular area. A standard commission rate does not exist! Commission rates are set by individual brokerages as part of an independent business decision. It would be a violation of antitrust laws to even suggest there is a standard commission.

Group Boycotting

A boycott is a *concerted refusal to deal with a particular party*, such as when two or more businesses agree to refuse to deal with another competitor in order to force a change in a competitor's behavior or to attempt to drive the competitor out of business.

The typical group boycott allegation in the real estate brokerage business involves a claim that **two or more real estate firms** have agreed to refuse to cooperate, or to cooperate on less favorable terms, with a third firm. Often the target of the alleged boycott is a broker that employs a "discount," "alternative," or other nontraditional commission/compensation arrangement with clients. The purpose of the boycott, either explicitly or implicitly, is to eliminate the firm as a competitor in the market, or to cause the firm to abandon the discount or alternative marketing strategies. The antitrust laws clearly make boycotts such as these illegal.

Boycotting Service Providers

Real estate firms or professionals may also be accused of boycotting service providers or suppliers to the real estate firms, for example by refusing to place advertising in certain publications. Concerted refusals to deal are illegal whenever they involve the purposeful elimination or limitation of competition, regardless of the ultimate motive or objective of the alleged conspirators. The most effective and obvious way to avoid antitrust liability for such boycott activities is for each firm to unilaterally and without consulting any other firm determine the service providers it will use and the terms and conditions of using such suppliers.

Market Allocation

Two or more brokers who conspire to divide their customers in any way are guilty of violating antitrust laws against **market allocation**. It could be that they've agreed to split their city into specific territories, or perhaps they've each agreed to handle properties within a certain price range or neighborhood. Even if the agreement seems logical, these actions could result in a restraint on trade because it limits the choices of the consumer, and *any* restraint on trade is illegal.

Tie-In Arrangements

If a real estate broker requires the consumer, as a condition of a transaction, to use, or not use, a particular service or product, it could constitute a **tie-in arrangement** that would violate antitrust regulations. A classic example is when a broker requires a buyer to use a certain inspection company, lender, or other service provider as a condition of an exclusive buyer agreement.

Disparaging the Competition

It's tempting for many people to puff themselves up by putting someone else down. You see it all the time in politics, in business, in the schoolyard. But that activity really has no place in a professional business environment, including the real estate industry. False, misleading, or negative comments about a competitor to a client, customer, or fellow licensee is, at best, gossip and could even land you in hot water.

An untruthful spoken statement about a person that harms his or her reputation or standing in the community is considered **slander**, and the slandered person could bring a civil lawsuit against the person who made the false statement under the Clayton Antitrust Act if such statements negatively affected that person's business.

Antitrust Awareness	
Violation	**Phrases to Avoid**
Price Fixing	• "This is the rate every firm charges." • "I'd like to lower the commission, but no one else in the MLS will show your house unless the commission is X%." • "Commission rates are pretty standard."
Group Boycotting	• "Before you list with XYZ Realty, you should know that nobody works on their listings." • "The MLS will not accept their listings because they charge a flat fee." • "If they were truly professional, they would not allow part-timers to work for them." • "I bet they'd drop their 'discount' program if we told them they couldn't market or sell our listings."
Market Allocation	• "It could save us both a lot of gas if your firm would concentrate on the north side and ours concentrated on the south side."
Tie-In Arrangements	• "If I'm going to submit an offer for you, I need you to use XYZ Home Inspectors." • "I only work with ABC Insurance Company, so you need to call them before we proceed."
Disparagement	• "You don't want to list with ABC Realty; they don't know how to close a deal."

Penalties for Antitrust Violations

Violating the state or federal antitrust law is a serious offense. Penalties under federal statutes include the following:

- Felony conviction
- Fines not to exceed $350,000 (for individuals)
- Fines up to $10 million (for corporations)
- Imprisonment not to exceed three years

In addition, any person whose business or property has been injured by anyone violating these antitrust laws may sue and recover **triple** the damages plus any reasonable attorney fees. And since any violation of these laws is considered a **criminal** offense, liability insurance cannot protect an offender.

Real Success

Antitrust is a fairly complicated subject and applies to many industries and professions. The nature of real estate practice makes real estate licensees particularly susceptible to antitrust challenges. Licensees vigorously compete to secure property listings to offer for sale, but they also regularly cooperate with one another, as subagents, buyer's agents, or broker's agents, to identify ready, willing, and able buyers for those listings. This dual tradition of competition and cooperation, which exists in few other professions, presents opportunities for antitrust misconduct, whether intentional or inadvertent. When engaging in real estate, you must ***never*** behave in such a way as to limit the consumer's choices.

The final word of advice for real estate licensees, or potential licensees, is ***never*** take part in an event, meeting, or even informal conversation where the discussion can be construed as an antitrust violation. You should not remain in a situation where suggestions of price-fixing, group boycotts, market allocation agreements, or tie-in arrangements are being discussed or even being subtly suggested.

Openly object to this type of conversation and physically remove yourself from the situation. Most often, **silence is not a defense in an antitrust accusation**. Failure to take action can potentially put you and your managing broker at the core of wrongdoing. **Any hint of an antitrust violation should be reported to your managing broker immediately.**

Real Estate Settlement and Procedures Act

The federal **Real Estate Settlement Procedures Act**, also known as RESPA, was passed by Congress in 1974 and implemented as Regulation X to protect consumers by disclosing actual closing costs in a timely manner. RESPA applies to loans for real estate transactions for one- to four-family residences (including condominiums and cooperatives). RESPA defines settlement services as *any service provided in connection with a prospective or actual settlement*, including, but not limited to, any one or more of the following:

- Services by a real estate agent or real estate broker
- Any services related to the origination, processing, underwriting, or funding of a mortgage loan, including service by a mortgage broker
- Title services, including title searches, title examinations, abstract preparation, insurability determinations, and the issuance of title commitments and title insurance policies
- Services by an attorney
- Preparation of documents, including notarization, delivery, and recordation
- Rendering of credit reports and appraisals
- Inspections, including inspections required by applicable law or any inspections required by the sales contract or mortgage documents prior to transfer of title
- Conducting of settlement by a settlement agent and any related services
- Services involving mortgage, hazard, flood, or other casualty insurance or homeowner's warranties
- Services involving real property taxes or any other assessments or charges on the real property
- Any other services for which a settlement service provider requires a borrower or seller to pay

RESPA prohibits a "required use" of specific settlement service providers, with some exceptions for lenders.

Kickbacks for Referrals

Section 8 of RESPA prohibits giving or accepting a fee, **kickback**, or anything of value in exchange for referrals of settlement service business. RESPA defines a "thing of value" very broadly, and it can include any of the following:

- Money or things
- Discounts
- Salaries, commissions, earnings, or fees
- Distribution of partnership profits or franchise royalties
- Credits representing money paid at a future date
- The opportunity to participate in a money-making program
- Special bank deposits or accounts, special or unusual banking terms
- Services, sales, or leases of all types at special or free rates
- Lease or rental payments based in whole or in part on the amount of business referred
- Trips and payment of another person's expenses
- Reduction in credit against an existing obligation

A thing of value does *not* include things of minimal value used for promotional purposes, such as pens, mementos, coffee cups, hats, etc.

Fee-Splitting and Unearned Fees

RESPA also prohibits fee-splitting and receiving unearned fees or a percentage of any charge made or received for services **not actually performed**. The following payments, however, are allowed:

- Payment of fees to attorneys, title companies, or agents for service actually performed.
- Payment of a bona fide salary or compensation to a person for goods or products actually furnished or services actually performed in the making of a loan.
- Payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers.

Legitimate Discounts

RESPA allows **legitimate discounts** on services to consumers if a combination of settlement services is offered at a total price lower than the sum of the individual settlement services, as long as:

- The use of any such combination is **optional** to the purchaser, and
- The lower price for the combination is **not made up by higher costs** elsewhere in the settlement process.

Affiliated Business Arrangements (AfBAs)

While kickbacks from referrals are prohibited, RESPA does recognize the legitimacy of affiliated business arrangements involving real estate settlement services. An **affiliated business arrangement** is a situation where a person in a position to refer settlement services—or an associate of that person—has either an affiliate relationship with or a direct or beneficial ownership interest of more than **1%** in a provider of settlement services and who then refers business to that provider or in some way influences the selection of that provider. Within the scope of this definition, a "person" could be an individual or a corporation, association, partnership, or trust. The term "associate" refers to someone who has one or more of the following relationships with a person in a position to refer settlement business:

- A spouse, parent, or child of that person
- A corporation or business entity that controls, is controlled by, or is under common control with such person
- An employer, officer, director, partner, franchisor, or franchisee of that person

- Anyone who has an agreement, arrangement, or understanding with that person when the purpose or substantial effect of which is to enable that person to benefit financially from the referrals

How someone with ownership interest receives compensation for settlement services is important under RESPA. Legitimate fees or wages for **services actually rendered** or hours worked are permissible. Additionally it is permissible to accept **bona fide compensation** from the ownership interest or franchise relationship between entities in an affiliate relationship, as long as it is for ordinary business purposes and is not a fee for the referral of settlement service business or an unearned fee.

Affiliated Business Arrangement (AfBA or ABA) Disclosure

This is required whenever a settlement service provider involved in a RESPA covered transaction refers the consumer to a provider with whom the referring party has an ownership or other beneficial interest. The referring party must give the **AfBA disclosure** to the consumer **at or prior to the time of referral**. The disclosure must describe the business arrangement that exists between the two providers and give the borrower an estimate of the second provider's charges. Except in cases where a lender refers a borrower to an attorney, credit reporting agency, or real estate appraiser to represent the lender's interest in the transaction, the referring party may not require the consumer to use the particular provider being referred.

Seller Required Title Insurance

Section 9 of RESPA prohibits a seller from requiring the homebuyer to use a particular title insurance company, either directly or indirectly, as a condition of sale. Buyers may sue a seller who violates this provision for an amount equal to **three times** all charges made for the title insurance.

Penalties for RESPA Violations

RESPA subjects violators to the following criminal and civil penalties:

- Fines up to $10,000
- Imprisonment up to one year
- Liability up to three times the amount of the charge paid for the service (civil lawsuit)

RESPA Awareness	
Violation	**RESPA Violation?**
A title insurance agency tells a real estate broker that they will give the broker a fax machine if she refers five buyers to them for title insurance. The purpose of the fax machine is to help the broker communicate with the title insurance agency. Is this a violation of RESPA?	Yes. Why did they give them the fax machine? Because they sent them five pieces of business. This could be considered a kickback.
Motley Home Builders has asked Zach to use Acme Title Insurance Company because the builder has a long-standing agreement with the title company. Is the builder violating RESPA requirements by doing this?	No. It would be a violation to require Zach to use a preferred title company, but it's not a violation to ask. There are many issues with a new build, which is why the builder might recommend a specific title company who already has all of the necessary information.
XYZ Agency encourages buyer clients to employ attorney Bob to perform title searches and related settlement services in connection with their transaction. XYZ and Bob have an understanding that in return for the referral of this business, Bob provides legal services to XYZ's agents and employees at abnormally low rates or for no charge. Since the buyer is not required to use the attorney, is anyone in violation of RESPA?	Both the attorney and the agency are in violation of RESPA since they are rendering of something of value in exchange for the referral. RESPA defines a thing of value to include any payment, advance, funds, loan, service, or other consideration. That definition also includes discounts or credits representing money and services at special or free rates.

Summary

1. **Antitrust** laws are intended to combat any restraint on trade. Antitrust issues in real estate include **price-fixing, group boycotts, market allocation agreements, tie-in arrangements,** and **disparaging the competition.** Discussing commission rates among competitors is potentially price-fixing. Commission rates are set independently by each broker; therefore, there can be no standardized rate among competitors or members of any organization.
2. Penalties for antitrust violations under federal statutes include: Felony conviction, fines not to exceed $350,000 (for individuals) or up to $10 million (for corporations), imprisonment not to exceed three years. Licensees should report any potential antitrust violation to their brokers immediately. Silence is no defense for an accusation of antitrust violations.
3. The **Real Estate Settlement Procedures Act**, also known as RESPA, prohibits giving or accepting a fee, **kickback**, or anything of value in exchange for referrals of settlement service business. RESPA also prohibits fee-splitting and receiving unearned fees or a percentage of any charge made or received for services not actually performed.
4. RESPA does allow **affiliated business arrangements** involving referrals of real estate settlement services as long as the referring party gives the **AfBA disclosure** to the consumer **at or prior to the time of referral**.
5. RESPA prohibits a seller from requiring the home buyer to use a particular title insurance company, either directly or indirectly, as a condition of sale.

Quiz

1. ***Antitrust laws are in place to ensure that***
   a. all monies in financial transactions are accounted for.
   b. competition in the marketplace is fair and unrestrained.
   c. licensees have a minimum level of education and training to protect the public.
   d. no one is discriminated against because of race, sex, or national origin.

2. ***Of these federal laws, which was the first to address monopolies in business?***
   a. Civil Rights Act
   b. Clayton Antitrust Act
   c. Federal Trade Commission Act
   d. Sherman Antitrust Act

3. ***Brokers Rob and Bonnie are having dinner when Bonnie mentions she's having trouble getting listings in a particular part of town. Rob says he's happy to handle all the listings in that neighborhood if she agrees to quit trying to land clients there. In exchange, he'll send prospective clients her way if they live closer to her business. This is an example of***
   a. boycotting.
   b. market allocation.
   c. price-fixing.
   d. tying in.

4. ***If you have a client who questions your firm's commission fee, you should NOT***
   a. defend your firm's prices and other competitive business decisions in terms that are consistent with competition, not conspiracy.
   b. present prices to the client in a manner that confirms the fees were established independently.
   c. point out the value of the services your client will receive for the fee charged.
   d. refer to the pricing policies of the local association of REALTORS®.

5. ***Gary is one of three brokers recently convicted of illegal boycotting. What did Gary and his fellow co-conspirators do?***
   a. They agreed to charge the same commission for specific services.
   b. They divided up their town into four quadrants so that each could focus on their specific area.
   c. They decided to avoid showing clients homes listed by Discount Dan.
   d. They included a clause in their listing contracts requiring clients to use AAA Co. as their home inspector.

6. ***At a local convention of real estate licensees, broker Dan mentioned that he was going to have to raise his commission rates or close his office. Dan could be found guilty of***
   a. allocation.
   b. price-fixing.
   c. securities violations.
   d. nothing; he did not violate any rules or laws.

7. ***Which of these phrases would LEAST LIKELY be evidence of conspiracy to commit an antitrust violation?***
   a. "If you list with us, just be aware that we will use only YES Title for the closing."
   b. "Let's do something about her discount fee policy."
   c. "Our agency charges 6%. If you want to pay less, you'll have to talk to the managing broker."
   d. "You can have the listings north of Broad Street, and I'll take the ones south of Broad."

8. ***Spencer is interested in listing his house with licensee Terry because she is very successful. Terry knows that to show well, the walls need to be painted and the carpet needs to be replaced. She tells Spencer she'll take the listing as long as he uses Ultimate Remodeling to do the work. Did Terry do anything wrong?***
   a. No, if Spencer is OK about using Ultimate, Terry didn't do anything wrong.
   b. No, she didn't do anything wrong as long as she doesn't accept a fee from Ultimate.
   c. No, she doesn't have to accept the listing if she does not want to.
   d. Yes, Terry could be guilty of promoting an illegal tie-in arrangement.

9. ***A real estate broker rents office space from a title company at a discount in exchange for referring customers for settlement services. Which federal law does this arrangement violate?***

   a. Federal Trade Commission Act
   b. RESPA
   c. Sherman Antitrust Act
   d. It does not violate any federal law.

10. ***Donna, a licensed real estate broker, receives a fee for every client she refers to a mortgage company that results in loan. Is this permitted?***

   a. No, this is not permitted under RESPA.
   b. Yes, it's permitted if she discloses the fee arrangement to the client when she makes the referral.
   c. Yes, it's permitted if she discloses the fee arrangement to the client before the sale is finalized.
   d. Yes, it's permitted as long as she does not require the client to use that mortgage company.

11. ***Jason, a real estate broker, also owns the mortgage company his buyer chooses. Which of the following is true under RESPA?***

   a. Jason must advise his buyer to select a different mortgage company.
   b. Jason may refer the buyer to his mortgage company as long as he discloses his interest in the company to the buyer.
   c. Jason may not refer buyers to his mortgage company, but if the buyer chooses the company independently, this is permitted, as long as Jason discloses his interest in the company.
   d. Jason may not refer buyers to his mortgage company, but if the buyer chooses the company independently, Jason has no obligation to disclose his interest in the company.

12. ***Pam really wanted seller Sam to accept her offer for his house. He told her he would sign the sales contract as long as she used the services of attorney Julie for the settlement. Julie's fees seemed to be reasonable ($450), so Pam agreed. Later, she learned that Julie and Sam were partners in the same law firm. Can she sue?***

   a. No, the fees were reasonable and Pam agreed, so she has no standing to sue.
   b. No, but she can file a complaint. If found guilty, Sam can be fined.
   c. Yes, she can sue Julie for $450 for accepting fees under false pretenses.
   d. Yes, she can sue Sam for $1,350 for non-disclosure.



UNIT 2

REAL ESTATE AGENCY

Chapter 5 – Agency Relationships

Chapter 6 – Agency Obligations in Illinois



5 Agency Relationships

Agency is a relationship of trust created when one party gives another the right to represent him in dealings with third parties. This is a consensual relationship that both enter into willingly. When buyers or sellers hire a licensee to represent them in a real estate transaction, for example, an agency relationship is created. The individual authorized to represent the client, therefore, is known as the **agent**. The two terms agency and brokerage represent two distinct concepts, although in some ways the functionality overlaps. The term **agency** alludes to a relationship between a principal and a party representing her interests. **Brokerage** is a business concept premised primarily on bringing parties together for the purpose of a transaction. In this chapter, you will examine critical concepts related to agency and see the types of agency relationships recognized in the State of Illinois.

You will learn:

- The basic duties that any agent owes his or her clients.
- How an agency relationship is formed.
- Levels of authority an agent may have.
- How to identify legal forms of agency in Illinois.
- Circumstances that may terminate the agency relationship.

Key Terms

Accountability
Agency
Brokerage
Buyer's Agent
Client / Principal
Confidentiality
Customer
Designated Agency
Disclosure
Dual Agency
Expressed Agency
Fiduciary Relationship
General Agent
Gratuitous Agency
Implied Agency
In-House Transaction
Loyalty
Obedience
Offer of Cooperation
Reasonable Care
Seller's Agent
Selling Agent
Single Agency
Special Agent
Subagent
Undisclosed Dual Agency
Universal Agent
Vicarious Liability

The Agent as Fiduciary

In the most general sense, the relationship between an agent and a principal can be described as a **fiduciary relationship**, which is *one of trust and confidence where one party owes the other (or both parties owe each other) a higher standard of good faith than they owe to third parties or customers*. The fiduciary role is that of an **advocate**, and the agent owes such duties *only to the client*. Fiduciary duties provide a benchmark of expected performance for someone entrusted with the role of an agent.

Client or Customer?

The party granting the right of representation through an agency relationship, such as in a real estate transaction, is known as the **client** or **principal** in the relationship. A third party to a transaction whom the agent works *with, but not for,* is considered a **customer** of the agent. Real estate licensees must take great care not to use the terms *client* and *customer* out of context or improperly, as it may imply a relationship not yet established.

Common Law Fiduciary Duties

Common law defines basic fiduciary duties that an agent owes a client in any agency relationship. So you do not get "rusty" in recognizing an agent's basic fiduciary duties, it might help to remember them with the acronym OLD CAR.

Obedience. An agent *must follow the legal instructions of the principal, obey the parameters of the agency relationship, and not stray beyond the scope of his authority*. If agents do not follow this duty, they could be held liable to the principal for losses. Of course, if the principal gives his agent an illegal instruction, such as telling him to discriminate against a potential buyer, the agent must *not* follow it.

Loyalty. The agent *must put the principal's interests above all others', including his own.* For example, a seller client is willing to accept the first offer on her house, even though it is on the low end. The agent talks the client out of accepting the offer, knowing that it means a lower commission. In this case, the agent put his own interests above those of his client.

Disclosure. An agent must make a complete disclosure of any material fact. A **material fact** is *something that could affect someone's decision regarding the transaction if it were known*.

Confidentiality. To keep from destroying the integrity of the agency process, an agent can neither reveal confidential information nor take advantage of it for personal benefit.

Accountability. The duty of financial accountability recognizes that *money received in an agency relationship is received on behalf of the principal, not the agent.* Since an agent acts on behalf of the principal, the agent has the duty to strictly account for any amount received.

Reasonable Care. Agents must always use reasonable care, skill, and diligence when acting on behalf of a client. The agent is viewed as a professional and an expert. A form filled out incorrectly or a law misunderstood could cause problems for a client. If a client loses money due to an agent's incompetence or carelessness, the agent can be held liable for **negligence**, which is an unintentional breach of a legal duty.

An agent owes these duties to a client, but *not* to a customer in a real estate transaction. While an agent owes customers and other third parties the duty of honesty and fairness, the agent is not required to advance the customer's interests. For example, a seller's agent owes no loyalty to the buyer customer. The agent's duty of loyalty to his seller client prohibits this.

The specific statutory obligations of a licensee to a client as defined in the Illinois Real Estate License Act are covered in detail later.

Levels of Agency Authority

Actual authority is power or permission given intentionally to an agent by the principal. **Express authority** is power or permission for a specific act or outcome communicated by the principal to the agent. **Implied authority** (or incidental authority) is the authority to do everything reasonably necessary to carry out the principal's express orders, within the limits of the law.

Throughout the relationship with their clients, agents must take care not to exceed the boundaries of the authority granted by the principal. A broker representing a seller as a listing agent, for example, is within his scope of authority to market the property by conventional practices in an effort to locate a ready, willing, and able buyer. Typically, without specific consent, however, an agent cannot:

- Sign contracts or other documents on behalf of the client.
- Place advertising or list the property in a Multiple Listing Service.
- Negotiate terms, such as price, concessions, possession, personal property, etc.
- Make decisions on behalf of the client as to the quality of an offer or a potential buyer.

Generally speaking, an agent would have various levels of authority depending on their role, for example, as an executor, trustee, attorney-in-fact, real estate agent, etc. The level of authority is reflected by the responsibility and specific level of service necessary to represent the client.

Typical Agency Relationships in Real Estate

Client/Principal	Agent	Agent Authority
Homeowner who wants to sell his house or landlord who wants to rent apartment units	Listing broker	Special agent
Someone looking for a house to buy or apartment to rent	Buyer's broker	Special agent
Sponsoring broker	Affiliated licensees	General agent
Owner of an apartment building wanting someone to supervise the property and tenants	Property manager	General agent

Universal Agent

A **universal agent** is authorized to do *anything and everything that can be lawfully delegated to a representative.* For example, a universal agent may be created through the granting of a power of attorney, which allows the attorney-in-fact to do most everything the person granting that authority could do (sell assets, make purchases, sign legal documents, etc.), with no prior approval to act. Appointment as a universal agent could last for an indefinite period of time—until the authority is revoked or the person granting the authority dies, for example—or for a defined or limited period of time. Real estate agents are rarely considered universal agents.

General Agent

A **general agent** is authorized to *represent the principal in a broad range of specified matters, usually as part of a long-term relationship*. A **real estate broker** is actually a general agent of his or her sponsoring broker. The sponsoring broker, the principal in that employment relationship, gives general authority to his agents to conduct real estate business. Another good example is a property manager who, as a general agent, might have the authority to perform designated tasks involved with managing the property, such as renting units, advertising, collecting rents, paying bills, and arranging for maintenance, while the property owner, the principal, reserves some of the authority for himself, such as hiring employees.

Aside from an employment scenario, a limited power of attorney could also create a general agent role in which the attorney-in-fact is granted limited authority to perform specific tasks. For example, someone who is transferred out of state and must sell his house might give a friend or relative limited power of attorney to sign all closing documents in his absence.

Special Agent

A **special agent**, also called a limited agent, has *limited authority to perform a specific task or conduct a specific transaction*. This is generally a short-term relationship. For example, when a real estate broker is contracted by a client to sell a house, the broker is considered a special agent. In this role, authority is limited and narrow (i.e., marketing activities, access to show the property, locating a buyer for the property or a property for a buyer).

Agency Coupled With an Interest

You may encounter the concept of **agency coupled with an interest**. This is when the ***agent holds an ownership interest in the property being sold.*** For example, a real estate broker and a developer become business partners in a subdivision project. The broker puts up $2 million for the project and has an agency contract giving him the exclusive right to list the finished homes. The broker gets commission on the sale of each home, as specified in the listing agreement, as well as a split of the profits, as specified in the partnership agreement. Because the broker made an investment in the project, the developer partner cannot terminate the agency relationship. Also, an agency coupled with an interest is not terminated by the death, incompetence, or bankruptcy of the principal.

Creation of Agency

Most commonly in a real estate transaction, an agency relationship is formed through a **contract between the agent and the principal,** for example, a listing agreement between a broker and a seller, or a buyer representation agreement between a broker and buyer, both of which will be covered in great detail later. Such **expressed agency** is the most airtight and preferred method of creating any agency relationship. The advantage to a written agreement is that it is more easily enforceable and it spells out the expectations of all parties in the relationship.

According to the Illinois Real Estate License Act, the payment or promise of compensation to a licensee is **not** in and of itself an indicator of whether an agency relationship has been created between a consumer and that licensee *(225 ILCS 454/15 40)*. For example, a licensee who has a buyer client is typically compensated by the seller, but that **does not create an agency relationship** between the licensee and the seller.

Implied Agency

Implied agency is created *through the actions or words of one or both parties.* When a real estate agent *behaves* as if he is an agent for a party in a transaction, for example, it is possible that a consumer will interpret it as an agency relationship. Implied agreements are difficult to enforce and often lead to confusion and misunderstanding between the parties. The hazards of an implied agency relationship are compounded when the result can be an undisclosed (and non-consensual) dual agency, which is discussed in more detail later.

Gratuitous Agency

Just as the payment of compensation does not create an agency relationship, the absence of payment of compensation does not mean that no agency relationship exists. An agent may choose to offer his or services free of charge, for example, a licensee who lists his mother's home for sale and does not accept commission for his services. A situation such as this is referred to as **gratuitous agency**. Although compensation is not part of the agreement, the agent is **not released** from his statutory obligations to his client.

Agency Relationships Within a Brokerage

Up to this point, the discussion has mostly focused on the concepts of agency as they apply to the broker-client relationship. But the sponsoring broker's association with his or her affiliated licensees is also a form of agency. As you know, a real estate licensee may not work independently of his or her sponsoring broker and, in fact, can function only with the consent of the sponsoring broker with whom he or she is associated. A sponsored broker cannot independently:

- Enter into listing agreements or other contracts to represent people,
- Conclude a sale,
- Receive a commission, or
- Advertise.

All of these actions must be done in the name of the sponsoring broker. Therefore, when a sponsoring broker gives authority to an affiliated licensee to act on behalf of the brokerage, the **affiliated licensee becomes a general agent of his or her sponsoring broker**, who is the **principal** in the broker-licensee relationship. The affiliated licensee is the agent, and all duties of good faith and loyalty that are due to clients must also be observed with the sponsoring broker.

Vicarious Liability

Since an agent's authority always comes from the principal, in this case, the sponsoring broker, when an affiliated licensee acts within the scope of his or her authority, the sponsoring broker is legally liable for the licensee's acts. This concept is known as **vicarious liability,** *liability that is created because of the relationship between a principal and the actions of an agent who is actually liable.* So, a third party can sue the sponsoring broker instead of, or in addition to, an agent. But if an affiliated licensee exceeds his or her authority, the sponsoring broker may or may not be liable, depending on whether the sponsoring broker was aware of any transgression.

When the principal in question is a seller or buyer client of a real estate brokerage, the concept of vicarious liability becomes void. Under Illinois law *(225 ILCS 454/15-60)*, a **consumer cannot be held vicariously liable** for the acts or omissions of a licensee who is providing licensed activities on or behalf of that client.

Single Agency

The most basic form of real estate agency is when **one agent** of a brokerage represents just **one party** in a specific transaction. You may see this referred to as "single agency," "principal agency," or "traditional agency." This simple relationship leaves little room for confusion about who represents whom.

In the past, this traditional agency was reserved for sellers; buyers were left to fend for themselves. Even when a buyer contacted a broker to assist him with finding a home, the buyer's interests were likely not represented. This fact may not have been clear to the buyer, who probably assumed the broker represented him. In today's real estate market, most brokers are willing to represent both sellers *and* buyers. In a single agency transaction, however, the broker represents *either* the buyer or the seller, but never both at the same time.

Seller Agency

An agency relationship between a seller and a sponsoring broker is created with a listing agreement. A **listing agreement** is a *written agency contract between a seller and a real estate broker stipulating the broker will earn a fee for finding a ready, willing, and able buyer for a seller's property.* The role of a **seller's agent** is fairly clear: *When representing only the seller in a transaction, the agent owes all loyalties to that seller client.*

Buyer Agency

Most brokers today see the advantages of providing specific representation to buyers, and buyer's agency is becoming more and more common. When a buyer contracts with a broker to assist in the purchase of a home, the buyer is the principal.

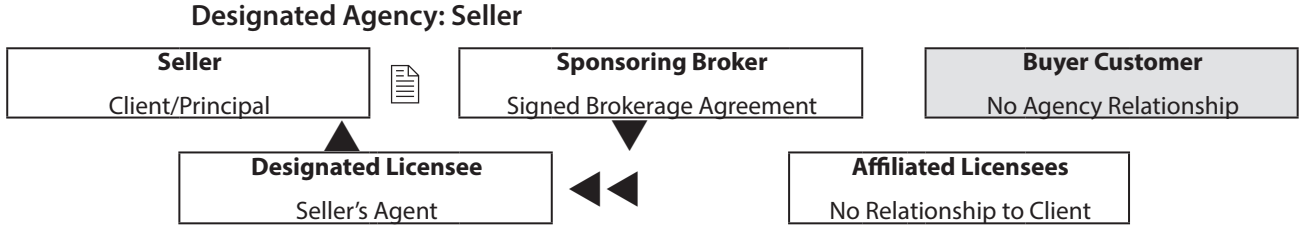
An agency relationship between a buyer and a licensee in a real estate transaction can be created with a document such as a buyer brokerage agreement, which may also be called a buyer representation agreement, among other names. A **buyer brokerage agreement** is a *written agency contract between a buyer and a real estate broker stipulating the broker will be paid a commission when the buyer purchases real estate.*

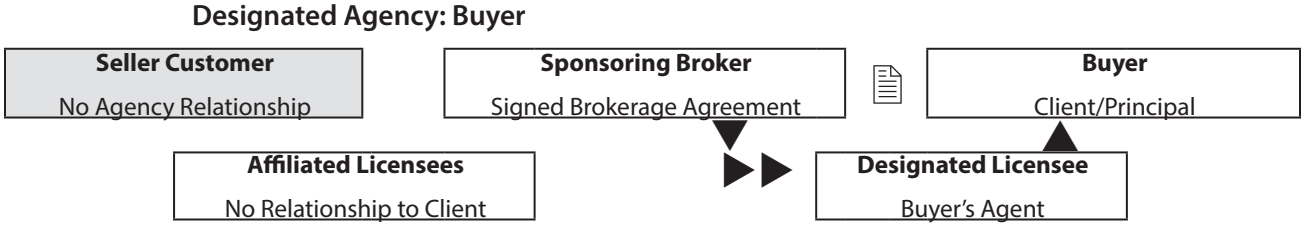
Buyer's agents owe all loyalties to the buyer in a real estate transaction. A buyer's agent should employ all legal means to discover pertinent information about the seller. In order to avoid legal liability, buyer's agents should perform this task as diligently as if the agent himself were buying the property.

Designated Agency

225 ILCS 454/15-10

Designated agency came about as a way to deal with complications inherent in having all affiliated licensees become agents of every client of their sponsoring broker. To create this relationship, when the sponsoring broker enters into an agency agreement with any person—buyer or seller, lessee or lessor—the sponsoring broker must delegate the authority to act as the legal agent of the client to one or more affiliated licensees **to the exclusion of any other affiliated licensee.**



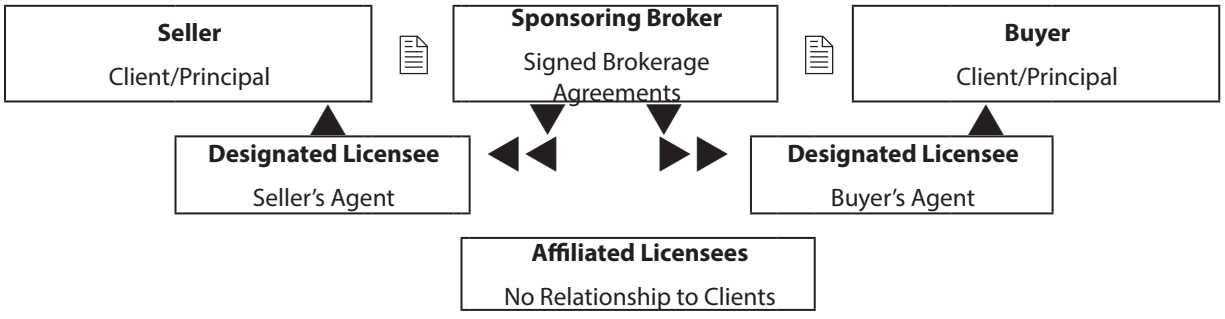


When a licensee is performing only clerical or administrative tasks for the consumer, however, no agency relationship exists. This situation may be called non-agency, assuming proper disclosure was made.

In-House Transactions

When possible, sponsoring brokers like to keep transactions within the brokerage, called "in-house" transactions. This occurs when the brokerage procures a buyer for one of its listed properties. While financially it benefits the sponsoring broker, since it's not necessary to split the commission with other brokerages, licensees must understand their agency role in an in-house transaction, as risk and liability can be created if all licensees are not performing their statutory obligations.

Designated Agency: In-House Transaction



When the buyer is simply a **customer**, he or she does *not* have representation, and no agents within the brokerage owe that buyer the same fiduciary obligations that are due a client. The brokerage and its licensees have a duty to be fair and honest, as well as to disclose all latent material adverse facts.

Dual Agency

When both the seller and buyer are clients of the brokerage, however, a **dual agency** situation may exist. Generally speaking, **dual agency** refers to *a single licensee who represents both a buyer and seller in the same transaction.* A dual agent owes statutory duties to both buyer and seller, but must remain **neutral** at all times. A dual agent must be careful not to disclose confidential information from one party to the other party, for example, especially with regard to price or any other matter that may have an adverse affect on one of the parties.

While the State of Illinois allows for dual agency in general, individual brokerage companies may or may not allow licensees to assume the role of dual agents. It is at the discretion of the brokerage whether or not its licensees may practice dual agency.

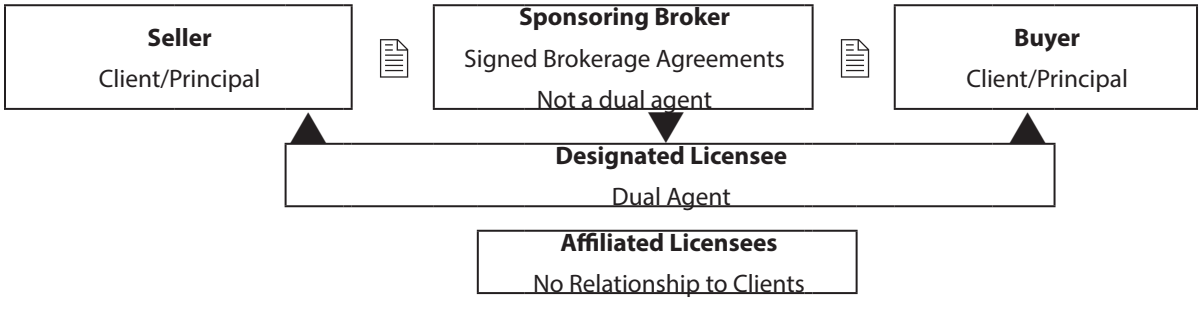
Dual Agency with a Designated Agent

When a brokerage secures both the seller client and the buyer client in the same transaction, the State of Illinois allows a sponsoring broker to appoint specific designated agents to *advocate separately for the buyer client and the seller client in negotiating the transaction.* If the sponsoring broker appoints one licensee to represent the seller client and a different licensee to represent the buyer client in the same real estate transaction, under Illinois law, **no one**, including the sponsoring broker, is considered a dual agent.

If the brokerage practices designated agency, and the **same** affiliated licensee is appointed to represent **both** the buyer client and the seller client in a real estate transaction, the designated agent would be considered a dual agent, but other affiliated licensees would **not** be agents of the clients in any way.

A sponsoring broker could permit one or more of its sponsored licensees to act as dual agents in the same transaction.

Dual Agency with a Designated Agent



Risks of Dual Agency

Critics of dual agency accurately point out that these arrangements create an **inherent conflict of interest**. A seller is looking for the highest price, while the buyer is looking for the lowest price. It is sometimes difficult, if not impossible, to adequately represent these two opposing interests. Since this type of agency relationship might not be acceptable to one or both parties, it requires the **informed written consent of both clients**. The disclosure requirements will be covered in detail later.

Undisclosed Dual Agency

Undisclosed dual agency occurs when *both principals in the same transaction are represented by an agent without full disclosure to and approval from both clients*. This could unintentional, for example, a designated seller agent shows a listing to a buyer client before confirming whether or not both the buyer and seller consented to dual agency.

The risks a sponsoring broker and affiliated agent face for acting as undisclosed dual agents are serious under Illinois license law, including:

- Loss of license or other disciplinary action.
- Loss of a commission associated with the transaction.
- Possible liability (should there be damages due to a rescinded transaction).

Limits on Dual Agency

Rules: Section 1450.820

According to the Administrative Rules of the Illinois Department of Financial and Professional Regulation, a licensee is **prohibited** from acting as a dual agent for any transaction in which:

- The licensee is a party to the transaction.
- An entity in which the licensee has an ownership interest is a party to the transaction.

Cooperative Transactions

Sponsoring brokers who list property commonly extend offers to outside brokerages to sell listed property to outside buyers. When a sponsoring broker submits a property listing to a Multiple Listing Service (MLS), the act constitutes a unilateral blanket **offer of cooperation**, *an open invitation to other brokers to sell property listed by another broker*. Outside brokers might bring buyers who are either customers or clients, depending on how that relationship was formed within their brokerage.

Multiple Listing Service

The **Multiple Listing Service** was created so that brokers could have a common place where they could share all property listings, exposing them to a broader market of prospective buyers. The MLS also lets an agent know what commission might be available if he or she is the selling agent on one of those listed properties. For example, you may see a notation in the MLS of BA 3%, meaning the listing broker is willing to pay a commission of 3% to a buyer's agent.

All brokers must sign a contract in order to join the MLS, but under Illinois law *(225 ILCS 454/15-55)* such membership does **not create a subagency** relationship between the listing clients and all of the agents in the MLS or similar information source. In fact, Illinois law **prohibits** any offer of subagency being made through a MLS. One reason for this goes back to the concept of **vicarious liability** discussed earlier. If a MLS listing created a true subagency relationship, then legally, the listing broker would have vicarious liability for every other member of the MLS. But realistically, how much control does one broker have over another broker?

Agency Relationships With Landlords and Tenants

The examples and discussion in this chapter focus on sellers and buyers. An agent's relationship with landlords and tenants works very much the same way. An agent could work for or work with either and must follow the law related to agency disclosure. An agent could also have an exclusive or an open relationship with a landlord or prospective tenant.

Real estate brokers list property for lease or rent by using agreements very similar to listing contracts. Especially for nonresidential properties, prospective lessees often engage their own broker—much like a buyer forms a relationship with a buyer's agent or buyer broker—for the purpose of locating suitable property. In some areas, this practice is also popular for residential properties.

Termination of Agency

An agent's authority to act on behalf of the client ends when the agency ends (although some obligations survive the termination of agency). Agency may be terminated by:

Accomplishment of Purpose. Perhaps the most common reason for termination of an agency relationship is the purpose of the agency has been accomplished. The agency relationship between a client and a real estate broker ends when the reason for the agency relationship ends, for example when the listed property is sold and the transaction closes.

Expiration. If an agency agreement specifies the agency is for a limited term, either a certain period of time or with a set expiration date, the agency automatically ends when the term expires. In Illinois, an expiration date is **required** to be in any brokerage agreement, such as a listing agreement or buyer broker agreement, and cannot be automatically extended.

Operation of Law. An agency relationship ends automatically, as a matter of law, if certain events occur. An agency is terminated by operation of law if:

- Either party dies or becomes incapacitated.
- Either party goes bankrupt.
- The subject property of the agency is destroyed or condemned.
- The agent (sponsoring broker) loses his license.

Mutual Agreement. Agency is a consensual relationship, meaning it is based on the consent of both parties. If both the principal and agent want to end the agency, they can agree to terminate it at any point. When an agency is terminated by mutual consent, neither party is liable to the other for breach of contract. This is considered the best and most correct way for early termination of an agency.

Renunciation. When *something that has been granted is later given up or rejected,* it has been **renounced**. If an agreement is left open-ended, without a specific termination date, one party may renounce the contract at any time with no obligation. But if there is an end date, as is required in a listing agreement, the renunciation may be a breach of contract, making the breaching party liable for damages.

Revocation. The *withdrawal of something granted or offered* is a **revocation**. Principals may revoke agency power any time (but may incur liability). The principal is firing the agent. For open-ended agreements, a principal has to reimburse an agent only for expenses incurred. For agreements with ending dates, a principal may be liable to an agent for damages due to breach of contract. An exception to this is that a principal does not have the right to revoke an agreement if the agency is coupled with an interest.

Summary

1. **Agency** is a relationship of trust created when one party (such as a seller, buyer, landlord, or tenant) gives another (a real estate licensee) the right to represent them in dealings with third parties. The party granting the right of representation to a real estate transaction is known as the **principal** or **client** in the relationship. The licensee is known as the **agent**. **Brokerage** is a business concept premised primarily on bringing parties together for the purpose of a transaction.
2. Real estate licensees must take great care **not** to use the terms "client" and "customer" out of context or improperly as that may imply a relationship that has not been established. A **client** is the principal with whom an agent has a contractual obligation. A real estate licensee is employed by a client. A **customer** is a third party to the transaction whom the agent works **with** but not **for**. In a general sense, an agent is considered a **fiduciary** of the client. The fiduciary relationship is one of trust and confidence in which an agent owes the client a higher standard of good faith than owed to third parties or customers.
3. General fiduciary duties owed by an agent to a principal include (**OLD CAR**): **Obedience,** an agent must follow the (legal) instructions of the principal, obey the parameters of the agency relationship, and not stray beyond the scope of authority; **loyalty**, the agent must put the principal's interests above all others' including the agent's own; **disclosure**, any material fact that could influence a client's judgment in a transaction must be brought to her attention; **confidentiality**, any information learned during the course of the agency relationship can never be revealed or used later against the principal, even after the transaction is closed; financial **accountability**, money received in an agency relationship is received on behalf of the principal, **not** the agent; and **reasonable care**, skill and diligence must always be used, because an agent could be held liable for **negligence**, an unintentional breach of a legal duty.
4. There are various types of agents that have differing types of authority within specific fiduciary roles. A **universal agent** is authorized to do anything and everything that can be lawfully delegated to a representative. A **general agent** is authorized to represent the principal in a broad range of matters as specified, usually as part of a long-term relationship. An affiliated licensee's relationship to his or her sponsoring broker is also that of a general agent. A **special agent** has limited authority to do a specific task or conduct a specific transaction. This is generally a short-term relationship. A special agent may also be called a **limited agent**. A real estate licensee's relationship to a seller or buyer client is generally that of a special agent.
5. Agency relationships can be formed in several different ways; payment of compensation does not create an agency relationship. The most basic form of agency is when one agent represents just one party in a specific transaction, either as a seller's agent or buyer's agent. This is referred to as **single agency**. In Illinois, an agent working with a client is assumed to be a **designated agent** unless the sponsoring broker's contract with the client declares otherwise. With designated agency, other affiliated licensees are not considered agents of that client. The **selling agent** is the one who procures a buyer. It could be a buyer's agent or a seller's agent.
6. **Dual agency** can occur when a brokerage represents both the seller client and the buyer client in the same in-house transaction. A dual agent owes statutory duties to both buyer and seller. A designated licensee representing both buyer and seller is the **only dual** agent. No one else, including the sponsoring broker, is considered to be a dual agent. Dual agency requires **informed, written consent** of all parties. Through their own independent business decision, sponsoring brokers establish the types of agency relationships their brokerage firm offers, usually incorporated into the firm's company policies on agency.
7. **Vicarious liability** means one person is responsible for the actions of another. A sponsoring broker may have vicarious liability for affiliated licensees. A client does not have vicarious liability for the actions of a real estate licensee performing brokerage tasks.
8. Sponsoring listing brokers commonly extend an offer to outside brokerage firms to sell (or rent) the listing to outside buyers (or tenants) through an **offer of cooperation**, most commonly through a **Multiple Listing Service** (MLS). This cannot create a subagency relationship in Illinois.
9. An agency relationship may be terminated for a number of reasons: Accomplishment of purpose, expiration, operation of law, mutual agreement, renunciation, or revocation.

Quiz

1. ***What is another word for principal?***
   a. agent
   b. client
   c. consumer
   d. customer

2. ***Teresa is granted power of attorney to care for all aspects of her incapacitated brother's life. She maintains all of his finances, signs any legal papers, hires caregivers, and if he doesn't look well, Teresa takes him to the doctor, whether he wants to go or not. Which type of agency does this represent?***
   a. general agency
   b. limited agency
   c. special agency
   d. universal agency

3. ***Lou is a sponsoring broker. He contracts with licensee Ed to work for him as an affiliated real estate broker. What level of agency authority does Ed have?***
   a. general agent
   b. limited agent
   c. special agent
   d. universal agent

4. ***Lisa is looking for someone to sell her house, and she speaks to several potential brokers. What event will create an express seller agency relationship between Lisa and one of the brokers?***
   a. Lisa sends an e-mail to a broker asking for more information.
   b. Lisa signs a broker-buyer contract.
   c. Lisa signs a listing agreement.
   d. Lisa tells a broker that she thinks she would like to work with them.

5. ***Paul signs a listing agreement with ABC Realty to sell his house. Unless the listing agreement states otherwise, the selling agent working to market Paul's property is considered to be a***
   a. designated agent.
   b. dual agent.
   c. seller's agent.
   d. single agent.

6. ***Joe's real estate brokerage practices designated agency. Agent Sara brings Joe a listing agreement with a seller. Agent Ben brings Joe a buyer brokerage agreement with the buyer for that property. Who is a dual agent in this scenario?***
   a. Ben
   b. Joe
   c. Sara
   d. no one

7. ***Licensee Patti is having lunch with an old school friend, Janet. Janet tells Patti, "It's time to downsize. I sure wish I could sell my house." Patti responds, "Well, I have just the person for you. Make sure you're home at 7:00 this evening." Identify the statement that best describes the situation.***
   a. Janet cannot assume any relationship.
   b. Janet could be Patti's client through express agency.
   c. Janet could be Patti's client through implied agency.
   d. Janet has just made Patti her universal agent.

8. ***Otto signs a listing agreement with Ace Realty. Managing broker John has to fire designated broker Kim for embezzlement. What happens to Otto's agency relationship?***
   a. It is terminated through an operation of law since Kim is no longer licensed.
   b. John must designate another agent within 24 hours.
   c. Kim can take Otto with her to her new sponsoring broker.
   d. Nothing, Otto's contract is with Ace, not Kim.

9. ***Frank is a real estate licensee with sponsoring broker Top Realty. Frank would NOT have an agency relationship to all of Top Realty's clients if it practices***
   a. designated agency.
   b. dual agency.
   c. single agency
   d. traditional agency.

10. ***Broker Tim places his listing for seller Ivy on the MLS. When broker Ron sees it, he thinks that it sounds perfect for his buyer client and asks to show the property. What is the relationship between Ivy and Ron?***

    a. Ron is a dual agent to his buyer and Ivy.
    b. Ron is Ivy's subagent.
    c. Ron is Tim's subagent, and therefore, Ivy's agent.
    d. They have no agency relationship; Ivy is Ron's customer.

11. ***ABC Brokerage in Kankakee has 20 affiliated brokers. When seller Susan signed a listing agreement, managing broker Dan named Gloria as Susan's designated agent. How many people represent Susan?***

    a. 1
    b. 2
    c. 20
    d. 21

12. ***In a seller agency, who represents the buyer?***

    a. the agent who shows the home to the buyer
    b. the listing agent
    c. the sponsoring broker
    d. no one

6

Agency Obligations in Illinois



As a real estate licensee, you should always be asking: "Who is my client? Who am I representing? What are my obligations to them?" In an ongoing attempt to protect consumers involved in real estate transactions, agency laws were created. Though agency laws can vary from state to state, they all provide the same basic requirement: Real estate licensees must notify all parties with whom they work whom they represent, and what duties are required to fulfill that representation. In this chapter, we will look specifically at agency laws in the State of Illinois.

You will learn:

- An agent's statutory obligations to clients and customers.
- The purpose of agency disclosure.
- How and when to present agency disclosure forms.
- Other types of required disclosures.

Key Terms

Actual Fraud
Agency Disclosure
Client / Principal
Confidential Information
Constructive Fraud
Contemporaneous Offers
Customer
Designated Agent
Disclosure
Dual Agent
First Substantive Contact
Informed Consent
Latent Defects
Material Fact
Minimum Services
Misrepresentation
Non-Agency

Illinois Real Estate License Act

225 ILCS 454/15-5

In **Article 15-Agency Relationships** of the Illinois Real Estate License Act, the Illinois General Assembly recognizes that applying the common law of agency to the relationships among real estate brokers and consumers of real estate brokerage services can result in misunderstandings and consequences that have been contrary to the best interests of the public. The General Assembly further finds that the real estate brokerage industry has a significant impact upon the economy of the State of Illinois and it is, therefore, in the best interest of the public to provide codification of the relationships between real estate brokers and consumers of real estate brokerage services. The purpose of Article 15 is to:

- Prevent detrimental misunderstandings and misinterpretations of the relationships by consumers and real estate brokers.
- Promote and provide stability in the real estate market.

While Article 15 of the Real Estate License Act is not intended to prescribe or affect contractual relationships between real brokers and the broker's affiliated licensees, it does define **acceptable agency relationships** and the **statutory obligations** that an agent owes to his or her clients and customers.

Key Definitions

225 ILCS 454/1-10

Let's begin with a review of the following key definitions found in the Illinois Real Estate License Act:

- **Agency.** A relationship in which a real estate broker or licensee, whether directly or through an affiliated licensee, represents a consumer by the consumer's consent, whether express or implied, in a real property transaction.
- **Client.** A person who is being represented by a licensee. (Recall that another name for a client is "principal.")
- **Consumer.** A person or entity seeking or receiving licensed activities.
- **Customer.** A consumer who is not being represented by the licensee.

Duties of Licensees Representing Clients

A licensee representing a client of real estate brokerage services must **perform the terms** of the brokerage agreement. Recall that brokerage agreements may include:

- Listing agreements with seller clients.
- Buyer brokerage agreements with buyer clients.

Promoting the Client's Best Interests

A licensee also has duty to promote the best interest of his or her clients. This includes the following obligations.

Transaction Price and Terms

A licensee must seek a transaction at the price and terms **stated in the brokerage agreement** or at a price and terms **otherwise acceptable** to the client.

Timely Presentation of Offers

Licensees must present **all** offers to and from the client in a timely manner, unless the client has **waived** this duty, for example, a seller client who indicates in the listing agreement that he does not want to see any offers that are for less than the listing price of $200,000. His agent would be obeying the client's specific directions, therefore, if an offer for $192,000 was not presented to the client.

Disclosure of Material Facts

Agents must disclose to the client any material facts concerning the transaction of which the licensee has **actual knowledge**, *unless* that information is **confidential**. For example, a seller's agent must tell the seller all the known facts about a buyer customer's financial position, such as assets, income, or credit rating, as well as the source of down payment (e.g., a loan from friends rather than savings) and the form of earnest money deposit. This is especially important if the contract is contingent upon the ability to obtain financing.

Accounting

Agents must account for all money and property received in which the client has, may have, or should have had an interest in a timely manner. The licensee must, for example, put any deposit money into an escrow account so as not to **commingle** the principal's funds with those of the brokerage. Failure to be accountable breaches the agency relationship, which could result in legal liability and loss of license. This duty survives *after the termination* of the agency agreement. Specific requirements for handling escrow accounts in Illinois are contained in Section 1450.750 of the Administrative Rules of the Illinois Department of Financial and Professional Regulation.

Obedience

A licensee must obey the **specific directions** of the client that are not otherwise contrary to applicable statutes, ordinances, or rules. For example, if a seller client insists on listing his house for $250,000 and the agent knows that it's not worth $200,000, the agent can either decline the listing or list the house for $250,000 as requested by his client.

Loyalty

An agent must always act in a manner that is consistent with **promoting the client's best interests** as opposed to promoting the licensee's of any other person's self interest. For example, let's say that a listing agreement is due to expire shortly. An offer comes in that is not acceptable to the seller client, but the licensee sees it as the only way he'll make a commission for all of his hard work promoting the property. If the licensee strongly encourages the seller to accept the offer, that licensee is promoting not only his interest, but the interests of the buyer over the interests of his seller client.

Here's another example. Agents must tell sellers a property's **true value** and never inflate a suggested selling price just to get a listing. If during the listing period an agent finds new information affecting valuation (e.g., new comparable sales), the seller must be told. Agents should also point out things they know about the property that may affect its worth or suggest repairs that may increase the selling price. If an agent does not provide this information, then buys the property and makes these improvements and sells at a higher price, the agent used a superior knowledge of real estate for personal gain, not for the principal's gain, breaching loyalty and good faith.

Reasonable Skill

A licensee must exercise reasonable skill and care in the performance of brokerage services. The concept of reasonable care refers to the fact that all real estate agents are held to a **minimum standard of competence** and should never take on tasks beyond their ability or claim expertise where they have no special training or skills. For example, unless the licensee is also a home inspector, contractor, or licensed or certified appraiser, he should refrain from implying that his advice is that of a professional and that the client should rely on it for making decisions.

Also, many aspects of real estate transactions obviously raise legal questions or have legal consequences. Real estate licensees need to remember that unless they are licensed to practice law they should **never give legal advice** or perform any acts that require a lawyer's expertise.

Real Success

The minimum standard of competence for an agent includes knowledge in these areas:

- Valuing property
- Clarifying the principal's needs
- Discovering pertinent facts about the property, neighborhood, and parties to a contract
- Making a best effort to sell or find a property
- Explaining, in simple terms, the purpose and effect of contracts, while never practicing law without a license
- Negotiating offers and counteroffers
- Diligently meeting contract deadlines

To protect themselves from liability, agents should always be prepared to advise a client to seek advice from an expert. (When providing a reference, it's a good practice to offer at least three different options so that the decision belongs to the client.)

Confidentiality

A licensee must not disclose any confidential information received from the client. According to the definitions found in Article 1-10 of the Illinois Real Estate License Act, **confidential information** is information obtained by a licensee from a client during the term of an agency agreement that:

- Was made confidential by the written request or written instruction of the client.
- Deals with the negotiating position of the client.
- Is information that, if disclosed, could materially harm the negotiating position of the client.

Recall that in Illinois, unless otherwise indicated in a brokerage agreement, a sponsoring broker **designates** a specific affiliated licensee to represent a client. The other affiliated licensees in that brokerage are **not considered to be agents** of that client. Therefore, a designated licensee cannot share confidential information about his or her client with another licensee in that brokerage.

Duty to Safeguard Confidential Information

According to the Administrative Rules *(Section 1450.800)*, licensees who are in receipt of confidential information must take reasonable steps to **safeguard** such information from unauthorized disclosure. Such steps may include the following:

- Managing brokers must have a plan for maintaining document security, including storage of paper and electronic files. For example, office policy may require placing all pending transaction documents in locked desks, cabinets, or storage rooms at the end of the work day.
- Filing or recordkeeping systems that include confidential information *cannot* be housed on an open network which allows open access; confidential paper files must be locked up and not shared.
- Team members should have shared access to *only* the confidential information they are permitted to know or view.
- Managing brokers must have a plan for retention of documents, including shredding of confidential documents or destroying or erasing electronic media when required.

Duty of Sponsoring Broker in Designated Agency

In Illinois, a sponsoring broker who designates one or more affiliated licensees to act as agents of a client is required to take ordinary and necessary care to **protect confidential information** disclosed by a client to his or her designated agent. A designated agent may disclose to his or her sponsoring broker or persons specified by the sponsoring broker a client's confidential information for the purpose of seeking advice or assistance for the benefit of the client in regard to a possible transaction. According to Section 15-50 of the Illinois Real Estate License Act, confidential information cannot be disclosed by the sponsoring broker or other specified representative of the sponsoring broker unless otherwise:

- Required by the Real Estate License Act.
- Requested or permitted by the client who originally disclosed the confidential information.

Case in Point

Both the buyer and seller in a particular transaction are clients of ABC Realty. The sponsoring broker designates Sue to be the seller's agent and Bonnie to be the buyer's agent. Sue is a veteran in the business. She requires little guidance and is fully capable of providing her client with excellent service. Bonnie, on the other hand, is relatively new to the real estate business. And because she is new, she asks her designated managing broker for guidance on how to advise her client and how to strategize negotiations. No one in the transaction is acting unethically; however, the designated managing broker must be very cautious that any advice he gives to the buyer's agent is not biased or could work to the seller's advantage. He must also be careful that he does not inadvertently pass on any of the buyer's confidential information to seller's agent Sue.

Duty of Confidentiality Lasts Forever

The agent's duty of confidentiality is forever. The licensee has a statutory duty to keep confidential the information provided by a client, even if the agency relationship is terminated or the transaction is closed, *unless*:

- The client provides a written release that permits the disclosure of the confidential information given by that client by word or conduct.
- The disclosure is required by law.
- The information becomes public from a source other than the licensee.

Follow the Law

While a licensee has a statutory obligation to obey the directions of his or her client, licensees must comply with all requirements of the Illinois Real Estate License Act, the Administrative Rules, and all other applicable statutes and regulations, including, without limitation, **fair housing and civil rights statutes**. For example, if a seller client told the agent that he did not want his house shown to a member of a protected class the agent would not be breaching his statutory obligation of obedience to his client by ignoring such an illegal directive.

Actions That Do Not Breach Duties

225 ILCS 454/15-15

According to the Illinois Real Estate License Act, a licensee does *not* breach a duty or obligation to a client by:

- Showing alternative properties to prospective buyers or tenants.
- Showing properties which a client is interested in to other prospective buyers or tenants.
- Making contemporaneous offers or contracts to purchase or lease the same property *as long as* the licensee discloses that fact and obtains written permission from all clients involved in the offers and is willing to refer any client that requests it a referral to another designated agent.
- Working on a basis that the licensee will receive a higher fee or commission in obtaining a higher selling price or lease cost.

Relationships with Customers

While a licensee is *not* required to advance a customer's interests in a real estate relationship, a licensee does owe a customer certain basic obligations, such as fairness, honesty, and integrity. The Illinois Real Estate License Act requires licensees to treat all customers honestly and prohibits a licensee from negligently or knowingly giving a customer false information.

Honesty

225 ILCS 454/15-25

In a real estate transaction, honesty could be defined as:

- Disclosing information that one is obligated to disclose.
- Avoiding misrepresentation or fraud.

Being honest with a customer does *not* require disclosing information deemed confidential in the agent-client relationship, however. An example of such confidential information might be disclosure of the seller's motivation to sell or that the seller would be willing to accept less than the asking price without the seller's consent. A reply such as "I cannot disclose that information without my seller's consent" is an honest response.

Honesty *does* require an agent to **disclose all material adverse facts** to a customer in a timely manner. A material fact is one that, if known, could affect a consumer's decision. For instance, if the agent knows his client would be unable to close a pending transaction as specified in an agreement for some reason or another, that is material and requires disclosure.

Under Illinois law, licensees engaged by a seller client must also provide timely disclosure to customers who are prospective buyers of all **latent defects** pertaining to the physical condition of the property that are actually known by the licensee and that could not be discovered by a reasonably diligent inspection of the property by the customer. For example, if a basement wall is cracked but not obvious to buyers entering the home, it is the duty of the agent to disclose the crack—even though a seller may feel the disclosure compromises their position on price and salability. By not disclosing the crack to potential buyers, the agent is being dishonest and violating a basic tenet of customer duty.

Fraud and Misrepresentation

Being honest with everyone means you should avoid fraud—intentional or unintentional—at all times. Either may lead to civil, and even criminal, penalties if it causes harm to another party. **Negligence** is *an unintentional breach of a legal duty*. It's a tort if it causes harm, though, and you can be sued for it. **Fraud** is *intentional or negligent misrepresentation or concealment of material facts.* Failing to disclose information you're required to disclose can be a form of fraud. Fraud also includes actively concealing information and making false or misleading statements.

Actual Fraud. Actual fraud is *an intentional misrepresentation or concealment of a material fact.* Actual fraud occurs when a person actively hides information, or makes statements known to be false or misleading. When any of these is done with intent to deceive, they constitute actual fraud. (This is also called deceit or intentional misrepresentation).

Constructive Fraud. Constructive fraud is *a negligent misrepresentation or concealment of a material fact.* When information is not disclosed or false statements are made unintentionally, it may be considered constructive fraud. Here, the false statements or failure to disclose are the result of carelessness or negligence, rather than an intent to deceive. (This is also called negligent misrepresentation.)

The three primary ways in which fraud is committed are:

- **Material misrepresentations**, such as lying on a license application
- **Material misstatements**, such as telling a customer he is represented when there is no brokerage agreement in place.
- **Omission**, such as failing to mention a known latent defect or deliberately leaving critical information off of a license application.

Liability

225 ILCS 454/15-15, 15-25

The Illinois Real Estate License Act indicates that a licensee is **not liable to a client** for providing false information obtained from a customer unless the licensee knew or should have known the information was false. It also indicates that a licensee is **not liable to a customer** for providing false information obtained from a client unless the licensee had actual knowledge that the information was false.

No cause of action may arise on behalf of any person against a licensee for revealing information in compliance with Article 15, however, nor does anything contained in Article 15 change a licensee's duty under common law as to negligent or fraudulent misrepresentation of material information.

Disclosure of Agency Relationships

Understanding agency is one of the most important areas of knowledge a real estate licensee has. Since agency deals with the rights of the consumer, it is very important for licensees to be able to explain the concept to prospective buyers or sellers. **Agency disclosure** *ensures that all parties know who a licensee works for and the obligations of the licensee in a transaction,* depending on the agency relationship.

It is a licensee's legal obligation to explain the concept of agency and disclose the statutory obligations of an agent to a prospective client or customer. Therefore, agents should know:

- The types of agency allowed by the state.
- The types of agency that are practiced by their brokerage.
- The role that each type of agent plays in a real estate transaction.

When performing agency disclosure, licensees should confirm that consumers understand the meaning of **customer** and **client** and the licensees' obligations to both. Agents can take this opportunity to explain that they may advise on real estate matters but that the consumer should seek advice from other experts as necessary.

In Illinois, written disclosure of the agency relationship may be accomplished with a separate disclosure form or it may be incorporated into a brokerage agreement. Records of agency disclosure must be maintained by the real estate brokerage firm either electronically or in hard copy format for **five years**.

Designated Agency Required Disclosures

Designated agency, as you know, is *a contractual relationship between a sponsoring broker and a client in which one or more licensees associated with or employed by the sponsoring broker are designated as the agent of the client*. Unless specifically indicated otherwise in written agreement between a consumer and sponsoring broker, a designated agency is the **assumed relationship** when a client signs a brokerage agreement. Such a relationship may even be legally assumed by a consumer if proper disclosure is not made.

It must be standard procedure for every licensee to disclose in writing the relative nature of the agency relationship with prospective buyers and sellers **no later than beginning to work as a designated agent** on behalf of the consumer.

Designated agency disclosure requirements apply not only to sellers and buyers of real estate—commercial and residential—but also must be followed by property managers when working with potential tenants on behalf of a landlord.

Seller's Designated Agent

The following is typical of the designated agent disclosure that might be found in an exclusive listing agreement:

> **DESIGNATED AGENT.** Broker and Seller hereby agree that (a) _____, a sponsored licensee of Broker, is Seller's exclusive designated agent ("***Designated Agent***") under this Agreement with Broker, and (b) neither Broker nor other sponsored licensees of Broker will be acting as agent for Seller. Seller understands and agrees that Broker and any of Broker's other sponsored licensees may enter into agreements with prospective buyers of the Property as agents of those buyers.

Notice that this disclosure example provides the following key facts:

- A designated agency relationship exists and the name of the designated licensee.
- The designated licensee is the *only* one acting as a legal agent for the client.
- The broker or other licensees *may* become legal agents of prospective buyers.

Remember: This disclosure may also be handled with a separate document, for example, during a listing appointment.

ILLINOIS ASSOCIATION OF REALTORS®
DISCLOSURE OF SELLER'S DESIGNATED AGENT
(for possible use during listing presentation)

_____ (Brokerage company hereinafter referred to as "Broker") designates _____ ("Designated Agent") as the legal agent(s) of Seller for the purpose of temporarily representing Seller on a non-exclusive basis for the duration of the listing presentation/meeting.

Seller understands and agrees that neither Broker nor any other associates affiliated with Broker will be acting as legal agent of the Seller for the duration of this listing presentation/meeting. Designated agent will thus protect any confidential information that Seller might share with Designated Agent during this meeting whether Seller enters into an exclusive brokerage agreement (listing) with Brokerage Company or not.

Date copy furnished to Seller: _____ By: _____

_____ _____
Seller's Signature (OPTIONAL) Seller's Signature (OPTIONAL)

(NOTE: Give copy to Seller and retain copy for Brokerage company file.)

SAMPLE

Form 349S 3/18/10

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Buyer's Designated Agent

It is common for designated agency disclosure for buyers to be contained in a separate disclosure document.

Minimum Services of Designated Agents

225 ILSC 454/15-75

Another disclosure requirement in an exclusive brokerage agreement is a list of the **minimum services** that a designated agent must perform for his or her client. Such a disclosure can provide the agent with protection against a claim that one thing was said about the agency relationship but another was done. Listing these services in the brokerage agreement affirms what the client can expect from his or her designated agent. The absence of certain services also shows that an individual acting as a real estate agent is not qualified in fields other than real estate, and gives the agent the opportunity to advise a client to seek qualified expert guidance in other areas as needed.

The Illinois Real Estate License Act defines the following **minimum services** required when there is an **exclusive brokerage agreement** in place:

- Accept delivery of and present to a client offers and counteroffers to buy, sell, lease, or otherwise transfer any interest in the property or any portion of it.
- Assist a client in developing, communicating, negotiating, and presenting offers, counteroffers, and notices that relate to the offers and counteroffers until a lease or purchase agreement is fully executed and all contingencies are satisfied or waived.
- Answer a client's questions relating to the offers, counteroffers, notices, and contingencies.

Non-Agency Disclosure

225 ILCS 454/15-35

When a licensee is **not performing the minimum services** required under an exclusive brokerage agreement, and is, therefore, **not acting as the consumer's exclusive agent**, that licensee must disclose this fact **in writing** to the consumer. This situation may be referred to as **non-agency**. Such a non-agency disclosure, which is typically in a separate document, should be given to every consumer *before any confidential information can be shared.* The latest that a non-agency disclosure should be made is prior to any presentation of offers to purchase or lease property.

It's important to explain to consumers that a simple acknowledgment of non-agency **does not create an agency relationship**. Such a disclosure is not, in and of itself, a binding contract. It might be more accurately described as a consumer notice. Non-agency does not obligate a licensee to anything beyond the duties of honesty and fair dealing required for customers in real estate transactions.

Once the consumer has been informed about the options for agency representation, he or she may choose to:

- Sign the non-agency disclosure and work with the licensee as a customer, knowing that the agent is required to provide only clerical administrative tasks and that any confidential information shared with the licensee may be used against him in any negotiations.
- Sign a brokerage agreement—either a listing agreement or a buyer brokerage agreement as the case may be—with the sponsoring broker. In most cases, the sponsoring broker would then designate a licensee in that brokerage to represent his interests (which could result in a dual agency relationship if it's the same licensee).

While the State of Illinois does not mandate that customers sign a non-agency disclosure, most brokerages will insist upon it and will put policies into place for handling a customer's refusal to sign. This may be as simple as a space on the form for an agent to declare that the named customer was presented with the non-agency disclosure on this date and refused to sign.

Non-agency disclosure requirements apply not only to sellers and buyers of real estate—commercial and residential—but also must be followed by property managers when working with potential tenants on behalf of a landlord.

ILLINOIS ASSOCIATION OF REALTORS®
DISCLOSURE OF BUYER'S DESIGNATED AGENT

_____ (Brokerage company hereinafter referred to as "Broker") designates _____ ("Designated Agent") as the legal agent(s) of _____ (hereinafter referred to as "Buyer") for the purpose of representing Buyer in the acquisition of real estate by Buyer. Buyer understands and agrees that neither Broker nor any other sales associates affiliated with Broker (except as provided for herein) will be acting as legal agent of the Buyer. Broker shall have the discretion to appoint a substitute or additional designated agent for Buyer as Broker determines necessary. Buyer shall be advised within a reasonable time of any such substitution or addition.

Broker acknowledges and agrees that Buyer has no current exclusive Buyer representation agreement with any other real estate agent or firm. Buyer represents that if Buyer previously entered into an exclusive Buyer representation agreement(s) that they have expired and/or have been terminated. Further, Buyer agrees to immediately inform Designated Agent if Designated Agent is showing to Buyer a property previously shown to Buyer.

Buyer, by continuing to work with Buyer's Designated Agent, acknowledges that the representations and agreements made above are true and correct.

BUYER REPRESENTATION OPTIONS

Check the box that applies

☐ Use **IAR Terms of Non-Exclusive Buyer Representation,** if Buyer does not choose to enter a buyer brokerage representation agreement.

- Use form number 341.

NOTE: If Buyer consents to Dual Agency, use form number 335, Disclosure and Consent to Dual Agency, together with form number 341.

☐ Use **IAR Non–Exclusive Buyer Representation Contract**, if Buyer does not want an exclusive agency relationship with Broker, but will sign a non-exclusive agreement.

- Use form number 339 with Disclosure and Consent to Dual Agency
- Use form number 339a if Broker's office policy does not allow disclosed dual agency or if Buyer does not consent to dual agency.

☐ Use **IAR Exclusive Buyer Representation/Exclusive Right to Purchase Contract**, if Buyer will enter exclusive agency relationship with Broker.

- Use form number 338 with Disclosure and Consent to Dual Agency
- Use form number 338a if Broker's office policy does not allow disclosed dual agency or if Buyer does not consent to dual agency.

Date copy furnished to Buyer: _____ By: _____

_____ Buyer's Signature **(OPTIONAL)**

_____ Buyer's Signature **(OPTIONAL)**

(NOTE: Give copy to Buyer and retain copy for Brokerage company file.)

Form 349 2/17/10

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ILLINOIS ASSOCIATION OF REALTORS®
NOTICE OF NO AGENCY RELATIONSHIP

Name of Licensee: _____

Name of Sponsoring Brokerage Company_____

Property Address_____

☐ **NOTICE OF NO AGENCY RELATIONSHIP**
(Check here if you represent either seller or buyer)

Thank you for giving Licensee the opportunity to (Insert description of work, i.e. showing property of a FSBO)

_____

in regard to the above mentioned property.

Licensee's Sponsoring Broker has previously entered into an agreement with a client to provide certain real estate brokerage services through Licensee who acts as that client's designated agent. As a result, Licensee will not be acting as your agent.

THIS NOTICE OF NO AGENCY IS BEING PROVIDED AS REQUIRED BY STATE LAW.

_____ Date_____
Licensee's Signature

_____
Print Customer's Name (OPTIONAL)

_____ Date_____
Customer Signature (OPTIONAL)

_____
Print Customer's Name (OPTIONAL)

_____ Date_____
Customer Signature (OPTIONAL)

SAMPLE

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Timing of Agency Disclosures

Agency disclosure should be made upon the **first substantive contact** *before any confidential information can be shared.* Ideally, licensees should have the prospective buyer or seller sign an agency disclosure as early as possible in the first meeting but in any case, no later than beginning to work as a designated agent on behalf of a consumer.

With a seller this could be:

- Prior to discussions about listing property.
- Prior to presenting a comparative market analysis.
- Prior to entering into a listing agreement.

With a buyer this could be:

- Prior to showing property.
- Prior to discussions about specific needs.
- When someone walks into a real estate office to ask an agent about a listed property.
- At an open house when he displays serious interest.

Changing Relationships

Agency relationships can change. For example, a customer who signs a non-agency disclosure early in the process may **later** choose to enter into a brokerage agreement at some point. When this happens, an agent is required to make the appropriate designated agency disclosure. Perhaps the designated agent is unable to fulfill the terms of the brokerage agreement for some reason, and a new designated agent must be named. Or the sponsoring broker names another licensee in the brokerage to work with the original designated agent. These situations should be disclosed as well. It's also possible that a client with a signed brokerage agreement could later face the possibility of a **dual agency** situation, which has its own specific disclosure requirements.

Dual Agency Disclosure

Dual agency is a situation where *the buyer and the seller in the same real estate transaction are both clients of the same agent*. When a dual agency situation arises, there are some options available to the consumer and the brokerage:

- The buyer and seller could agree, in writing, to some form of dual agency.
- If either client is uncomfortable with dual agency and refuses consent, the sponsoring broker could dissolve the relationship with the buyer, who could find another broker or represent himself, or dissolve the relationship with the seller, who could find another broker or represent himself.
- The sponsoring broker could designate a different agent to represent either the buyer or the seller.

Recall that there are some variations on how dual agency may be created:

- A brokerage that does *not* practice designated agency has both the buyer client and the seller client in the same real estate transaction. In this scenario, the sponsoring broker and all affiliated brokers are dual agents to both clients.
- When the brokerage practices dual agency with designated agents and the same licensee represents both buyer and seller clients, that licensee—and only that designated licensee—is dual agent of those clients. If different agents are designated to represent buyer and seller, no one is a dual agent.

These variations on dual agency are permissible in Illinois as long as the nature and consequences of dual agency are completely disclosed in a timely manner. Both parties in the transaction must consent to the dual agency, in writing, and acknowledge that they understand that certain duties in the relationship cannot be delivered.

Dual agency disclosure requirements apply not only to sellers and buyers of real estate—commercial and residential—but also must be followed by property managers when working with potential tenants on behalf of a landlord.

ILLINOIS ASSOCIATION OF REALTORS®
ADDITIONAL AGENT DESIGNATION

(Use this form when naming an additional designated legal agent
to represent a seller-client, buyer-client or tenant/lessee client)

_____ ("Broker") is designating the licensee named below as an additional designated agent for the client named below.

Additional Designated Agent: _____
(print or type name)

Additional Designated Agent Signature: _____

Additional Designated Agent shall serve you as one of your agents until such time as
(check all that apply)

☐ terminated by the client or Broker

☐ for the time period beginning _____, 2_____ until _____, 2_____.

Broker: _____
(signature)

Client Name: _____
(print or type)

Property Address (if listing): _____

Form 340 12/9/09

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Language of Dual Agency Disclosure

Informed written consent is presumed to have been given by any client who signs a document that includes the mandated information as shown in the accompanying example. By law, the disclosure must include the description of what a licensee can and cannot do as a dual agent **exactly as shown**.

Timing of Original Dual Agency Disclosure

When a brokerage allows dual agency, that fact must be disclosed to the client **at the time the brokerage agreement is entered into** even if a dual agency situation does not exist. The client may acknowledge and accept potential dual agency:

- At the time the brokerage agreement is signed.
- At any time before a dual agency situation arises.

Confirmation of Prior Consent

A licensee acting in a dual agency capacity in a transaction must obtain a **written confirmation** from his or her clients of their **prior consent** for the licensee to act as a dual agent in the transaction. This confirmation must be obtained at the time the clients are **executing any offer or contract to purchase or lease** in a transaction in which the licensee is acting as a dual agent.

Such confirmation may be included in another document, such as a contract to purchase, in which case the client must:

- Sign the document.
- Initial the confirmation of dual agency provision.

Such confirmation must state, at a minimum, the following:

> "The undersigned confirm that they have previously consented to (insert name(s)), ("Licensee"), acting as a Dual Agent in providing brokerage services on their behalf and specifically consent to Licensee acting as a Dual Agent in regard to the transaction referred to in this document."

Refusing Dual Agency

If a client refuses to consent to dual agency in any transaction, the sponsoring broker may—without liability—**withdraw** from representing that client. Such a withdrawal may not prejudice the ability of the licensee to:

- Continue to represent the other client in that transaction.
- Limit the licensee from representing the client who refused consent in other transactions.

When such a withdrawal occurs, the sponsoring broker cannot receive a **referral fee** for referring a client to another licensee unless **written disclosure** is made to both the withdrawing client and the client who continues to be represented by the licensee.

Other Points about Dual Agency *225 ILCS 454/15-45* *Rules: 1450.755, 1450.820*

- No cause of action shall arise on behalf of any person against a dual agent for making disclosures allowed or required by Article 15-45 of the Illinois Real Estate License Act.
- A dual agent does not terminate any agency relationship by making the allowed or required disclosures.
- Each client and the licensee possess only actual knowledge and information. There shall be no imputation of knowledge or information among or between clients, brokers, or their affiliated licensees.
- A licensee may not serve as a dual agent in any transaction to which he or she, or an entity in which he or she has an ownership interest, is a party to the transaction.
- Records of dual agency authorization must be maintained by the brokerage firm either electronically or in hard copy format for **five years**.

ILLINOIS ASSOCIATION OF REALTORS®
DISCLOSURE AND CONSENT TO DUAL AGENCY

(DESIGNATED AGENCY)

NOTE TO CONSUMER: THIS DOCUMENT SERVES THREE PURPOSES. FIRST, IT DISCLOSES THAT A REAL ESTATE LICENSEE MAY POTENTIALLY ACT AS A DUAL AGENT, THAT IS, REPRESENT MORE THAN ONE PARTY TO THE TRANSACTION. SECOND, THIS DOCUMENT EXPLAINS THE CONCEPT OF DUAL AGENCY. THIRD, THIS DOCUMENT SEEKS YOUR CONSENT TO ALLOW THE REAL ESTATE LICENSEE TO ACT AS A DUAL AGENT. A LICENSEE MAY LEGALLY ACT AS A DUAL AGENT ONLY WITH YOUR CONSENT. BY CHOOSING TO SIGN THIS DOCUMENT, YOUR CONSENT TO DUAL AGENCY REPRESENTATION IS PRESUMED.

The undersigned _____, ("Licensee"),
(insert name(s) of Licensee undertaking dual representation)
may undertake a dual representation (represent both the seller or landlord and the buyer or tenant) for the sale or lease of property. The undersigned acknowledge they were informed of the possibility of this type of representation. Before signing this document please read the following:

Representing more than one party to a transaction presents a conflict of interest since both clients may rely upon Licensee's advice and the client's respective interests may be adverse to each other. Licensee will undertake this representation only with the written consent of ALL clients in the transaction.

Any agreement between the clients as to a final contract price and other terms is a result of negotiations between the clients acting in their own best interests and on their own behalf. You acknowledge that Licensee has explained the implications of dual representation, including the risks involved, and understand that you have been advised to seek independent advice from your advisors or attorneys before signing any documents in this transaction.

WHAT A LICENSEE CAN DO FOR CLIENTS WHEN ACTING AS A DUAL AGENT

1. Treat all clients honestly.
2. Provide information about the property to the buyer or tenant.
3. Disclose all latent material defects in the property that are known to the Licensee.
4. Disclose financial qualification of the buyer or tenant to the seller or landlord.
5. Explain real estate terms.
6. Help the buyer or tenant to arrange for property inspections.
7. Explain closing costs and procedures.
8. Help the buyer compare financing alternatives.
9. Provide information about comparable properties that have sold so both clients may make educated decisions on what price to accept or offer.

WHAT LICENSEE CANNOT DISCLOSE TO CLIENTS WHEN ACTING AS A DUAL AGENT

1. Confidential information that Licensee may know about a client, without that client's permission.
2. The price or terms the seller or landlord will take other than the listing price without permission of the seller or landlord.
3. The price or terms the buyer or tenant is willing to pay without permission of the buyer or tenant.
4. A recommended or suggested price or terms the buyer or tenant should offer.
5. A recommended or suggested price or terms the seller or landlord should counter with or accept.

If either client is uncomfortable with this disclosure and dual representation, please let Licensee know. You are not required to sign this document unless you want to allow the Licensee to proceed as a Dual Agent in this transaction.

By signing below, you acknowledge that you have read and understand this form and voluntarily consent to the Licensee acting as a Dual Agent (that is, to represent BOTH the seller or landlord and the buyer or tenant) should that become necessary.

CLIENT:_____

Date:_____

Document presented on _____, 20____
By: _____
(Broker/Licensee Initials)

CLIENT:_____

Date:_____

LICENSEE:_____

Date:_____

Form 335 3/9/10

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[TO BE EXECUTED AT TIME OF EXECUTION OF ANY OFFER OR CONTRACT TO PURCHASE (OR LEASE)]

CONFIRMATION OF INFORMED CONSENT TO DUAL AGENCY
(SAME AGENT TRANSACTION)

Seller Client(s): _____

Buyer Client(s): _____

Broker: _____

Designated Agent (sometimes referred to herein as Licensee): _____

The above named seller and buyer clients previously consented to and authorized Designated Agent to engage in dual agency in accordance with the following:

"The above named Broker and Designated Agent may undertake a dual representation (represent both the seller or landlord and the buyer or tenant) for the sale or lease of your property or properties they may show you. The undersigned acknowledge they were informed of the possibility of this type of representation. Before signing this document, please read the following:

Representing more than one party to a transaction presents a conflict of interest since both clients may rely upon Licensee's advice and the clients' respective interests may be adverse to each other. Licensee will undertake this representation only with the written consent of ALL clients in the transaction.

Any agreement between the clients as to a final contract price and other terms is a result of negotiations between the clients acting in their own best interests and on their own behalf. You acknowledge that Licensee has explained the implications of dual representation, including the risks involved, and understand that you have been advised to seek independent advice from your advisors or attorneys before signing any documents in this transaction.

WHAT A LICENSEE CAN DO FOR CLIENTS WHEN ACTING AS A DUAL AGENT

1. Treat all clients honestly.
2. Provide information about the property to the buyer or tenant.
3. Disclose all latent material defects in the property that are known to Licensee.
4. Disclose financial qualification of the buyer or tenant to the seller or landlord.
5. Explain real estate terms
6. Help the buyer or tenant to arrange for property inspections.
7. Explain closing costs and procedures.
8. Help the buyer compare financing alternatives.
9. Provide information about comparable properties that have sold so both clients may make educated decisions on what price to accept or offer.

WHAT A LICENSEE CANNOT DISCLOSE TO CLIENTS WHEN ACTING AS A DUAL AGENT

1. Confidential information that Licensee may know about the clients, without that client's permission.
2. The price the seller or landlord will take other than the listing price without permission of the seller or landlord.
3. The price the buyer or tenant is willing to pay without permission of the buyer or tenant.
4. A recommended or suggested price the buyer or tenant should offer.
5. A recommended or suggested price the seller or landlord should counter with or accept.

If either client is uncomfortable with this disclosure and dual representation, please let Licensee know. You are not required to sign this document unless you want to allow the Licensee to proceed as a dual agent in this transaction.

By signing below, you acknowledge that you have read and understand this form and voluntarily consent to the Licensee acting as a dual agent (that is, to represent BOTH the seller or landlord and the buyer or tenant) should that become necessary."

Therefore, the undersigned confirm that they have previously consented to the above named Broker and Designated Agent acting as a dual agent in providing brokerage services on their behalf and specifically consent to Designated Agent acting as a dual agent to the transaction referred to in this document.

Seller client(s): _____ Buyer client(s): _____

_____ _____

Date: _____ Date: _____

REV 03/02

Phone: Fax:

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SAMPLE

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Action for Damages

In any action brought against a licensee for violations of Article 15 of the Illinois Real Estate License Act–Agency Relationships, the court may, in its discretion, award only actual damages and court costs, or grant injunctive relief, when appropriate.

Any action for violations of Article 15 must be commenced:

- Within **two years** after the person bringing the action *knew* or *should reasonably have known* of such act or omission.
- No more than **five years** after the date on which the act or omission occurred.

If the person entitled to bring the action is under the age of 18 or under legal disability, the period of limitations does not begin to run until the disability is removed.

Other Required Disclosures

As you know, **disclosure** is one of the **statutory obligations** that real estate licensees have to their clients. For example, any **material fact** that could influence the client's judgment in a transaction must be brought to his or her attention. While the duty of disclosure to a client is complete, a licensee also has certain disclosure duties to the general public, such as the disclosure of the licensee's relationship with his or her principal in the transaction.

At the same time, recall that another statutory duty of a real estate licensee to his or her client is that of **confidentiality**. While being aware of one's disclosure obligations, licensees in receipt of confidential information must take reasonable steps to safeguard that information from unauthorized disclosure *(Rules: Section 1450.800).*

What follows is a survey of a licensee's many other disclosure obligations.

Disclosure of Compensation

You saw earlier how a sponsoring broker's compensation and policy regarding cooperating brokers must be disclosed in an exclusive brokerage agreement. While a licensee can and should be compensated for putting together a successful real estate transaction, there are many other tasks related to that transaction for which a licensee should *not* be compensated **without prior disclosure and written consent** of the client. For example, an agent receives compensation from a party to the transaction other than the client. Even the promise of future business from a party to the transaction other than the client must be disclosed.

Compensation in Exclusive Brokerage Agreements *225 ILSC 454/15-35*

The licensee representing a client as a designated agent through an exclusive brokerage agreement must discuss the following matters related to commission:

- The sponsoring broker's **compensation**.
- The policy with regard to **cooperating with brokers** who represent other parties in a transaction.

The following is typical of a compensation disclosure that might be found in an exclusive listing agreement:

COMMISSION. In the event Broker produces a buyer ready, willing and able to close on the Transfer of Property on the terms provided in this Agreement, then Seller shall pay Broker a commission in the amount of _____ **%** [percent] of the Purchase Price ("***Sale Commission***") plus $_____ ("***Additional Fee***"). In the event Seller enters into a leasing agreement with a tenant during the term of this Agreement, Seller agrees to pay Broker a rental commission of _____ _ ("***Rental Commission***") plus $_____ ("***Additional Rental Fee***"). In the event the Property is later purchased by the tenant, or an option to purchase is later granted to and exercised by tenant, then in addition to the Rental Commission and Additional Rental Fee, Seller must pay Broker the Sale Commission and Additional Fee. The Sale Commission, Additional Fee, Rental Commission and Additional Rental Fee are referred to collectively as "***Commission***". Broker shall be entitled to the Commission pursuant to this Agreement (a) upon the closing of any Transfer of Property prior to the Termination Date, regardless of whether the Transfer of Property resulted from the service and/or effort of the Broker, Designated Agent, Seller or any other persons or entities; or (b) upon the closing of any Transfer of Property within 180 days after the Termination Date to any person to whom the Property was submitted prior to the Termination Date. Notwithstanding the foregoing, if (i) the Property is residential property of four units or less, (ii) the Termination Date has passed, and (iii) Seller has entered into a valid, bona fide, written listing agreement with another licensed real estate broker during the 180 day period, then Broker shall not be entitled to any Commission pursuant to this Agreement on any Transfer of Property. For Property which is not residential property of four units or less, if the Property is listed with another licensed real estate broker during the 180 day period following the Termination Date, Seller shall be liable for the entire Commission, which shall be shared by the Broker and the other licensed real estate broker. The actual allocation of the Commission will be determined pursuant to a separate agreement between Broker and the other licensed real estate broker. Broker is authorized to share Broker's compensation or commission with all cooperating brokers regardless of any cooperating broker's agency relationship to Seller, Broker or the buyer.

Disclosure of Interest in Referrals

If a licensee refers a client to a third party in which the licensee has greater than a 1% ownership interest or from which the licensee receives or may receive dividends or other profit sharing distributions, other than a publicly held or traded company, for the purpose of the client obtaining services related to the transaction, then the licensee must disclose that fact to the client at the time of making the referral.

Compensation from Two Parties

225 ILCS 454/10-10 ***Rules: Section 1450.760***

If in any one transaction a sponsoring broker receives compensation from both the buyer and seller (or lessee and lessor) of real estate, the sponsoring broker must disclose in writing to a client the fact that the compensation is being paid by both.

Disclosure of Offers

225 ILCS 454/15-20 ***Rules: Section 1450.830***

Unless a client waives this right, agents are obligated to present all offers to a client, even if an offer seems unacceptable or would result in a lower commission. The client, not the agent, decides if an offer is acceptable.

Contemporaneous offers are offers to purchase or lease on behalf of two or more clients represented by the same designated agent for the same real estate parcel or unit that the designated agent knows or has known or has reason to know will be taken under consideration by the owners or owners' representative at the same time.

If there are contemporaneous offers from two or more clients of the same designated agent, written disclosure must be provided to the clients. Clients can then make an informed decision about whether or not they want to continue with their designated agent or take advantage of the opportunity to be referred to a different designated agent.

Disclosure of Interest

225 ILCS 454/10-27 *Rules: Section 1450.765*

When a licensee has a personal interest of any kind—direct or indirect—in the property being sold or leased, he must disclose his **licensee status** to all parties in the transaction. This alerts the seller or buyer to a possible conflict of interest, so she may find another agent, if she chooses. Failure to disclose could result in a **secret profit**, which is *a financial benefit that an agent takes from a transaction without authorization from the principal and without informing the principal of the benefit retained.* A common example involves **self-dealing**, which is when *a broker buys the listed property for himself, and then receives a commission on the sale.*

Property-Related Disclosures

Licensees have certain disclosure obligations related to the condition of the property they are contracted to sell. **Patent** defects are **plainly observable**, such as a large crack in a basement wall. **Latent defects** are *not* plainly observable or would not be discovered in a reasonable inspection. If a large crack in a basement wall is covered by paneling, and therefore not observable, it would be considered latent, for example. A seller's agent **must always disclose latent physical defects** to buyers. As you learned earlier, material information that is intentionally withheld is fraud.

Residential Real Property Disclosure

765 ILCS 77/

Under the **Illinois Residential Real Property Disclosure Act**, the **seller** of a residential real property:

- Must complete all applicable sections of the Residential Real Property Disclosure Report form.
- Deliver the completed disclosure form to the buyer prior to the signing of any written agreement or contract to transfer ownership of the residential real property.
- May complete a **separate mold disclosure** form.

The **broker does not complete the required disclosure form** and **cannot complete it on behalf of the client**. The seller must fill out the form and answer the questions asked based on actual knowledge of conditions as they are. ***This disclosure is covered in more detail in Chapter 32: Property Concerns.***

Failure to Disclose Information Not Affecting Physical Condition

225 ILCS 454/15-20 *Rules: Section 1450.810*

While licensees do have certain disclosure obligations related to the physical condition of a property, **no cause of action** may arise against a licensee for the failure to disclose the following:

- That an occupant of that property was afflicted with Human Immunodeficiency Virus (HIV) or any other medical condition, such as AIDS or cancer.
- That the property was the site of an act or occurrence that had no effect on the physical condition of the property or its environment or the structures located on that property (for example, murder or suicide).
- Fact situations on property that is not the subject of the transaction.
- Physical conditions located on property that is not the subject of the transaction that do not have a substantial adverse effect on the value of the real estate that is the subject of the transaction.

This provision is intended to apply to actions taken by the Illinois Division of Financial and Professional Regulation as well as to all civil actions in Illinois.

ILLINOIS ASSOCIATION OF REALTORS®
DISCLOSURE OF CONTEMPORANEOUS OFFERS

_____, an agent (hereinafter referred to as Designated Agent) with _____ (Brokerage company hereinafter referred to as Broker), is acting as Designated Agent for more than one prospective buyer or tenant who the Designated Agent has reason to believe are making or preparing to make contemporaneous offers to purchase or lease the property located at _____.
(street address or description of property).

At this time, buyers/tenants have the option of being referred to another designated agent who will serve as the agent for buyer/tenant.

Buyer elects: (choose one of the following)

- ☐ to remain with Designated Agent identified above notwithstanding that another client of Designated Agent may be making a contemporaneous offer to purchase or lease the real property identified above.
- ☐ to be referred to another designated agent who will act as agent for buyer/tenant in the making of an offer to purchase or lease the real property identified above.

Signed by: _____ dated _____
(Designated Agent)

Signed by: _____ dated _____
(Buyer or Tenant)

Signed by: _____ dated _____
(Buyer or Tenant)

Form 427 12/18/09

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SAMPLE

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Summary

1. Illinois licensees owe the following **statutory duties** to clients: Promote the client's best interests, which includes seeking acceptable terms, timely presentation of offers, disclosure of material facts, accounting, obedience, loyalty, reasonable skill, confidentiality (which survives the termination of agency), and following the law.
2. Agents have ethical duties to other parties in the transaction, including to be **fair** and **honest** in all duties and to **disclose** known material facts and defects.
3. **Fraud** is an intentional or negligent misrepresentation or concealment of a material fact. Fraud can be **actual** (intentional misrepresentation or concealment of a material fact or information, or making statements known to be false or misleading) or **constructive** (negligent misrepresentation or concealment of material facts).
4. **Article 15** of the Illinois Real Estate License Act requires that **written disclosure of an agency relationship** by the agent be provided at the **first substantive contact** before any confidential information is shared, before beginning to work as a designated agent. The agency disclosure may be made as part of a brokerage agreement or may be made in a separate document. Agency disclosure provides affirmation that the agency relationship was disclosed to the consumer and that informed consent of the party for a specific relationship has been given.
5. When a licensee is **not performing the minimum services** required under an exclusive brokerage agreement, and is, therefore, not acting as the consumer's agent, that licensee must disclose this fact **in writing** to the consumer. This situation is referred to as **non-agency**. Signing a non-agency disclosure does not create an agency relationship. Records of agency disclosure must be maintained by the sponsoring broker either electronically or in hard copy format for **five years**.
6. **Dual agency** is a situation where the buyer and the seller in the same real estate transaction are both clients of the same brokerage. Both parties in the transaction must consent to the dual agency, in writing, and acknowledge that they understand that certain duties in the relationship cannot be delivered. When a brokerage allows dual agency, that fact must be disclosed to the client at the time the brokerage agreement is entered into even if a dual agency situation does not yet exist. The language in the dual agency disclosure is mandated by law. Written confirmation of **prior consent** for dual agency must be obtained before executing an offer or contract.
7. After an initial relationship is formed between a broker and a principal, that relationship could change. For example, a broker could change his relationship with the buyer/tenant and work with her as a customer, become a dual agent for the buyer/tenant and seller/landlord, or become a dual agent with designated agents for the buyer/tenant and seller/landlord. Changing agency relationships is permissible as long as the agent discloses the revised relationship, and obtains informed consent for the new relationship.
8. These are among a licensee's other obligations of disclosure: **Compensation** from more than one party to a transaction; interest in referrals; licensee **status** if there's any personal interest in the property transaction; **contemporaneous offers**; ownership in **advertising**; **latent** property defects (**not** required to disclose any information not affecting the property's physical condition, however).

Quiz

1. ***Kim's brokerage company offers dual agency. Tom and Don are two of her licensed brokers. Tom has been appointed to represent the seller, and Don has been appointed to represent the buyer in an in-house transaction. In this situation, who is a dual agent?***
   a. Kim only
   b. Kim, Tom, and Don only
   c. all licensed brokers in Kim's brokerage
   d. no one

2. ***Which statement is TRUE about designated agency disclosure?***
   a. It does not create an exclusive agency relationship.
   b. It is not required for buyer clients, only seller clients.
   c. It cannot be provided after obtaining a signed non-agency disclosure.
   d. It must be on the mandated stand-alone disclosure form.

3. ***Yvonne has listed her house with ACE Realty, and Harvey is her designated seller agent. Karen, another licensee at ACE, has been working with a buyer customer Alex for a couple of months now, and thinks he is a good prospect. What must Karen do before bringing Alex to Yvonne's open house?***
   a. get Alex to sign a designated agency disclosure
   b. get informed written consent for dual agency from both Yvonne and Alex
   c. get informed written consent for dual agency from client Yvonne
   d. nothing

4. ***At what point should a non-agency or designated agency disclosure be provided by a broker to a consumer?***
   a. prior to closing a transaction
   b. prior to discussing any confidential information
   c. prior to distributing commission
   d. prior to welcoming a potential buyer to an open house

5. ***Identify the statement that is FALSE.***
   a. A licensee does not breach a duty or obligation to a client by showing alternative properties to prospective buyers or tenants.
   b. A licensee is required to disclose facts about the physical condition of a neighboring property that is not the subject of the transaction.
   c. A licensee under a brokerage agreement cannot be held liable for disclosing information made confidential by the written request of a client if the disclosure is required by law.
   d. A licensee who passes along false information provided by a customer is not liable to a client for providing false information.

6. ***Bruce has a buyer client who is paying him a flat fee for his efforts. Bruce is also expecting a commission split from the listing brokerage. In this scenario, Bruce***
   a. has no disclosures to make.
   b. must disclose in writing to all parties that he is being paid by each party to the transaction.
   c. must disclose in writing to his buyer that he is being paid by the seller as well.
   d. must disclose in writing to the seller that he is working on a flat fee basis with the buyer.

7. ***After listing a property that the designated agent believes is overpriced, the agent returns to the office and complains to a fellow licensee at his brokerage that the property will never sell at that price. The agent has breached***
   a. the customer duty of fair dealing.
   b. the client duty of confidentiality.
   c. the duty of disclosure.
   d. no statutory duty, as every licensee in the brokerage is also an agent of the sponsoring broker's client.

8. ***When showing a listing, a sales agent is asked about the condition of the basement. Without having seen the basement, the agent states that, to the best of her knowledge, the basement is free of dampness. In fact, the basement leaks steadily whenever it rains. The agent most likely has committed***
   a. fraud.
   b. intentional misrepresentation.
   c. misrepresentation.
   d. no error; this is protecting the homeowner's interest.

9. ***Jane and Paul are affiliated licensees working for sponsoring broker Evan. Buyer Maggie has no buyer brokerage agreement. Jane shows a house to Maggie, then submits Maggie's offer to purchase to Paul, who is the designated agent for the seller. Which of these statements is true?***
   a. Jane can tell Maggie that the seller is desperate to sell.
   b. Jane is not obligated to advise and assist Maggie during contract negotiations.
   c. Jane must protect the best interests of her client Maggie.
   d. Sponsoring broker Evan is a dual agent.

10. ***What confidential information should be disclosed to a buyer by the seller's agent?***
   a. the fact that the seller has begun to notice termite damage inside one of his closets
   b. the fact that the seller may be willing to accept less than the list price on his home
   c. the seller's concerns about the shabby appearance of the carpeting throughout the house
   d. the seller's motivation for selling his house

11. ***Broker Arnie has a listing agreement with seller Nan. Which situation would NOT require some sort of disclosure by Arnie?***
   a. He is being compensated by both the buyer and seller.
   b. He knows that the seller's live-in son has AIDS.
   c. There are other offers on the same house from multiple buyers.
   d. His seller client tells him he put up paneling to hide a leak.

12. ***Peter is the listing agent for seller Jan. Of these acts, which would breach Peter's statutory duty of loyalty to Jan if he performed it for a buyer customer?***
   a. advising the buyer on his best negotiation position
   b. completing information on the buyer's offer to purchase Jan's house
   c. referring the buyer to another brokerage
   d. responding to the buyer's questions about the property at an open house



UNIT 3

REAL ESTATE BROKERAGE

Chapter 7: Advertising and Marketing

Chapter 8: Brokerage Office Issues



7

Advertising and Marketing

Advertising and marketing are powerful tools for real estate professionals. Often, the primary source of information that a consumer has about a particular property, real estate brokerage, or licensee comes from advertising, whether it's in print, on the radio, on television, or on the Internet. While there are obviously many federal and state laws that have been put in place to protect the public, consumers generally rely on the honesty and integrity of those professionals with whom they deal. In this chapter, you will examine how advertising can impact a consumer as you look at specific Illinois Statutes and Administrative Rules that address advertising, as well other fundamental principles that should be considered when preparing advertisements so that they do not violate the letter or the spirit of the law.

You will learn:

- Illinois Statutes and Administrative Rules related to advertising.
- Considerations related to advertising on the Internet.
- What constitutes deceptive and misleading advertising.
- How to avoid discrimination in advertising.
- How privacy laws impact advertising, marketing, and communications in general.
- A licensee's responsibility to present a true picture to consumers.

Key Terms

Advertisement
Bait and Switch
Blind Advertisement
Browser
Domain Name
Established Business Relationship (EBR)
Farming
Firewall
Frame
Home Page
HTML
Meta Tag
National Do Not Call Registry
Phishing
Puffing
Scraping
Spam
Steering
True Picture
URL

Brokerage Advertising Requirements

225 ILCS 454/10-30

In the most generic sense, **advertising** may be defined as the *placement of public announcements in any medium with the intention of promoting or enticing a consumer into purchasing goods or engaging the services of someone*. A **medium** of advertising includes, but is not limited to, print, electronic, social media, and digital forums. Section 10-30 of the Illinois Real Estate License Act documents provisions related to advertising that must be followed by licensees.

Deceptive Advertising

No advertising, whether in print, via the Internet, or through any other media, may be:

- Fraudulent,
- Deceptive,
- Inherently misleading, or
- Proven to be misleading in practice.

Advertising would be considered misleading or untruthful if, when taken as a whole, there is a distinct and reasonable possibility that it will be **misunderstood** or will **deceive** the ordinary consumer. Advertising must contain **all information necessary** to communicate the information to the public in an accurate, direct, and readily comprehensible manner.

Disclosure of Status and Interest

Licensees have a legal obligation to disclose—in writing—their **licensee status** and any direct or indirect **interest** they may have in the real estate in question to all parties in a transaction.

While disclosure of ownership is **not** necessary on broker yard signs or in broker advertisements, the ownership must be indicated on any **property data form** accessible to consumers and disclosed to persons responding to any advertisement or any sign. The term "broker owned" or "agent owned" is sufficient disclosure.

Solely Owned Property

A sponsored or inactive licensee selling or leasing property, **owned solely** by the sponsored or inactive licensee, **without utilizing brokerage services** of their sponsoring broker or any other licensee, may advertise "By Owner." In this case, according to Section 10-30, property is "solely owned" by a sponsored or inactive licensee if he or she:

- Has a 100% ownership interest alone,
- Has ownership as a joint tenant or tenant by the entirety, or
- Holds a 100% beneficial interest in a land trust.

Sponsored or inactive licensees selling or leasing "By Owner" must comply with the following **if advertising by owner**:

- On "By Owner" yard signs and advertisements used in any medium, the sponsored or inactive licensee must indicate "broker owned" or "agent owned."
- If a sponsored or inactive licensee runs advertisements for the purpose of purchasing or leasing real estate, he or she must disclose in the advertisements his or her status as a licensee.
- A sponsored or inactive licensee **may not use the sponsoring broker's name** or the sponsoring broker's **company name** in connection with the sale, lease, or advertisement of the property, nor utilize the sponsoring broker's or company's name in connection with the sale, lease, or advertising of the property in a manner likely to create confusion among the public as to whether or not the services of a real estate company are being utilized or whether or not a real estate company has an ownership interest in the property.

Identification

A sponsored licensee **cannot** advertise under his or her own name. Advertising in any media must be **under the direct supervision** of the sponsoring or designated managing broker. Furthermore, advertising must be in the sponsoring broker's **business name**, which, in the case of a franchise, must include the **franchise affiliation** as well as the name of the individual firm. A **blind advertisement** used by any licensee, in any media, is prohibited. The Real Estate License Act defines blind advertisement as *any real estate advertisement that does not include the sponsoring broker's business name and that is used by any licensee regarding:*

- The sale or lease of real estate, including his or her own.
- Licensed activities.
- The hiring of any licensee.

Any **electronic advertisement** that does not include a **direct link** to a display with all required disclosures is also considered a blind ad.

This provision does not apply when the licensee is acting on his or her own behalf under these circumstances:

- When a licensee enters into a brokerage agreement relating to his or her own real estate, or real estate in which he or she has an ownership interest, **with another licensed broker**.
- When a licensee is selling or leasing his or her own real estate or buying or leasing real estate for himself or herself, **after providing the appropriate written disclosure** of his or her ownership interest.

Directories and Business Cards

A licensee may not list his or her name or otherwise advertise in his or her own name to the general public through any medium of advertising as being in the real estate business—without listing his or her **sponsoring broker's business name**.

The sponsoring broker's business name and the name of the licensee must appear in all advertisements, **including business cards**. A sponsoring broker's name must be **at least equal in size or larger** than a team name or the name of an individual licensee.

The Administrative Rules (Section 1450.715) clarify that nothing requires a sponsoring broker to include the name of one of its sponsored licensees on signs or other general advertising.

Designated Managing Broker Designation

Those individuals licensed as a managing broker and registered with the Department as a designated managing broker by their sponsoring broker must identify themselves to the public in advertising as a designated managing broker. No other individuals holding a managing broker's license may hold themselves out to the public or other licensees as a designated managing broker but may refer to themselves as managing brokers.

Grounds for Discipline

The following are **grounds for discipline** under the Illinois Real Estate License Act ***(225 ILCS 454/20-20)*** related specifically to advertising:

- Using misleading, inaccurate, or untruthful advertising including deceptive signage, blind advertisements, or free offers when conditions or obligations for receiving the free merchandise or services are not disclosed.
- Making false promises to influence, persuade, or induce.
- Making false promises through agents, salespeople, advertising, etc.
- Using trade name or insignia for an organization of which the licensee is not a member.
- Engaging in dishonest dealings or dishonorable, unethical, or unprofessional conduct likely to deceive, defraud, or harm the public

.

Internet Advertising

The world is a different place today because of the Internet. Consumers shop, read the news, play games, socialize, all without leaving their living rooms. Members of the real estate business community advertise, provide guidance and counseling, show and sell property. The Internet has become indispensible, and the power of the Internet to reach potential consumers for real estate products and services seems virtually limitless. It's critical to understand that the same laws that regulate print and broadcast media apply equally to advertising, promotion, and marketing on Internet websites and through social media such as Facebook and Twitter. In a nutshell:

- Advertising must be truthful and not misleading.
- Advertisements cannot be unfair.

An unfair or deceptive message will be unfair or deceptive *wherever* the consumer views or hears it.

Web-Related Terms

Here are some web-related terms that will be useful to understand before continuing:

- **Domain Name.** The name that identifies a website, usually followed, for commercial purposes, by the .com suffix. Other common suffixes are .gov for government websites and .edu for schools and other educational institutions.
- **URL.** The address of a specific website or file on the Internet (Uniform Resource Locator).
- **Browser.** The program used to access and display formatted pages on the web.
- **HTML.** The language that web pages are written in (Hyper-Text Markup Language) so that they can be displayed correctly in a web browser.
- **Page.** Each html document; can include several screens of information that are viewed by scrolling down to the end of the document.
- **Frame.** Refers to that portion of the web page that does not change when the user links to a different site or moves to different pages.
- **Home Page.** The starting page or first page on a particular website.
- **Firewall.** A system designed to prevent unauthorized access to or from a private network. Information in front of a firewall is public; information behind a firewall is private and is, therefore, not considered to be advertising.
- **Meta Tag.** A special HTML tag that is used to store information about a web page but that is not displayed in a web browser; Internet search engines can return specific websites based on the meta tags that are embedded in a web page, as well as codes and words actually displayed on a page.

Administrative Rules on Internet Advertising

The Illinois Department of Financial and Professional Regulation (IDFPR) specifically addresses the use of the Internet in its Administrative Rules. The Rules apply to Internet sites for both advertising and marketing of:

- **Real properties** that have been listed with a real estate brokerage company, the identity of that real estate brokerage company or licensee for each property, and information related to those properties.
- **Real estate brokerage services** that includes an offer or solicitation to provide services related to marketing or identifying real property for sale or lease.

The Rules also provide guidance on the use of **e-commerce or electronic communications** tools such as e-mail, e-mail discussion groups, and bulletin boards for marketing or transactional purposes.

Remember: All licensees, including sponsoring brokers, must **periodically review** the advertising and marketing information on their site and update as necessary to assure that the information is current and not misleading.

Sponsoring Broker

Property. A sponsoring broker that has authorized advertising or marketing real property must include the following on the company's or firm's advertising or marketing materials:

- The city or geographic area in which the property being advertised or marketed is located
- The company's name as registered with the Administrative Code Division (or the registered assumed name; commonly recognized abbreviations are permitted)
- The regulatory jurisdictions in which the sponsoring broker holds a real estate brokerage license (if it is other than where the property is located)

If this information is contained on the frame on the sponsoring broker's site, it does not have to be included on every page of the site.

Brokerage Services. A sponsoring broker's advertising or marketing real estate brokerage services must include the following on the company's **home page** or on a **clearly identified link** appearing on that page:

- The company's name as registered with the Administrative Code Division (or the registered assumed name; commonly recognized abbreviations are permitted)
- The city and state in which the company's principal office is located

If this information is contained on the frame on the sponsoring broker's site, it does not have to be included on every page of the site.

E-commerce or Electronic Communications. A sponsoring broker using e-commerce or electronic communications must include the following on the first or last page of all communications:

- The company's name as registered with the Administrative Code Division (or the registered assumed name; commonly recognized abbreviations are permitted)
- The city and state in which the sponsoring broker's main office or the office from which the communication originated is located

This requirement does not apply to communications between a sponsoring broker and a member of the public provided that the member of the public has sent a communication to the licensed company and that the sponsoring broker's initial communication contained the required information.

Licensees

Property. Any licensee who has authorized advertising or marketing real property must include the following on the page of the site on which the licensee's advertisement or information appears:

- The licensee's name
- The city or geographic area in which the property being advertised or marketed is located
- The name of the company with which the licensee is affiliated as registered with the Division (or the registered assumed name; commonly recognized abbreviations are permitted)
- The regulatory jurisdictions in which the broker holds a real estate broker license (if it is other than where the property is located)

If this information is contained on the frame on the licensee's site, it does not have to be included on every page of the site.

Brokerage Services. A licensee advertising or marketing real estate brokerage services must include the following on his or her **home page**:

- The licensee's name
- The name of the company with which the licensee is affiliated as registered with the Division (or the registered assumed name; commonly recognized abbreviations are permitted)
- The city and state in which the licensee's office is located

If this information is contained on the frame on the licensee's site, it does not have to be included on every page of the site.

E-Commerce or Electronic Communication. Any licensee using e-commerce or electronic communications must include the following on the first or last page of all communications:

- The licensee's name
- The name of the company with which the licensee is affiliated as registered with the Division (or the registered assumed name; commonly recognized abbreviations are permitted)
- The city and state in which the licensee's office is located

This does not apply to communications between a licensee and a member of the public provided that the member of the public has sent a communication to the licensee and that the licensee's initial communication contained the required information.

Scraping and Linking

Rules: 1450.720

The term **scraping** refers to using or altering existing listing information or keywords that are copied from one Internet site and posted or displayed for the benefit of the general public *in front of a firewall* at *another site without written or electronic authorization* and disclosure of ownership. It is a violation of the Real Estate License Act and the Administrative Rules to scrape listing information from another site. Listing information obtained from another Internet site and placed *behind a firewall* or other device that is password protected or requires registration by the consumer in order to access, however, need not identify the original listing broker.

A sponsoring broker or licensee may **link** to listing information from another Internet site without approval, unless the owner of the site linked to specifically requires consent. Any link must be done in such a way that it does not mislead or deceive the public as to the ownership of any listing information.

Deceptive and Misleading Advertising

When determining whether an advertisement is deceptive or misleading, it's also critical to consider what the ad does *not* say. Does the omission of certain facts create a false impression in the minds of reasonable consumers? The issue is whether the act or practice is *likely to mislead*, rather than whether it causes actual deceptions. Deceptive and misleading practices are prohibited by both state and federal law.

Administrative Rules on Deceptive and Misleading Advertising

Rules: 1450.715

The Illinois Department of Financial and Professional Regulation (IDFPR) specifically addresses deceptive and misleading advertising in its Administrative Rules. It's important to note that in the Administrative Rules, **unsolicited marketing** of a licensee's real estate brokerage services and **farming** or **prospecting** are also considered to be forms of advertising.

Deceptive and misleading advertising includes, but is not limited to, the following:

- Advertising a property that is subject to an **exclusive listing agreement** with a sponsoring broker other than the licensee's own **without the permission** of and identifying that listing broker.
- **Failing to remove advertising** of a listed property within a reasonable time, given the nature of the advertising, the licensee's control over the removal or stopping of the advertising, the ease of removing or stopping the advertising, knowledge that the advertising was continuing, and any other pertinent criteria after the earlier of the closing of a sale on the listed property or the expiration or termination of the listing agreement.
- Advertising a property at **auction** as an absolute auction or auction without reserve, when there is a minimum bid or opening bid required.
- Advertising a property in a manner that creates a reasonable likelihood of confusion regarding the **permitted use** of the property. Examples of such advertising would be advertising a property zoned single family as appropriate for multi-dwelling use by using words or phrases such as "apartment," "two units," or "separate living arrangement" unless that use is permitted by the zoning ordinance, a variance from the zoning ordinance, a conditional permitted use, or an existing legal non-conforming use.

- Use of URL, domain name, meta tag, keyword, or other device or method intended to deceptively direct, drive, or **divert** Internet traffic or **mislead** consumers.
- **Phishing**, which is the criminally fraudulent process of attempting to acquire sensitive information such as usernames, passwords, and credit card details by masquerading as a trustworthy entity in an electronic communication.

It is also a violation to use a URL or domain name that is deceptive or misleading or to deceptively or without authorization from another real estate brokerage or multiple listing service website *(225 ILCS 454/10-35).*

Real Success

Any discussion on deception and misrepresentation obviously applies not just to what you say, but what you put in an advertisement. In the zeal to show off a unique, difficult, or underappreciated property, some brokers attempt to embellish a home's good qualities and disguise a home's bad features. It should go without saying that any advertisement for property that is placed by a licensed real estate professional should be truthful and should not mislead a potential customer in an attempt to lure them into looking at a property. If the property is a quarter mile inland, it is not beachfront property. If a home has four bedrooms and an unfinished basement, it does not have five bedrooms.

But the line between misrepresentation and harmless exaggeration can seem very thin at times. What if an ad says: "This house has the greatest view in the county"?

That could be considered and example of "**puffing**," which is *a superlative statement about the quality of a property that may be difficult to back up with proof and should not be considered an assertion of fact*. Here are some other examples of puffing:

- "The landscaping is the most beautiful I've ever seen."
- "The living room is so comfortable, you'll never want to leave."
- "This is the prettiest house in the neighborhood."
- "This kitchen is fabulous. You'll cook better meals than the finest restaurant."

Puffing is not against the law, per se, as it's reasonable to conclude that consumers can decide whether or not the view is that good on their own. Still, as a licensee, you should always strive to be truthful and present a **true picture** of the property or service you're advertising. A real estate agent should be very cautious about offering unsubstantiated opinions, however. A court may allow recovery based on opinions stated by an expert who was hired to give advice because of his superior knowledge. Someone who states an opinion he does not actually believe—especially if it influenced someone's opinion—may also be held liable.

Illinois Uniform Deceptive Trade Practices Act

The **Illinois Uniform Deceptive Trade Practices Act** *(815 ILCS 510/2)* regulates advertising, among other practices. The following are among the trade practices prohibited by this Act:

- Passing off one's goods or services as the goods or services of another.
- Causing the likelihood of confusion or misunderstanding as to the affiliation, connection, or association with or certification by another.
- Using deceptive representations or designations of geographical origin in connection with goods or services.
- Representing that goods or services have something they do not have, such as sponsorship, approval, affiliation, or connection.
- Disparaging another person's goods, services, or business of another by false or misleading representation of fact.
- Advertising goods or services with the intent not to sell them as advertised, a practice known as **bait and switch**.
- Engaging in any conduct that creates a likelihood of confusion or misunderstanding.

Non-Discrimination in Advertising

Words carry great power to influence and inform, and sometimes, mislead consumers. The misuse of words, even if unintentional, can create problems. For example, certain phrases used in real estate advertising could convey either overt or tacit discriminatory preferences or limitations. In addition to outlawing discrimination in housing, the federal **Fair Housing Act of 1968** restricts the publication of any real estate advertising that indicates a limitation, preference, or intent to discriminate based on race or other protected class. Specifically, § 804(c) of the Fair Housing Act states that it is:

> *"… unlawful to make, print, or publish, or cause to be made, printed, or published, any notice, statement, or advertisement, with respect to the sale or rental of a dwelling, that indicates any preference, limitation, or discrimination because of race, color, religion, sex, handicap, familial status, or national origin, or an intention to make any such preference, limitation, or discrimination. However, the prohibitions of the Act regarding familial status do not apply with respect to housing for older persons..."*

Licensees should choose their words very carefully and should measure whether advertising content could be construed as being in violation of the federal Fair Housing Act or the Illinois Human Rights Act. It's critical to find the right elements that will interest a potential buyer, but if the ad describes the great parochial schools nearby, the ethnicity of the neighborhood, or the maturity of the local population, it has crossed the line into discrimination. Under certain circumstances, even the newspapers chosen for advertising may be held to have the effect of **steering**, which is *channeling prospective buyers or tenants to particular neighborhoods based on their race, religion, national origin, or ancestry.*

Use of Images

While words in an ad can be very powerful, they don't always tell the complete story. For example, an advertisement that includes photographs of people should strive to include models who are clearly definable as reasonably representing majority and minority groups in the metropolitan area, both sexes, and, when appropriate, families with children.

Furthermore, according to advertising guidelines from the Department of Housing and Urban Development, ads should portray persons in an equal social setting and indicate to the general public that the housing, product, or service is open to all without regard to race, color, religion, sex, handicap, familial status, or national origin, and is not for the exclusive use of one such group. Nor should an advertisement include symbols or logotypes which imply or suggest membership in a protected class.

These guidelines pertain to *all* types of media (print, television, radio, and Internet).

Real Success

Creating effective ads that meet fair housing guidelines does not have to be difficult. As long as you ***describe the property itself and not the people who live in or around it***, you will be fine. For example, "traditional Italian neighborhood" would violate fair housing advertising guidelines, but "desirable neighborhood" would not. "Perfect for young singles" would violate fair housing guidelines, but "cozy two-bedroom" would not. "Exclusive community" would violate fair housing guidelines, but "gated community" would not.

Some words or phrases you might think could be construed as discriminatory are acceptable, for example, "master bedroom suite," "family room," "walk-in closets," "quiet neighborhood," "walk to bus stop." The key is that these are ***physical descriptions*** of the property that is being advertised. Always pay close attention to the words you use to describe listings. When in doubt, consult your managing broker.

Fair Housing Logo and Poster



All advertising of residential real estate for sale or rent and for real estate financing should contain a **fair housing logo**, **statement**, or **slogan** as a means of educating the public that the property is available to everyone regardless of race, color, religion, sex, disability, familial status, or national origin. The choice of logo, statement, or slogan depends on the type of media used, and, in print advertising, its size. If other logos are used, such as for the National Association of REALTORS®, the fair housing logo must be at least equal in size to the largest of the other logos.

When there is not room in an ad to display the fair housing logo, the fair housing **statement** or **slogan** is required:

> *We are pledged to the letter and spirit of U.S. policy for the achievement of equal housing opportunity throughout the Nation. We encourage and support an affirmative advertising and marketing program in which there are no barriers to obtaining housing because of race, color, religion, sex, handicap, familial status, or national origin.*

Advertisements may also require the inclusion of a statement related to any state or local fair housing or human rights ordinances that prohibit discrimination in the sale, rental, or finance of dwellings.

The federal Fair Housing Act also requires **fair housing posters** to be prominently displayed in any place of business where housing is offered for sale or rent. Using the fair housing logo, statement, slogan, and poster declares to the public that the brokerage and its licensees subscribe to the principles of fair housing practices. If a broker or lender is investigated for alleged discriminatory acts, *failure to display the poster and use the logo may itself be considered evidence of discrimination.*

U. S. Department of Housing and Urban Development



EQUAL HOUSING OPPORTUNITY

We Do Business in Accordance With the Federal Fair Housing Law

(The Fair Housing Amendments Act of 1988)

It is illegal to Discriminate Against Any Person Because of Race, Color, Religion, Sex, Handicap, Familial Status, or National Origin

- In the sale or rental of housing or residential lots
- In advertising the sale or rental of housing
- In the financing of housing
- In the provision of real estate brokerage services
- In the appraisal of housing
- Blockbusting is also illegal

Anyone who feels he or she has been discriminated against may file a complaint of housing discrimination:
1-800-669-9777 (Toll Free)
1-800-927-9275 (TTY)

U.S. Department of Housing and Urban Development
Assistant Secretary for Fair Housing and Equal Opportunity
Washington, D.C. 20410

Previous editions are obsolete form HUD-928.1 (2/2003)

HUD Guidelines

The Department of Housing and Urban Development (HUD) has issued guidelines on the acceptance and investigation of allegations of discrimination under § 804(c) of the Fair Housing Act involving the publication of real estate advertisements.

Protected Class	Acceptable	Unacceptable
Race, color, national origin	Neutral descriptions, images	Use of words describing the housing, the current or potential residents, or the neighbors or neighborhood in racial or ethnic terms
Religion	Descriptions of properties (apartment complex with chapel) or services (kosher meals available); use of secularized terms or symbols relating to religious holidays (Santa Claus, Easter Bunny, etc.)	Explicit preference, limitation or discrimination on account of religion; religious references or symbols (such as a cross)
Sex	Use of physical descriptive terms (master bedroom, mother-in-law suite, bachelor apartment, etc.)	Explicit preferences, limitations, or discrimination based on sex
Handicap	Descriptions of properties (great view, fourth-floor walk-up, walk-in closets, etc.), services or facilities (jogging trails, etc.), or neighborhoods (walk to bus-stop, etc.); conduct required of residents (non-smoking, sober, etc.)	Explicit exclusions, limitations, or other indications of discrimination based on handicap
Familial Status	Descriptions of properties (two bedroom, cozy, family room, etc.), services and facilities (no bicycles allowed, etc.), or neighborhoods (quiet streets, parks nearby, etc.)	Limitations on the number or ages of children; a stated preference for adults, couples, or singles

Consumer Privacy

Licensees have a statutory obligation to clients to keep any information gathered as part of a real estate transaction **confidential**. Licensees also have an obligation to protect *all consumers* from the:

- Nuisance of unwanted solicitations.
- Unauthorized use or sharing of private information.

As a response to the ever-changing world of technology, various federal and state privacy laws have been established. For example, according to the Illinois Real Estate License Act, licensees intending to sell or share consumer information gathered from or through the Internet or other electronic communication media must **disclose** that intention to consumers in a timely and readily apparent manner (*225 ILCS 454/10-35).*

Fair and Accurate Credit Transaction Act (FACT Act)

The federal **Fair and Accurate Credit Transaction Act** of 2003 (Pub.L. 108-159), referred to as either the FACT Act or simply FACTA, amended the federal Fair Credit Reporting Act and is intended primarily to *help consumers fight the growing crime of identity theft.* Accuracy, privacy, limits on information sharing, and consumer rights to disclosure are included in the FACT Act. To protect the privacy of consumer financial information, one provision of the FACT Act requires businesses to take measures to responsibly **secure and dispose** of sensitive personal information found in a consumer's credit report. Reasonable methods for security and disposal include:

- Burning or shredding papers that contain consumer report information so that information cannot be reconstructed.
- Destroying or erasing electronic files or media so that information cannot be recovered or reconstructed.
- Placing all pending transaction documents in locked desks, cabinets, or storage rooms at the end of the work day.

National Do Not Call Registry

A provision of the federal Telemarketing Sales Rule (16 C.F.R. Part 310), the National Do Not Call Registry (DNC) is managed by the Federal Trade Commission (FTC), and enforced by the FTC, the Federal Communications Commission (FCC), and state law enforcement officials.

The National Do Not Call Registry applies to any plan, program, or campaign to sell goods or services through interstate phone calls. This includes telemarketers who solicit consumers, often on behalf of third party sellers. It also includes sellers who provide, offer to provide, or arrange to provide goods or services to consumers in exchange for payment. The DNC Registry does *not* limit calls by political organizations, charities, or telephone surveyors.

Consumers are required to register **only once** to maintain their home or mobile telephone numbers on the National DNC Registry permanently unless or until:

- The number is invalid, disconnected, or reassigned.
- The individual to whom the number is assigned requests to have it removed.

To keep from violating DNC regulations, a company must maintain national and internal lists of customers and prospects and keep them updated regularly. The federal DNC list must be updated every three months, and the internal do not call list must be updated every 30 days.

Anyone who receives a telemarketing call on a registered phone number may file a complaint with the FTC. Violators could be fined up to **$40,000 per incident.**

Established Business Relationship

A telemarketer or seller may call a consumer with whom it has an **established business relationship** (EBR) for up to **18 months** after the consumer's last purchase, delivery, or payment, even if the consumer's number is on the National Do Not Call Registry. In addition, a company may call a consumer for up to **three months** after the consumer makes an inquiry or submits an application to the company. Obtaining the name, phone number, and signature from a consumer provides written consent that does not expire until rescinded.

One warning: If a consumer has asked to be put on a company's **internal** do not call list, the company may not call to solicit new business, even if there is an EBR. Calls may be made to consumers in reference to a current relationship, such as a creditor making a collection call or a broker following up on a showing.

Illinois Telephone Solicitations Act

815 ILCS 413/

The **Illinois Telephone Solicitations Act** complements the National Do Not Call Registry and sets guidelines on the use of the telephone for marketing and solicitation. The following are among the provisions of this Act:

- No person shall solicit the sale of goods or services by placing a telephone call between the hours of 9 p.m. and 8 a.m.
- Live operators must immediately state their names, the name of the business or organization being represented, and the purpose of the call
- Operators must inquire at the beginning of the call whether the person consents to the solicitation or requests to be taken off the contact list.
- If the person contacted has requested to be removed from the call list, the operator must refrain from calling that person again and take all steps necessary to have that person's name and telephone number removed from the contact records.
- A person may not solicit the sale of goods or services by telephone in a manner that impedes the function of any caller ID.

Junk Fax Prevention Act

Registering a phone number on the national Do Not Call Registry prevents only telephone solicitations directed to that number, not fax advertisements. However, under the federal **Junk Fax Prevention Act** of 2005, which amended the **Telephone Consumer Protection Act** (TCPA), it is unlawful to send **unsolicited advertisements** to any fax machine—at both businesses and residences—with the following exceptions:

- The recipient provides **prior express invitation or permission**.
- The sender has an **established business relationship** with a recipient who voluntarily provided the fax number or posted it in some appropriate manner, as on the recipient's own directory, website, or advertising.

Senders are required to:

- Take reasonable steps to **verify** that the recipient consented to have a fax number listed, if it was obtained from a directory or other source of information compiled by a third party.
- Provide notice and contact information on the fax that allows recipients to **opt-out** of future faxes (and honor such opt-out requests within the shortest reasonable period of time, not to exceed 30 days).

Under the Junk Fax Prevention Act of 2005, the sender of an unsolicited advertisement sent to a person's fax machine is liable for a **minimum of $500 per page** and triple damages if a court finds that the violation was willful or knowing.

The CAN-SPAM Act

The federal **CAN-SPAM Act** (Controlling the Assault of Non-Solicited Pornography and Marketing) was enacted to curb the annoying and costly problem of unsolicited commercial e-mail, or **spam**, to both computers and wireless devices without prior permission. The CAN-SPAM Act:

- Establishes requirements for the use of commercial e-mail.
- Gives recipients the right to opt-out of receiving e-mails at any time.
- Provides tough penalties for violations, with fines up to **$16,000** for each e-mail violation.

The Act covers what the law defines as "any electronic mail message the primary purpose of which is the commercial advertisement or promotion of a commercial product or service."

The law makes **no exception** for business-to-business e-mail.

Real Success

If you plan to market your services to clients through electronic means, follow this CAN-SPAM checklist to make sure you are in compliance:

Header Information. Your routing information—including the originating domain name and e-mail address—must be accurate and identify the person or business who initiated the message.

Content. The subject line must accurately reflect the content of the message.

Ad Identification. Clearly and conspicuously disclose that your message is an advertisement.

Disclose Physical Location. Your message must include a valid physical postal address. This can be your current street address, a post office box you've registered with the U.S. Postal Service (USPS), or a private mailbox registered with a commercial mail receiving agency according to USPS regulations.

Opt-Out Instructions. **Y**our message must include a clear and conspicuous explanation of how the recipient can opt out of receiving e-mail.

Honor Opt-Out Requests Promptly. Any opt-out mechanism you offer must be able to process opt-out requests for at least 30 days after you send your message. You must honor a recipient's opt-out request **within 10 business days**, may not charge a fee, require personally identifying information beyond an e-mail address, or make the recipient take any step other than sending a reply e-mail or visiting a single webpage.

Monitor. If you hire another company to handle your e-mail marketing, you remain liable for the actions that company takes on your behalf.

Illinois Electronic Mail Act

815 ILCS 511/

To protect its citizens from unsolicited or misleading e-mail, the State of Illinois enacted the **Illinois Electronic Mail Act**. This Act prohibits any individual or entity from initiating an unsolicited electronic mail advertisement if the e-mail ad:

- Uses a third party's Internet domain name without permission.
- Misrepresents any information in identifying the point of origin.
- Contains false or misleading information in the subject line.

The following are among some the provisions of the Act:

- The initiator of an unsolicited e-mail ad must establish a toll-free telephone number or valid sender-operated return e-mail address so that the recipient may opt-out of further ads.
- The initiator of an unsolicited e-mail ad may not sell or transfer the e-mail address of anyone who has opted out.
- The subject line of each unsolicited e-mail ad must include "ADV:" as its first four characters.
- Any person, other than an e-mail service provider, who suffers actual damages as a result of a violation of this Act may bring a civil action against such individual or entity.

While many portions of the Illinois law have been pre-empted by CAN-SPAM, the anti-fraudulent portions of the law remain in effect.

True Picture and the NAR® Code of Ethics

The National Association of REALTORS® promulgates a **Code of Ethics** addressing the many obligations that a real estate professional has to clients and customers, to other licensees, and to the general public. Recall that all REALTORS® are licensees, but not all licensees are REALTORS®. REALTORS® are real estate professionals who have chosen to join NAR® and abide by its Code of Ethics. While the NAR® Code of Ethics is **not binding** on non-members, all licensees can benefit from reviewing and abiding by the Code. The Code of Ethics is organized into Articles, most of which have associated Standards of Practice.

Article 12 of the Code of Ethics is sometimes referred to as the "Truth in Advertising" Article. It cautions that real estate professionals are obligated to present a **true picture** in all representations. One should never misrepresent a property through false words or images that would mislead someone, for example, by implying certain things about a property. The requirement to be honest and truthful relates to all aspects of a real estate professional's dealings with consumers, including the following:

- Advertising services and property in any medium (television, radio, print, Internet, etc.)
- Disclosing interest or licensee status in advertising and other communication
- Maintaining accurate and current information on websites
- Refraining from practices that could mislead, misdirect, or confuse consumers on websites

Summary

1. The Illinois Real Estate License Act addresses brokerage advertising issues: Advertising must contain all information necessary to communicate to the public in a direct, accurate, and understandable manner; advertising cannot be "fraudulent, deceptive, inherently misleading, or proven to be misleading in practice;" **blind advertisements** may not be used by any licensee; a **broker's name** and **sponsoring broker's business name** must be in included on all advertising, including business cards; direct links to disclosures must be included in electronic ads; sponsored licensees cannot advertise under their own name; advertising must be placed under the **direct supervision** of a sponsoring or managing broker; sponsored or inoperative licensees selling or leasing property **owned solely** and **without utilizing brokerage services** may advertise "By Owner" if identifying licensee status; information available on a licensee's website that is behind a firewall (private) is not considered advertising.
2. Internet advertising is subject to the same restrictions as advertising in other media. All Internet marketing/advertising requires clear and conspicuous **disclosure** if any personal information collected online will be shared or sold with others. The Illinois Real Estate License Act prohibits the use of deceptive or misleading use of **meta tags** and key terms on websites, as well as using a URL or domain name deceptively or without authorization to frame another sponsoring broker's or MLS website. The Administrative Rules of the IDFPR define specific requirements for advertising both property and services on the Internet and other electronic communications for sponsoring brokers and brokers related to identification. **Scraping**, which is the use of existing listing information copied from one Internet site and posted for the public on another without permission, is prohibited.
3. Deceptive and misleading practices are prohibited by both state and federal law. Deception can be caused by a statement or by the omission of facts. The Administrative Rules of the IDFPR define the following practices as deceptive and/or misleading: Advertising a property subject to an exclusive listing agreement with another sponsoring broker **without permission**; **failing to remove advertising** of a listed property within a reasonable time; advertising a property at **auction** without reserve if there is a minimum bid; advertising that may confuse regarding the **permitted use**; using any device or method to deceptively **divert** Internet traffic or mislead consumers.
4. The federal **Fair Housing Act** prohibits the publication of any real estate advertising that indicates a limitation, preference, or intent to discriminate based on any protected class (race, color, religion, sex, handicap, familial status, or national origin). This includes the use of words or images and applies to all media (print, television, radio, and Internet). All advertising of residential real estate for sale or rent and for real estate financing should contain a **fair housing logo**, **statement**, or **slogan**.
5. Federal laws that address consumer privacy include: **Fair and Accurate Credit Transaction Act** (Fact Act), which requires businesses to take measures to responsibly secure and dispose of sensitive personal information; the **National Do Not Call Registry** (DNC), which restricts telemarketing calls to registered telephone numbers, which provisions for consumers who have an **established business relationship**; **Junk Fax Prevention Act**, which makes it unlawful to send unsolicited advertisements to any fax machine under most circumstances; the federal **CAN-SPAM Act**, which limits unsolicited commercial e-mail to computers and wireless devices, requiring opt-out provisions.
6. State laws that address consumer privacy include: The **Illinois Real Estate License Act**, which requires licensees intending to sell or share consumer information gathered from or through the Internet or other electronic communication media to **disclose** that intention to consumers in a timely and readily apparent manner (225 ILCS 454/10-35); the **Illinois Telephone Solicitations Act**, which sets guidelines on the use of telephone, such as limiting the hours of calling and clear identification; the **Illinois Electronic Mail Act**, which places strict limits on unsolicited e-mail advertisements.
7. All marketing/advertising must present a **true picture**. Names of URLs and domains must be representative and/or accurate. Names, descriptions, and images cannot be deceptive or misleading. **Phishing** and the deceptive use of metatags, keywords or other devices and methods to direct, drive or divert Internet traffic or otherwise mislead consumers is prohibited. **Puffing** (making statements that build up the property's benefits) and other opinions should be cautiously monitored.

Quiz

1. ***Which of these would NOT be considered a form of advertising?***
   a. business cards
   b. farming for prospects
   c. maintaining current listing data behind a firewall
   d. placing yard signs on a property

2. ***Broker Marie works for ACE Realty in Evanston. Her mother is selling her house in Springfield, and Marie gets the listing for ACE. Since her name is well known in the Springfield area—and ACE Realty is not—Marie puts up a yard sign with just her name on it. This is an example of a _____ ad.***
   a. blind
   b. permitted
   c. spam
   d. scraped

3. ***Which statement about real estate brokerage advertising in Illinois is FALSE?***
   a. Advertising in any media must be under the direct supervision of the sponsoring or managing broker.
   b. Only designated managing brokers may hold themselves out to the public to be designated managing brokers.
   c. A sponsored broker cannot advertise to the general public under his or her own name.
   d. A sponsoring broker must include the name of the designated sponsored licensee on a yard sign.

4. ***Licensee Chris is selling his house. He decided to list it with his sponsoring broker to take advantage of the company's fine reputation in the community. Which statement is TRUE?***
   a. Chris must include his sponsoring broker's phone number on the yard sign.
   b. Chris must disclose his licensee status on the yard sign.
   c. Chris must disclose his licensee status on the property data form.
   d. Since Chris is selling his own house, he does not have to adhere to any advertising rules and regulations.

5. ***Displaying the fair housing poster in a brokerage office is***
   a. not allowed.
   b. optional.
   c. recommended.
   d. required.

6. ***In an advertisement for a four-bedroom home, which of the following statements is considered discriminatory?***
   a. beautiful home in an exclusive neighborhood
   b. comfortable home near community recreation center
   c. excellent location; walk to bus stop
   d. large, four-bedroom on a quiet cul-de-sac lot

7. ***Of these, which is NOT required to be on a sponsored broker's home page?***
   a. the city and state where the licensee's office is located
   b. the geographic area in which the property being advertised is located
   c. the licensee's name
   d. the name of the sponsoring broker/company

8. ***Of these, which is MOST LIKELY to be considered an example of puffing?***
   a. "Beautifully-maintained colonial located in historic district"
   b. "Country charm on this 5-acre beauty"
   c. "Great bargain on the most prestigious street in town"
   d. "Stunning lakefront views from this modern condominium"

9. ***Which would NOT violate Illinois law related to real estate advertising?***
   a. advertising property for sale in an Illinois newspaper if your license is issued by the state of Indiana
   b. advertising property subject to an exclusive listing agreement with another broker without permission
   c. inserting a meta tag in your website that will bring your site up when a consumer searches your competitor's name
   d. putting the word REALTOR® on your business card when you're not a member of the NAR®

10. ***Broker David sold a house to Sue eight months ago and just heard that she's getting transferred. Even though her name is on the National Do Not Call Registry, can David call her to see if she would list her house with him?***

    a. No, since her name is on the national DNC Registry, she is protected from solicitation for new business.
    b. No, the transaction was so long ago that they no longer have an established business relationship.
    c. Yes, assuming that her name is not on his company's internal do not call list.
    d. Yes, they have an established business relationship that allows him to call her for up to 18 months with no restrictions.

11. ***Who is NOT violating the Illinois Telephone Solicitations Act?***

    a. Amy, who doesn't convey a request to remove a number from the company's contact list
    b. Bill, who makes a habit of calling prospects at 6 p.m. since he figures he'll catch them at home
    c. Cindy, who makes business calls from her home phone so that company's number won't show up on caller ID
    d. David, who waits until the basketball game ends at 9:30 p.m. to call a prospect he knows is a fan

12. ***Any solicitation done via e-mail must include instructions for***

    a. contacting the Illinois Division of Real Estate with complaints about the licensee.
    b. filing a complaint for a fair housing violation.
    c. opting out of receiving future e-mails.
    d. steps necessary to collect damages from the Illinois Real Estate Recovery Fund.



8

Brokerage Office Issues

Most real estate licensees operate as independent contractors, not as employees of the sponsoring broker; however, the distinction is important. Whether a licensee is legally considered an employee or an independent contractor affects both the business relationship and taxation issues. That is just one of the issues to consider as an affiliated licensee at a real estate brokerage. In this chapter, you will see the implications of being an independent contractor, and you will also see the legal supervisory authority and responsibility that sponsoring brokers and designated managing brokers have for affiliated licensees and the brokerage office.

You will learn:

- How to distinguish between employees and independent contractors.
- The purpose and required elements of an employee or independent contractor agreement.
- Provisions related to unlicensed assistants.
- How a real estate licensee may be compensated.
- Requirements for maintaining a real estate office in Illinois.
- Factors to consider when choosing a sponsoring broker.
- Safety considerations for real estate licensees.

Key Terms

Commission
Designated Managing Broker
Employee (Common Law)
Employee (Illinois License Law)
Employee Agreement
Errors and Omissions Insurance
Independent Contractor
Managing Broker
Offer of Cooperation
Procuring Cause
Regular Employee
Sponsoring Broker
Statutory Non-Employee
Unlicensed Assistant

Determining Employment Status

Several factors determine what legally constitutes an employee or an independent contractor relationship. This determination could create financial and legal challenges for brokers, as well as those who provide services, if there is a misclassification. Both could be held liable for additional federal and state taxes and associated penalties. The key to determining this relationship is the *amount of control, direction, and supervision the brokerage has over the services performed by the licensee.*

Real Success

If functioning as an independent contractor, licensees will need to understand these differences to prevent a problem with a sponsoring broker or the IRS. It is, therefore, recommended that real estate licensees enlist the services of a professional accountant from day one of their real estate career. Your status as an independent contractor demands the attention of an accountant, especially at tax time. Among other things, you will want to discuss the best way to withhold money from each transaction to cover your taxes and how to track expenses. Do not make the mistake many new licensees make and think about taxes when it is too late—on April 15!

Employee

An **employee** as defined under common law is *a person whose employer mandates the results. The employer controls how the results are accomplished*. Most individuals are considered employees under current tax law. The employer is responsible for withholding income tax as well as Social Security and Medicare taxes. The employer also pays a portion of these taxes. Examples of employees in a real estate office may include the receptionist, office administrator, and unlicensed assistants to specific agents. Very few real estate agents, particularly residential agents, are employees. Employees in the real estate business are typically in commercial real estate, selling shopping centers and office buildings. Because these types of transactions may take three to five years to complete, commercial agents often get a small salary and receive commissions on their sales. Property managers also tend to be employees rather than independent contractors.

Independent Contractor

Independent contractors typically *control the means and methods of accomplishing an assigned task; the paying entity has the right only to demand the end result*. Often these individuals perform special duties the firm does not have the ability or expertise to perform on its own. An independent contractor is responsible for his actions to the person or organization that contracted with him and for his own tax liability to the IRS, as well as other taxation agencies. Technically under the IRS code, **licensed real estate agents** are considered to be **statutory non-employees**. They are treated as **independent contractors** for all tax purposes if these conditions are met:

- The individual is a **licensed** real estate agent.
- All payments for services as direct sellers or real estate agents are directly related to **sales or other output**, rather than to number of hours worked.
- Services are performed under a **written contract** providing they will not be treated as employees for federal tax purposes.

Unlike employees, independent contractors are able to deduct business expenses from their income tax returns, for example, license fees, office expenses, gas mileage, a percentage of utilities, etc.

Common Law Rules

Common law requirements are considered when determining whether someone is an employee or an independent contractor. The *relationship between the worker and the business* is key to establishing the classification. All information that provides evidence as to the degree of control and degree of independence must be considered. This is determined by facts that fall into three categories: **Behavioral control, financial control,** and **the type of relationship** the parties have.

The Illinois Real Estate License Act defines a **regular employee** as a person who works an average of 20 hours a week for a person or entity who would be considered as an "employee" under the Internal Revenue Service main tests in these three categories.

Behavioral Control

Behavioral control focuses on the ability to direct and control how workers complete assigned tasks. An *employee* is generally subject to a business' instructions, whereas a contractor is not. The following examples represent typical instructions given to employees.

- When and where to do the work
- What tools or equipment to use
- Whom to hire or assist with the work
- Where to purchase supplies and services
- What work must be performed by an individual
- What order or sequence to follow

The depth of instruction can vary from job to job. The pivotal fact is whether the **business has retained the right to control the worker's performance**. In addition, if workers are provided with training on how to complete a task, they are generally treated as employees, not as independent contractors.

Financial Control

Independent contractors are much more likely to have business expenses that are *not* reimbursed. If someone incurs fixed costs regardless of activity, he is most likely an independent contractor. The amount of the worker's investment also helps determine whether he is an independent contractor or an employee.

The ability to find his own business opportunities also helps establish the relationship between a worker and a business. Independent contractors typically are free to search out business opportunities and to advertise.

Independent contractors are usually paid a flat rate for their services, while employees are paid an established rate for a given period of time (hourly, weekly, or monthly). However, some independent contractors are paid by the hour, especially in the case of professional services, such as law or accounting. In addition, independent contractors can make a profit or experience a loss.

Type of Relationship

The type of working relationship employers, employees, or contractors have plays a role in the classification of employment. The type of relationship can be established by:

- Written contracts.
- Employee-type benefits, such as insurance, pension, paid vacation or sick pay.
- Permanency of the relationship.
- Degree to which the services are an integral part of the daily business activities of the firm.

According to the Illinois Real Estate License Act, the generic use of the word "employee" when describing or referring to the relationship between real estate licensees includes an independent contractor relationship, provided that a written agreement exists that clearly establishes and states the relationship.

Elements of an Independent Contractor Relationship

Common characteristics of the sponsoring broker-independent contractor relationship include:

- Compensation is paid only for output **without regard for the number of hours** worked.
- Compensation is paid **without any deductions** for taxes, and the independent contractor is solely responsible for the payment of the taxes to the appropriate agencies.
- Agents **determine their own work hours**, depending on the needs of their clients.

- Sponsoring brokers can provide an office and supplies, but affiliated licensees are **responsible for expenses incurred**. (This may be in the form of a deduction from commissions when compensation is paid; however, this deduction does not fall into the disqualifying category of taxes withheld.)
- The sponsoring broker may **direct and supervise**, but does not fully control the actions of the licensee.
- Either the sponsoring broker or the affiliated licensee may terminate the agreement at any time.
- Federal and state laws require a **written agreement**, executed by both parties without duress or undue influence by either party.

Consequences of Not Meeting Requirements

Independent contractors must make sure they meet the legal criteria for claiming independent contractor status. Simply claiming contractor status, filing the proper tax forms, and waiving rights as an employee may not qualify a worker as an independent contractor under the law. If the independent contractor does not meet the qualifications of the relationship, either party may be liable for additional consequences. The employer may be liable to pay:

- Unemployment insurance premiums (state and federal)
- Workers' Compensation premiums
- Social Security taxes
- Medicare taxes
- State and federal withholdings
- Interest and penalties on the amounts not paid

For the licensee who *does not* meet independent contractor requirements, all income is treated as wages. Licensees cannot file a Form 1040 Schedule C and deduct normal business expenses related to income. In addition, because all income is treated as wages, the amount of income, Social Security, and Medicare taxes is much higher.

Tax Documentation

At the end of the tax year, an independent contractor receives a **1099 MISC** form detailing any commission-based income instead of a W-2. A licensee ***would*** receive a W-2, however, for any non-production income. For example, a sponsoring broker might pay affiliated licensees an hourly rate to attend required staff meetings or training sessions.

As you can see, there is more to being an independent contractor than simply signing on to work in a particular office. Be sure you fully understand your status when you set out in your new career. This will save you time, and potentially money, when tax time rolls around.

Relationship with Sponsoring Broker

Recall that a licensee may perform real estate activities only for his or her sponsoring broker. While a sponsoring broker has great flexibility in determining how the brokerage will operate, the Illinois Real Estate License Act does provide the framework for describing the sponsoring broker's relationship with affiliated licensees.

Written Agreement

225 ILCS 454/10-20

Every sponsoring broker, other than sole proprietors with no additional sponsored licensees, must have a **written employment agreement** or **independent contractor agreement** with every sponsored licensee. The employment agreement must be dated and signed by the parties.

The agreement must address the employment or independent contractor relationship terms, including without limitation:

- Supervision.
- Duties.
- Compensation.
- Termination.

Note that the sample contract included here references the affiliated licensee as a "salesperson." This describes the role played by the licensee, not the license itself, which is, of course, a broker's license.

Company Policy Manual

225 ILCS 454/10-40

The **sponsoring broker** must establish **written company policies** and remain ultimately responsible for compliance with the Administrative Rules of the Department of Financial and Professional Regulation. There is no mandated template that a sponsoring broker must follow in putting together a company policy manual, but a typical manual will likely address the following topics:

- The agency policy of the entity
- Fair housing, nondiscrimination, and harassment
- Confidentiality of client information
- Advertising
- Training and supervision of sponsored licensees
- Required disclosures and use of forms
- Handling of risk management matters
- Handling of earnest money and escrows
- A licensee's responsibilities for license maintenance, for example, continuing education

These topics are simply an example and are not intended to be inclusive or exclusive of other topics.

Supervision

Rules: Section 1450.705

While a sponsoring broker supervise all appointed designated managing brokers, it is the responsibility of the **designated managing broker** to exercise supervision over the activities of licensees and unlicensed assistants working in those offices that he or she manages. This supervision of activities includes, but is not limited to, the following:

- The implementation of and communication to sponsored licensees of office policies and procedures established by the sponsoring broker
- Training of licensees or unlicensed assistants
- Supervising and assisting licensees in real estate transactions
- Supervising those special (escrow) accounts over which the sponsoring broker has delegated responsibility to the managing broker in order to ensure compliance with the special (escrow) account provisions of the Real Estate License Act and the Rules of the Department of Financial and Professional Regulation
- Supervising all advertising, in any media, of any service for which a license is required
- Familiarizing sponsored licensees with the requirements of federal and State laws and local ordinances relating to the practice of real estate
- Compliance with the Rules of the Department of Financial and Professional Regulation for licensees and offices under his or her supervision

Designated managing brokers are also responsible for **directly handling** the following for any affiliated broker **who has not yet completed the required post-license education**:

- Contract negotiations
- Advertisements
- Earnest money and escrows

Any violation of the provisions of the Real Estate License Act on the part of any licensees employed by a sponsoring broker or associated by written agreement with the sponsoring broker, or unlicensed employee of a sponsoring broker, would not be cause for suspension or revocation of the license of the sponsoring broker or a designated managing broker **unless the sponsoring broker or designated managing broker had knowledge of the violation**.

However, **failure to provide an appropriate company policy or failure to properly supervise** *would* be cause for discipline, including suspension or revocation, of the license of the sponsoring broker or a designated managing broker.

Real Success

As a new licensee, you should be looking for a situation where the designated managing broker will show you the ropes, who's available to answer questions, and who will help you become an experienced professional. The value of this supervisory relationship should not end just because a broker has vast experience. The State of Illinois takes this requirement for the designated managing broker to supervise other licensees very seriously. Ultimately, your sponsoring broker is responsible for you ***no matter how many years you have been in the business.***

Liability

While a sponsoring broker is not required to be involved in the day-to-day activities in the office, the sponsoring broker will be responsible for the actions of affiliated licensees if there is actual knowledge that a violation occurred. A sponsoring broker **cannot** write a contract with a licensee that in any way diminishes these obligations.

Let's say, for example, that the sponsoring broker overhears a broker provide false information to a client and does nothing about it. Or the sponsoring broker knows that his designated managing broker allows an unlicensed employee to perform tasks that require a license. The sponsoring broker has actual knowledge of wrongdoing and is therefore responsible along with the person whose acts were unethical or illegal.

Insurance Considerations

Because a sponsoring broker does maintain a degree of liability for affiliated licensees, insurance requirements are likely to be part of the employment or independent contractor agreement.

Errors and Omissions Insurance

Errors and omissions (E&O) insurance is *professional liability insurance that protects licensees from mistakes or negligence.* A typical policy pays legal fees and judgments resulting from real estate activities. It does **not** generally cover:

- Fraud.
- Transactions involving buying or selling one's own real estate.
- Civil rights violations.

Some brokerages will carry an office policy that can cover all affiliated licensees for an additional fee. Sponsoring brokers are not required to carry E&O insurance, so it's up to every licensee to confirm coverage with his or her sponsoring broker. In a constantly changing profession with large and complex transactions, E&O insurance is critical.

ILLINOIS ASSOCIATION OF REALTORS®
SPONSORING BROKER-SALESPERSON CONTRACT

THIS AGREEMENT made and entered into this _____ day of _____, 2___, by and between _____ hereinafter referred to as "Sponsoring Broker", and _____, hereinafter referred to as "Salesperson".

WITNESSETH:

WHEREAS, Sponsoring Broker is duly licensed and does engage in business as a real estate broker in the City of _____ State of Illinois;

WHEREAS, Salesperson is now duly licensed and does engage in business as a real estate salesperson, and whereas, it is deemed to be to the mutual advantage of Sponsoring Broker and Salesperson to enter into this contract upon the terms and conditions hereinafter set forth.

NOW, THEREFORE, for and in consideration of the mutual covenants and promises herein contained and each act done pursuant hereto the undersigned hereby enter into the following agreement:

1. Facilities and Sales Effort.
   - A. Salesperson agrees to proceed diligently, faithfully, loyally, legally and within his/her best efforts to sell, trade, lease or rent any and all real estate listed with Sponsoring Broker (except for any special listings which are exclusively placed by Sponsoring Broker with another salesperson), to solicit additional listings and customers for Sponsoring Broker, and otherwise to promote the business of serving the public in real estate transactions to the end that each of the parties hereto may derive the greatest profit possible.
   - B. Sponsoring Broker agrees for the convenience of Salesperson to provide desk space, clerical service and office facilities at the office of Sponsoring Broker presently maintained at _____, _____, Illinois, and/or at such other places as Sponsoring Broker may from time to time utilize.
   - C. Sponsoring Broker agrees to make available to the Salesperson all current listings of the office, except such as the Sponsoring Broker, for valid and usual business reasons, may place exclusively in the temporary possession of some other salesperson, and agrees, upon request, to provide assistance and full cooperation to the salesperson.
2. Termination.
   - A. This agreement, and the relationship created hereby, may be terminated by either party hereto, with or without cause, at any time upon _____ (_____) days written notice given to the other; but the rights of the parties to any commissions which accrued prior to said notice shall not be divested by the termination of this agreement except as stipulated herein.
   - B. Upon termination of this agreement, all negotiations commenced by Salesperson during the term of this agreement shall continue to be handled through Sponsoring Broker and with such assistance by Salesperson as is reasonable under all the circumstances. Salesperson shall be compensated according to the Commission Schedule referred to in paragraph 5, after deduction of all appropriate expenses.
   - C. Salesperson, upon such termination, shall furnish Sponsoring Broker with a bona fide list of all prospects, leads and probable transactions developed by Salesperson, or upon which Salesperson shall have been engaged with respect to any transaction completed subsequent to termination of this agreement in which Salesperson has rendered assistance in accordance with this paragraph. Except as provided in subparagraph B above, Salesperson shall not be compensated in respect to any transaction completed subsequent to termination of this agreement unless agreed to in writing by Sponsoring Broker.
   - D. Upon termination of this agreement, Salesperson further agrees not to furnish to any person, firm, company or corporation engaged in the real estate business any information as to Sponsoring Broker's clients, customers, properties, prices, terms of negotiations nor Sponsoring Broker's policies or relationships with clients and customers nor any other information concerning Sponsoring Broker and/or his/her business. Salesperson shall not, after termination of this agreement, remove from the files or from the office of the Sponsoring Broker any maps, books and publications, card records, investor or prospect lists, or any other material, files or data, and it is expressly agreed that the aforementioned records and information are the property of Sponsoring Broker. Salesperson shall be entitled to photostats of certain instruments pertaining to transactions in which Salesperson has a bona fide interest, and Sponsoring Broker shall not unreasonably withhold the same from Salesperson.
3. Automobile. It is agreed that Salesperson shall furnish his/her own automobile and pay all expenses thereof and that Sponsoring Broker shall have no responsibility therefore. Salesperson agrees to carry public liability insurance upon that automobile with minimum limits of $ _____ for each person and $ _____ for each accident and with property damage limit of $ _____.
4. Real Estate Licenses, Insurance and Dues. Salesperson shall pay all of the cost of his/her own real estate license and his/her dues for membership in the National Association of REALTORS®, Illinois Association of REALTORS® and the _____ Board/Association of REALTORS® and any associations, membership organizations or trade associations to which Salesperson wishes to belong. Salesperson shall obtain and pay for errors and omissions insurance with a company and in an amount acceptable to Sponsoring Broker.
5. Commissions.
   - A. The commissions and fees for services rendered in the sale, rental, trade or leasing of real estate shall be those stated in the Sponsoring Broker's policy manual or other similar written document and shall be payable to the Sponsoring Broker. In no event shall Salesperson charge less than the commission or fee established by the Sponsoring Broker without the prior consent of the Sponsoring Broker. If Sponsoring Broker shall have entered into a special contract or agreement pertaining to any particular transaction the Sponsoring Broker shall advise Salesperson of such special arrangement. Commissions, when earned and paid pursuant to this agreement, shall be divided between Sponsoring Broker and Salesperson, after deduction of all expenses, according to the Salesperson's commission schedule as adopted by Sponsoring Broker from time to time. Sponsoring Broker shall notify Salesperson of any change in said commission schedule.
   - B. In the event that two (2) or more salespeople under contract with Sponsoring Broker participate in a transaction and claim a commission thereon, then and in that event the amount of the commissions allocable to each salesperson shall be divided equally among the salespeople or otherwise according to a written agreement among said salespeople.
   - C. In no case shall Sponsoring Broker be personally liable to Salesperson for any commission not collected, nor shall Salesperson be personally liable to Sponsoring Broker for any commission not collected. If commissions have been or are to be collected from the party or parties for whom the service was performed, it is agreed that such sums shall be deposited with the Sponsoring Broker and subsequently divided according to the terms of this agreement.
   - D. The division and distribution of the earned commissions as provided herein, which may be paid to or collected by Sponsoring Broker, but from which Salesperson is due certain commissions, shall take place as soon as practicable after collection and receipt of such commissions. However, Sponsoring Broker is first entitled to reimbursement for any expenses incurred such as attorney's fees, revenue stamps, abstract costs or expenses incurred in the collection of the commission with respect to any transaction.

*WITNESS the signature of the parties hereto on the day and year first above written in duplicate.

SPONSORING BROKER	SALESPERSON
_____	
By: _____	_____
Capacity _____	

*Original signature required on each copy

SAMPLE

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6. Supervision.

   A. Salesperson agrees to abide by the requirements and standards of Sponsoring Broker as set forth in Sponsoring Broker's Office Policy Manual.

   B. If Salesperson needs consultation in a transaction or situation, Salesperson agrees to seek the counsel of Sponsoring Broker or his/her designee.

7. Listings, Correspondence, Records and Forms.

   A. Salesperson agrees that any and all listings of property, and all actions taken in connection with the real estate business, shall be taken by Salesperson in the name of Sponsoring Broker. Such listings shall be filed with Sponsoring Broker within twenty-four (24) hours after receipt of same by Salesperson. All listings shall be and remain the separate and exclusive property of Sponsoring Broker unless otherwise agreed by the parties hereto.

   B. It is agreed by the parties hereto that all correspondence received, copies of all correspondence written, plats, listing information, memoranda, files, photographs, reports, legal opinions, accounting information, and any and all other instruments, documents or information of any nature whatsoever concerning transactions handled by Sponsoring Broker or by Salesperson, or jointly, are and shall remain the property of Sponsoring Broker, provided, however, that Salesperson is entitled to a copy of each upon reasonable request.

   C. The parties hereto shall mutually approve and agree upon all correspondence from the office of Sponsoring Broker pertaining to transactions being handled, in whole or in part, by Salesperson.

   D. The parties hereto agree that forms to be used by the Salesperson will be those provided or otherwise approved by the Sponsoring Broker.

   E. Sponsoring Broker shall have the right to review and approve all completed contracts and completed forms before they are presented to clients for signature.

8. Independent Contractor.

   A. This agreement does not constitute a hiring by either party. The parties hereto are and shall remain independent contractors bound by the provisions hereof. This agreement shall not be construed as a partnership, and neither party hereto shall be liable for any obligation incurred by the other except as provided elsewhere herein. Sponsoring Broker shall not withhold from Salesperson's commission any amounts for withholding or employment taxes or any other items. Salesperson will not be treated as an employee for federal and state tax purposes and will be responsible for the payment of any and all federal or state taxes based upon commissions earned and received. Sponsoring Broker will not make any premium payments or contributions for any workmen's compensation or unemployment compensation for Salesperson.

   B. Sponsoring Broker agrees to serve as Salesperson's sponsor as required by the Illinois Real Estate License Act of 2000, as amended, 225 ILCS 454/10-20 (a).

9. Default and Hold Harmless. The parties hereto mutually agree that if either party shall be in default of or breach any of the terms and conditions of this Contract and such default or breach shall result in any loss or damage to the other party, then and in that event, the defaulting party hereby agrees to pay to the other party any such loss or damage and further agrees to hold the other party harmless from any claim, demand, cause of action, or lawsuit which may result from or be caused by such breach of this Contract.

10. Ethics, Laws, and Trade Organizations.

   A. Salesperson and Sponsoring Broker each agree to conduct his/her business and regulate his/her habits and working hours so as to maintain and to increase the good will, business, profits and reputation of Sponsoring Broker and Salesperson, and the parties agree to conform to and abide by all laws, rules and regulations applicable to real estate brokers and real estate salespeople. Specifically, Salesperson and Sponsoring Broker shall be governed by the Code of Ethics of the National Association of REALTORS®, the Real Estate License Act of the State of Illinois, the constitution and bylaws of the local real estate board, the rules and regulations of any multiple listing service with which Sponsoring Broker now and in the future may be affiliated, and any further modifications or additions to the foregoing.

   B. Salesperson acknowledges Sponsoring Broker's commitment and support for all state, federal fair housing and antitrust laws and further understands the Sponsoring Broker expects Salesperson to be knowledgeable concerning these laws and to conduct his/her business practices accordingly.

11. Litigation and Controversies.

   A. In the event that Salesperson does not wish to enter into the following actions jointly with Sponsoring Broker, the Salesperson hereby grants to Sponsoring Broker the power of attorney in his/her name, place and stead to institute an action in a court of competent jurisdiction concerning commissions or other matters related to the conduct of such real estate business of Sponsoring Broker and Salesperson as have been pursued by the parties under this Agreement; to conduct the same to a final decision; to negotiate settlements; to defend actions, suits or proceedings pertaining to said real estate business; to employ counsel and to settle or pursue matters to a final conclusion in such manner and upon such terms as to Sponsoring Broker may seem expedient or desirable.

   B. In the event any transaction in which Salesperson is involved results in a dispute, litigation or legal expense, Salesperson shall cooperate fully with Sponsoring Broker. It is the policy to avoid litigation whenever possible, and Sponsoring Broker, within his/her discretion may determine whether or not any litigation or dispute shall be prosecuted, defended, compromised or settled, and the terms and conditions of any compromise or settlement, or whether or not legal expense shall be incurred; provided, however, that no compromise or settlement involving the payment of money or anything of value by Salesperson, or the foregoing of any commission not challenged or subject to dispute or portion thereof due Salesperson, shall be accepted by Sponsoring Broker without the written consent of Salesperson.

   C. Salesperson shall notify Sponsoring Broker of any transaction in which Salesperson is involved which Salesperson has reason to believe may result in litigation or arbitration involving the Sponsoring Broker.

12. Expenses. Sponsoring Broker shall not be liable to Salesperson for any expenses incurred by Salesperson or for any of his/her acts, nor shall Salesperson be liable to Sponsoring Broker for Sponsoring Broker's office help or expenses or any of Sponsoring Broker's acts, other than as specifically provided for herein.

13. Miscellaneous.

   A. Heirs, Successors and Assigns. This agreement shall be binding upon and the benefits shall inure to the heirs, successors and assigns of the parties hereto.

   B. Notices. All notices provided for under this agreement shall be in writing and shall be sufficient if sent by certified mail to the last known address of the party.

   C. Governing Law. This agreement shall be governed by the laws of the State of Illinois.

   D. Assignment. This assignment is personal to the parties hereto and may not be assigned, sold or otherwise conveyed by either of them.

   E. Waiver. The failure of any party hereto to enforce at any time any of the provisions or terms of this agreement shall not be construed to be a waiver of such provision or term, nor the right of any party thereafter to enforce such term or provision.

   F. Entire Agreement. This agreement constitutes the entire agreement between the Sponsoring Broker and Salesperson and there are no agreements or understandings concerning such agreement which are not fully set forth herein.

   G. Severability. If any provision of this agreement is invalid or unenforceable in any jurisdiction, the other provisions herein shall remain in full force and effect in such jurisdiction and shall be liberally construed in order to effectuate the purpose and intent of this agreement, and the invalidity or unenforceability of any provision of this agreement in any jurisdiction shall not affect the durability or enforceability of such provision in any other jurisdiction.

Form 201
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Automobile Insurance

The State of Illinois mandates that every driver must carry vehicle liability insurance. Drivers must carry their insurance cards in their vehicle and show it on request by any law enforcement officer. The State can impose a minimum fine of $500 for driving uninsured.

Since real estate agents often take clients and customers to look at property in their cars, the coverage of a personal automobile policy is not sufficient to cover this additional risk, and therefore, licensees should get a **business automobile policy** to reduce the exposure. Also, most licensees do consider the car as a business expense for tax purposes, so a business auto policy just makes sense.

Because a business auto policy costs more than a personal auto policy, some licensees may be tempted to keep only a personal auto policy, especially those who rarely, if ever, transport a client or customer in his or her car. However, many sponsoring brokers will insist upon a business auto policy because of the liability they have for affiliated licensees.

While each company's guidelines can vary on this point, sponsoring brokers will likely require proof of insurance and make it part of their office policy to verify that insurance annually.

Teams

Real estate **teams** are the norm in many markets. The Real Estate License Act defines a team as any two more licensees who provide brokerage services for the **same sponsoring broker** and who represent themselves to the public as a team. Teams have an identity—such as a name or logo—that is different from their sponsoring broker. The team name, however, cannot include misleading terms such as agency, company, real estate, realty, brokers, associates, or property.

An advantage of putting together a real estate team is that it allows team members to focus on their own strengths and, in theory, be more efficient and productive. Teams may include any number of real estate licensees working on specialized tasks—such as a lead generator or listing agent, and several buyers' agents. In many ways, a team functions almost as a brokerage-within-a-brokerage. Teams can recruit new team members just as brokers recruit new licensees. To comply with Illinois law, however, the **designated managing broker must supervise the team**.

Unlicensed Assistants

Running a busy real estate office requires a great deal of administrative support. Brokers logically prefer to spend their time interacting with clients and customers to bring about successful real estate transactions. The Administrative Rules of the Department of Financial and Professional Regulation provides that those who are licensed may employ, or otherwise utilize the services of, **unlicensed assistants** to assist them with administrative, clerical, or personal activities for which a license is not required.

A licensee, however, is not permitted to act as an unlicensed assistant for any licensee other than his or her sponsoring broker or a licensee sponsored by the sponsoring broker.

Permitted Activities

Generally speaking, stenographic, clerical, maintenance, engineering, building trades, security, or office personnel **not directly engaged in the practice of real estate brokerage are not required to be licensed**

An unlicensed assistant, on behalf of and under the direction of a licensee, *may* engage in the following brokerage-related administrative, clerical, or personal activities without being in violation of the licensing requirements:

- Answer the telephone, take messages, and forward calls to a licensee
- Submit listings and changes to a Multiple Listing Service

- Follow up on a transaction after a contract has been signed
- Assemble documents for a closing
- Secure public information from a courthouse, sewer district, water district, or other repository of public information
- Have keys made for a company listing
- Draft advertising copy and promotional materials for approval by a licensee
- Place advertising
- Record and deposit earnest money, security deposits, and rents
- Complete contract forms with business and factual information at the direction of and with approval by a licensee
- Monitor licenses and personnel files
- Compute commission checks and perform bookkeeping activities
- Place signs on property
- Order items of routine repair as directed by a licensee
- Prepare and distribute flyers and promotional information under the direction of and with approval by a licensee
- Act as a courier to deliver documents, pick up keys, etc.
- Place routine telephone calls on late rent payments
- Schedule appointments for the licensee (this does not include making phone calls, telemarketing, or performing other activities to solicit business on behalf of the licensee)
- Respond to questions by quoting directly from published information
- Sit at a property for a broker tour that is not open to the public
- Gather feedback on showings
- Perform maintenance, engineering, operations, or other building trades work and answer questions about that work
- Provide security
- Provide concierge services and other similar amenities to existing tenants
- Manage or supervise maintenance, engineering, operations, building trades, and security
- Perform other administrative, clerical, and personal activities for which a license is not required

This list is intended to be illustrative and declarative, not to increase or decrease the scope of activities for which a license is required.

Prohibited Activities

An unlicensed assistant of a licensee may *not* perform the following activities for which a license is required:

- Host open houses, kiosks, or home show booths or fairs
- Show property
- Interpret information on listings, titles, financing, contracts, closings, or other information relating to a transaction
- Explain or interpret a contract, listing, lease agreement or other real estate document with anyone outside the licensee's company
- Negotiate or agree to any commission, commission split, management fee, or referral fee on behalf of a licensee
- Perform any other activity for which a license is required

Again, this list is intended to be illustrative and declarative, not to increase or decrease the scope of activities for which a license is required.

Supervisory Responsibility

Rules: Section 1450.740

Any licensee who employs an unlicensed assistant must be responsible for the actions of the unlicensed assistant taken while under the supervision of, or at the direction of, the licensee. A responsible licensee who allows an unlicensed assistant to perform *any* activity for which a license is required is in violation of the Illinois Real Estate License Act.

Compensation for unlicensed assistants **cannot be transaction based**. This means that an unlicensed assistant cannot receive commission-related compensation or referral fees.

Broker Compensation

225 ILCS 454/10-20 (d)

Commission is the primary source of compensation for the real estate licensee. The commission rate that will be paid on the sale of property is **negotiated** between the client and the broker at the time a written agreement is made. Commission is typically a percentage of the transaction amount, although compensation could be a flat fee, hourly rate, or some other consideration.

Generally, the seller pays the commission on the sale of property to the listing broker, who then distributes the earned commission to the agents involved in the transaction under the terms of the agent's employment agreement.

To be eligible for a sales commission, an individual must be a real estate **licensee** and must be **employed** by the client under a valid contract. A licensee can receive the agreed upon share of the commission **only from his or her sponsoring broker.** An exception is that a broker *may be able* to receive commission from a *former* sponsoring broker *if* the broker was licensed under that former sponsoring broker at the time commission was earned. Such a policy must be clearly defined in the employee or independent contractor agreement.

A licensee may form a **business entity**, such as a solely-owned corporation, for the purpose of receiving earned compensation directly from the sponsoring broker. Such a corporation is not required to be licensed as long as the person who formed it is a licensee and is either the sole owner or co-owns with a spouse who is also a licensee with the same sponsoring broker.

Compensation Structure

Typical commission splits range anywhere from 40%-60% (meaning 40% to the broker and 60% to the sponsoring broker) to 100%. Some brokerages offer commission-splitting arrangements as high as 80%-20%, 90%-10%, and even 100% to the broker. Of course, these arrangements often necessitate that brokers pay for their own costs—sometimes even those costs associated with the closing. And the 100% arrangement often means that brokers need to pay the sponsoring broker a monthly fee for using the brokerage name, services, and facilities, even if no sales are made in that particular month.

Some brokerages offer choices in the middle. Licensees need to do research to find the situation that's right for them. Remember, a larger commission split may sound good, but paying for everything can add up. Plus, the larger commission split doesn't matter if a licensee can't make sales because he or she does not have the necessary tools or the proper training.

On the other hand, if a licensee has access to services, a sales background, or experience in some area of real estate, this may influence the choice of a broker. Some brokers like the image, prestige, and contacts they get by being associated with a large firm. Others like the opportunity to work with customers and clients in servicing the niche market of a smaller brokerage. Every licensee must decide what's right for them.

The employment contract should provide details about compensation and whether the sponsoring broker has a policy for adjusting the compensation structure. For example, some allow licensees to earn a larger split after they have:

- Worked for that sponsoring for a specified length of time.
- Had a specified number of transactions.
- Sold a specified dollar amount of real estate.

Case in Point

Sponsoring broker ABC Realty agrees to a 50-50 commission split with its affiliated licensees. Also, with an in-house transaction, ABC's policy is to give the listing agent 60% of the split and the selling agent 40%, so a $10,000 commission would be split as follows:

ABC Realty:	$5,000
Listing agent Sue:	$3,000
Selling agent Bob:	$2,000

If ABC Realty is associated with a parent company, it may be required to subtract a franchise fee off the top of the commission before it is distributed.

Real Success

The payment of compensation is ***not*** a requirement of an agency relationship. An agent may offer his or her services free of charge, for example, an agent who lists his mother's house for sale and does not want a commission for that transaction. This creates a situation called **gratuitous agency**. Although compensation is not part of the relationship, the agent is held to the same standard of statutory obligation due to any paying client. Lack of compensation does ***not*** release a broker or his sponsoring broker from liability.

Offering Compensation to the Public

In Illinois, a licensee may offer compensation to an unlicensed person who is a party to a contract to buy or sell real estate or is a party to a contract for the lease of real estate. Such compensation could include the following:

- Prizes
- Merchandise
- Services
- Rebates
- Discounts
- Other consideration

A licensee may also offer cash, gifts, prizes, awards, coupons, merchandise, rebates, or chances to win a game of chance—if not prohibited by any other law or statute—to a consumer as an **inducement** to that consumer to use the services of the licensee even if the licensee and consumer do not ultimately enter into a broker-client relationship.

Conditions or Obligations

225 ILCS 454/10-15 (c)(d), 20-20 (a)(35)

When advertising or offering merchandise or services as "**free**," the licensee must disclose any conditions or obligations necessary for receiving the merchandise or services in the same advertisement or offer. These conditions or obligations include without limitation the requirement that the recipient attend a promotional activity or visit a real estate site.

Other words or terms that may be used in an ad that require disclosure of conditions or obligations include:

- Award
- Prize
- No charge, free of charge, or without charge

It also applies to any similar word or phrase that reasonably would lead consumers to believe that they may receive or have been selected to receive something of value, without any conditions or obligations on their part.

Licensees cannot pay compensation to any unlicensed person who is not or will not become a party to a real estate transaction in exchange for a referral of real estate services.

Running a Brokerage

Up to this point, we've discussed the relationship between the licensee and his or her sponsoring broker. Now we'll refocus on the place of business and look at the responsibilities that a sponsoring broker has to maintain an office and the duties that a managing broker has to supervise the affiliated licensees. A sponsoring broker and a managing broker **could be the same person**, but let's review the definitions of each role:

- A **sponsoring broker** is the licensed person or entity who affirmed sponsorship of another licensed broker or a residential leasing agent. However, the sponsoring broker *may delegate* that responsibility to one or more designated managing brokers.
- A **designated managing broker** is a managing broker who has **supervisory responsibilities** for licensees in one or, in the case of a multi-office company, more than one office and who has been appointed as such by the sponsoring broker.

Appointing Designated Managing Brokers

The sponsoring broker must name a licensed **designated managing broker** for each office. The sponsoring broker must notify the Department of the **name** of all designated managing brokers and the office or offices they manage. The sponsoring broker must be responsible for supervising all designated managing brokers.

Any licensee holding a managing broker license and named as a designated managing broker with the Department must indicate that status in any marketing or advertising that includes their name. Those licensees holding a managing broker license and *not appointed* as a desginated managing broker with the Department must not represent or hold themselves out as a designated managing broker, but only as a managing broker.

Communicating Changes

225 ILCS 454/5-45 ***Rules: Section 1450.725-730***

The sponsoring broker must notify the Illinois Department of Financial and Professional Regulation (IDFPR) of any opening, closing, or change in location of any office **within 24 hours** after any change.

Any changes in designated managing brokers must be reported to the IDFPR **within 15 days** of the change. Failure to do so will subject the sponsoring broker to discipline.

Upon the **loss of a designated managing broker** who is not replaced by the sponsoring broker, or in the event of the death or adjudicated disability of the sole proprietor of an office, a written request for authorization allowing the continued operation of the office may be submitted to the IDFPR **within 15 days** of the loss.

The IDFPR may issue a written authorization allowing the continued operation, provided that a licensed broker, or in the case of the death or adjudicated disability of a sole proprietor, the representative of the estate, assumes responsibility, in writing, for the operation of the office and agrees to personally supervise the operation of the office until the real estate brokerage is closed, but not to actively engage in the brokerage business. Such written authorization will be valid for **no more than 60 days** unless extended by the Department for good cause shown and upon written request by the broker or representative. Good cause includes such circumstances as:

- Sales under contract pending closing.
- Loss of livelihood for affiliated licensees.
- Undue hardship caused to sellers.

Office Requirements

Each sponsoring broker must maintain an **office** or **place of business** within Illinois for the transaction of real estate business. The office or place of business cannot be located in any retail or financial business establishment unless it is separated from the other business by a separate and distinct area within the establishment.

If a sponsoring broker maintains more than one office within the State, the sponsoring broker must notify the Department. The office license must be displayed conspicuously in each office. The name of each office must be the same as that of the sponsoring broker's principal office or must clearly delineate the office's relationship with the principal office.

The Department may adopt rules to permit and regulate the operation of virtual offices that do not have a fixed location.

Out of State Offices

A broker who is licensed in Illinois by examination or through a reciprocal arrangement with another state is *not required to maintain a definite office or place of business in Illinois provided all of the following conditions are met:*

- The broker maintains an active broker's license in the state in which he or she lives.
- The broker maintains an office in the state in which he or she lives.
- The broker has filed written statements with the Illinois Department of Financial and Professional Regulation (IDFPR) appointing the Secretary to act as the broker's agent upon whom all judicial and other process or legal notices directed to the licensee may be served; agreeing to abide by all of the provisions of the Illinois Real Estate License Act with respect to his or her real estate activities in Illinois; and submitting to the jurisdiction of the IDFPR.

Signage

An identification sign must be conspicuously displayed on the **outside** of each physical office of adequate size and visibility, which means that the sign meets the following requirements:

- An identification sign on the outside of an office shall be of a size and nature that it will be reasonably readable by the public and semi-permanent or affixed to the office. Listings within building directories fulfill this requirement.
- Office identification signs must be professional in appearance and meet all applicable zoning restrictions and applicable restrictive covenants.
- The identification sign must be plainly visible from an area accessible to the public.

Display of Licenses

225 ILCS 454/5-45

Licenses of **all** licensees must be **readily available** to the public in the principal office of the licensee's sponsoring broker. "Readily available" may include, but is not limited to:

- Being visible on a wall of a public waiting or reception area.
- Being available for viewing at the sponsoring broker's principal office upon request.

Designated managing brokers assigned to manage more than one office must have **copies** of their licenses readily available in **each of those offices** they manage.

Record Keeping

The Real Estate License Act imposes certain requirements for maintaining records, such as transaction documents or escrow account records.

- **Physical** record must be securely stored and accessible for inspection by the Department at the sponsoring broker's principal office.

- **Electronic** records must be securely stored in the format in which they were originally generated, sent, or received and accessible for inspection by the Department by secure electronic access to the record. Electronic records must be backed up at least monthly.

Any record relating to a transaction of a special account must be maintained for a minimum of five years.

Inspections and Audits

The **Division of Real Estate** is authorized to inspect those areas of a sponsoring broker's office **open and generally available to the public at any time** during normal business hours, with or without the sponsoring broker's consent. With the sponsoring or responsible managing broker's consent or, if no consent is given, then upon **24 hours notice**, the Division may:

- Conduct a visual and physical inspection of the **non-public areas** of a sponsoring broker's office.
- Interview any person, including any licensee or non-licensee, who may have knowledge or information about the licensee's practice of real estate. The licensee may have an attorney present if he or she so chooses. The Division's action will not be postponed due to an unreasonable delay in the ability of the licensee's attorney to be present, however.

Upon any written or oral request by Division personnel for written documentation, a licensee must produce the requested documentation **within 30 days** after the request. In carrying out these provisions, the Division is authorized to obtain a licensee's original records, which would include hard copy or electronic records, for the purposes of inspection, audit, and reproduction. The Division must promptly return all original documents or records to the licensee.

Escrow Audits

The Division is authorized to audit special accounts, escrow records, and documents related to any escrow accounts maintained by the licensee. Escrow audits may be conducted:

- At any time with the sponsoring broker's consent, or
- With at least 24 hours notice without consent.

The licensee may have an attorney present if he or she so chooses, though again, the Division's action will not be postponed due to an unreasonable delay in the ability of the licensee's attorney to be present.

Escrow audits may include the following:

- A review and examination of all required, original escrow records as required
- A review and examination of any document, including originals, related to a licensee's escrow accounts
- Interviews of any person, including any licensee or non-licensee, who may have knowledge or information about the licensee's practices for maintaining and administering his or her escrow accounts

Audits of Special Funds by Outside Auditors

Rules: Section 1450.920-925

Upon receipt of a complaint from one or more members of the public, information from another regulatory or law enforcement agency, or evidence developed by the Division, any of which causes the Division to reasonably believe that escrow moneys required to be kept in a special account have been misappropriated, the Division may contract with **a licensed certified public accountant** for the purpose of auditing the special accounts of the sponsoring broker responsible for the accounts in question.

Reasonable Belief. To meet the criteria of **reasonable belief**, the complaints, information, or evidence available to the Division must be of a nature or have sufficient credibility that a prudent person in the exercise of good judgment would reasonably rely or act upon that information or evidence.

Misappropriation. This refers to the use of escrow moneys for a purpose other than that for which the escrow moneys were deposited or that is permitted by the Real Estate License Act or the agreements providing for the handling of the escrow moneys. The mere failure to follow the provisions the Administrative Rules of the Illinois Department of Financial and Professional Regulation dealing with the deposit and accounting for escrow moneys does *not* constitute misappropriation.

When an outside audit is determined to be necessary, the Division must notify the responsible sponsoring broker in writing:

- That an auditor has been retained to audit those special accounts.
- The identity of the auditor or auditing firm.
- The fact that the sponsoring broker must submit all pertinent records for audit **within 30 days** after receipt of the written notice.

The accountant performing the audit must provide a written report to the Division, with a copy to the sponsoring broker, detailing the findings with specific reference to compliance with the special account requirements of the Real Estate License Act and the Administrative Rules. The sponsoring broker will be liable for the cost of the audit if an order is issued by the Director of the Division finding that escrow moneys were misappropriated by the sponsoring broker or his, her, or its employees, independent contractors, agents, or designees.

Choosing a Sponsoring Broker

After confirming your preference for a real estate sales career over a career in another aspect of real estate, you must select a sponsoring broker with whom you'll work. This is one of the most important decisions that you'll make. There are many issues to consider when choosing a sponsoring broker. You will want to listen carefully and ask questions as you are talking with prospective brokers. Among the areas that should be considered are:

- The level of training provided.
- Broker services (such as staff support).
- Compensation structure.

Level of Training

The level of training offered to new licensees varies greatly. This help may be everything from assistance with filling in contracts, forms, and other documents, to how to prospect for and close a sale.

Many large brokerages have standardized training programs that all new licensees must complete. These training sessions cover a broad range of topics, including how to sell yourself and how to sell your company to prospective clients. This can be very helpful in attracting new listings. Some will ask you to volunteer for phone time, or even assign you a mentor to walk you through processes and procedures.

Many smaller brokerages do not have formal training programs, but still offer assistance. This type of arrangement usually gives you direct contact with your sponsoring broker, allowing you to profit directly from that experience. You need to know which level of training you are most comfortable with and which best suits your needs.

Broker Services

Broker services are those tools, in addition to administrative staff support, that are available to help you do your job effectively and efficiently. These may include websites, e-mail services, Internet connections, voice mail, electronic networking, online forms and software tools, and other means of electronic communication to keep you connected to your brokerage and to your clients. Brokers may also provide radio, television, and magazine advertising for you and your listings. Many brokerages will supply these things to you as part of your agreement with them; some will charge you a nominal fee; still others require that you provide these things at your own cost.

Safety Issues

Real estate licensees do much of their work alone. They welcome strangers into the homes of clients and customers. They transport people they may barely know in their cars. They meet people they've only spoken to over the telephone in places where there may few other people around. **Personal safety** should be a real concern of real estate professionals.

Here are some basic steps that every licensee can take to protect themselves:

- Plan to meet a consumer for the first time in your **office** when you know that co-workers will be around. Most people can learn a lot about someone from a face-to-face meeting. Introduce that person to other people in the office.
- Don't hesitate to ask consumers to make a copy of their **driver's licenses**. Also, make note of the make and model of their cars and the license numbers. Many brokerages have customer identification forms they use.
- Verify the **contact information** a consumer gives you. Check the phone directory, your county auditor's website, Internet searches, etc. Before meeting someone, call them at one of the phone numbers they've supplied.
- Don't let someone you've never met in your **car**. Instead, plan to meet them somewhere. Take along a colleague if you can.
- Don't work alone when holding an **open house**. If possible, position yourself where you can see the car someone arrived in. Make notes and ask those coming through to register.
- If possible, check out a **property** before you take a consumer through it. Be aware of the arrangement of rooms and make note of the exits.
- Make sure that someone knows your **schedule** for the day, whether an administrative person at your office or a family member or friend. On those days when you're out in the general public on your own, you may choose to make arrangements to check in with someone at regular intervals.
- Always carry a fully charged **cell phone** on your person with 911 on a quick dial.
- Some offices have designated an **alert word** or phrase that, if used in conversation, is a red flag that something is wrong.
- When promoting yourself, be careful to protect **personal information**. Sometimes, real estate agents are targeted because of their photographs in marketing materials or advertisements.
- **Trust your instincts.** If you're uncomfortable in a situation, try to get out of it as quickly as possible. If a particular person makes you nervous, share that with your managing broker and, together, come up with a strategy. It may be that you choose not to work with that person.

Ask a potential sponsoring broker what their office policies are related to the safety of its affiliated licensees. Although you are hired to bring buyers and sellers together to close real estate transaction, nothing is more important than your personal safety. Make sure your sponsoring broker recognizes this.

Interviewing Brokers

It's important that, as a licensee, you need to interview potential sponsoring brokers just as they need to interview you. Remember that you are an asset. When negotiating an employment contract with a sponsoring broker, it's also important to ask the right questions, for example:

- Is the firm local or part of a franchise? Are there multiple offices? How many employees are there?
- What is the focus of the firm: Sales, leasing, residential, commercial?
- What is the commission or fee schedule, and what is the commission split for affiliated licensees? How much of the earned commission must go to pay any required franchise fee?
- How are leads generated and distributed?
- What specific duties are assigned to brokers? Are brokers required to perform floor duty in the office?
- Is the brokerage a member of the MLS?
- What are the start-up fees, including training, if any?
- How does the brokerage advertise, and who pays for it?
- What technical equipment/support does the brokerage offer?
- Who pays for office expenses, including mailing, supplies, phone calls, etc?
- What type of formal training does the firm provide?

- Does the brokerage carry errors & omissions insurance for its licensees?
- What are the expectations for the first six months or year?
- What specifically will the designated managing broker and the company do to help licensees meet their goals?

Remember, a sponsoring broker who hires affiliated licensees must have a written office policy manual. When interviewing, it's reasonable to ask if there is such a policy manual and whether or not it can be reviewed prior to signing an employment or independent contractor agreement.

A final word of advice: Choose your sponsoring broker wisely. It makes no difference if your sponsoring broker is a big name franchise or a small independent office. Every licensee must find a situation that suits his or her own personal working style and goals.

Summary

1. Most *real estate licensees operate as independent contractors* and not as employees of the broker. The **factors** that determine whether the relationship is contract or employee are the amount of **control, direction, and supervision the broker has** over the services performed. The IRS classifies licensed real estate agents as **statutory non-employees** who may be treated as independent contractors provided they meet specific criteria. The two major differences between the employees and independent contractors is who directs activities and who pays payroll taxes. **Independent contractors** decide how to accomplish a given task; the payer determines the desired end result. **Employees under common law** are directed by employers who determine the result and how they want it to be achieved.

2. Three categories of common law rules determine whether the relationship between a worker and business is that of an employee or independent contractor: 1. **behavioral control,** 2. **financial control,** and 3**. type of relationship between the parties.** Independent contractors must make sure they meet the criteria for claiming independent contractor status; otherwise, the business and licensee could face fines and penalties from the IRS. In Illinois, the term **regular employee** is used to describe someone who works an average of 20 hours per week and would be considered an employee under the IRS test.

3. A **sponsoring broker** has the authority to sponsor other licensed brokers, managing brokers, or residential leasing agents. Sponsoring brokers must have a **written employment** or **independent contractor agreement** in place with every sponsored licensee. A **designated managing broker** has supervisory responsibilities in the offices for which they are **designated managing broker** of record. The term **employee** may be used in Illinois to describe the independent contractor relationship between a sponsoring broker and a sponsored licensee who has a written employment agreement.

4. Illinois law allows brokers to hire **unlicensed assistants** to help with administrative, clerical, or personal activities for which a license is **not** required, even if the activities may be brokerage related, such as collecting documents and public information, monitoring brokerage files and finances, drafting for approval by the broker and placing advertising or promotional flyers, acting as a courier, scheduling appointment, placing yard signs, performing maintenance, and similar. An unlicensed assistant may **not**: Host open houses, show property, interpret or explain contract details, negotiate or agree to any commission, or perform any other activity requiring licensure.

5. The primary form of compensation for a real estate licensee is **commission** on the sale of property. Commission is **negotiated** between a client and a broker. A licensee can receive commission payments **only** from his sponsoring broker.

6. A sponsoring broker must have an **office** in Illinois for transacting real estate business; each office must have a **designated managing broker**. Out-of-state brokers licensed in Illinois may be able to maintain their place of business outside of the state under certain conditions. Each physical office must have **identifying signage** displayed conspicuously outside of each office.

7. Licenses of all licensees must be available to the public in the sponsoring broker's principal office; copies may be maintained in other offices. Any **changes** to the office (opening, closing, location change) must be reported to the Department **immediately**; the loss of a designated managing broker not replaced by the sponsoring broker must be reported within 15 days. The law includes provisions for maintaining an office in the event of the death of a sole proprietor.
8. The **Division of Real Estate** has the authority to inspect public areas of an office at any time during normal business hours. Private areas must be open to inspection within 24 hours of notice by the Division. Any request for written documentation from the Division must be complied with within 30 days. The Division also has the authority to audit escrow accounts at any time with the consent of the sponsoring broker or **within 24 hours** without. The Division may bring in an **outside accountant** to audit special accounts if it reasonably believes that escrow moneys required to be kept in a special account have been **misappropriated**.
9. Choosing a sponsoring broker is an important decision for a licensee. Three main considerations are the **level of training** provided, **broker services** such as staff support, and **compensation structure**. Also, make sure the brokerage recognizes the importance of protecting the **personal safety of** its affiliated licensees.

Quiz

1. ***An important part of the relationship between a sponsoring broker and an independent contractor licensee is that the licensee***
   a. earns commission based on the results of his work efforts.
   b. is not subject to any direction or control by the broker.
   c. is paid for the number of hours worked.
   d. must be charged for office space or supplies provided by the sponsoring broker.
2. ***What expenses may those who have an IRS employee status deduct from their income taxes?***
   a. gas mileage
   b. license fees
   c. office expenses
   d. none of the above
3. ***At the end of the year, what form will a real estate broker who files as an independent contractor receive that details his or her compensation for the year?***
   a. 1040 IND
   b. 1099 MISC
   c. W-2
   d. W-4
4. ***Licensee Walter works for XYZ Brokerage. He sets his own hours, but broker Bob requires Walter to use specific forms and follow certain procedures. Walter is most likely classified by the IRS as a***
   a. common law employee.
   b. statutory independent contractor.
   c. statutory employee.
   d. statutory non-employee.
5. ***Which is NOT one of the factors used by the IRS to determine that a real estate agent can be treated as an independent contractor?***
   a. has a fiduciary relationship with clients
   b. paid for output, not hours worked
   c. properly licensed
   d. written and signed contract with sponsoring broker

6. ***For real estate licensees, which is NOT a characteristic that indicates they are an independent contractor?***
   a. The broker can set his or her own hours.
   b. The broker must be paid for hours spent in the broker's office.
   c. The sponsoring broker and the broker must have a signed agreement.
   d. The designated managing broker may supervise the broker's actions.

7. ***Seller agent Karen of Diamond Realty has concluded a lengthy and detailed negotiation with buyer-broker Jim of Garnet Realty. After the closing of this transaction, which is the most likely scenario?***
   a. Karen and Jim will both be paid by Diamond Realty.
   b. Karen and Jim will both be paid by Garnet Realty.
   c. Karen and Jim will both be paid by the seller.
   d. Karen is paid by Diamond Realty and Jim is paid by Garnet Realty.

8. ***Lisa has a buyer brokerage agreement with Doug. In that contract, Lisa agrees that Doug should earn 3% for finding her a house, whether it's paid by the buyer or seller. She makes on offer on a house where the listing broker is paying 3.5% commission to a buyer's broker. How much will Lisa owe Doug?***
   a. 3%
   b. 3.5%
   c. 6.5%
   d. nothing

9. ***Ace Realty has three brokerage offices in Illinois. Ace is NOT required to have***
   a. a written agreement with each affiliated licensed broker.
   b. an errors & omission insurance policy.
   c. a designated managing broker for each office.
   d. a written company policy.

10. ***Broker Joan advertises a chance to win dinner out at a local restaurant to those who attend an open house she's holding. Which statement is TRUE?***
    a. Joan cannot offer such a prize under any circumstances.
    b. Joan is obligated to give a dinner coupon to anyone who shows up.
    c. Joan must disclose any conditions associated with the prize in the ad.
    d. Joan must offer the prize through her sponsoring broker.

11. ***Which statement about brokerage office requirements in Illinois is FALSE?***
    a. A brokerage office cannot be located in a mortgage brokerage office.
    b. Each sponsoring broker must maintain a place of business.
    c. Every office must have the same name as or indicate a relationship with the principal office.
    d. Every physical office must have an identifying sign conspicuously displayed outside.

12. ***Escrow audits may be conducted _____ without the sponsoring broker's consent.***
    a. at any time
    b. with at least 24 hours notice
    c. with at least 48 hours notice
    d. All escrow audits require the consent of the sponsoring broker.

13. ***An unlicensed assistant can perform each of the following activities EXCEPT***
    a. compute commission checks.
    b. place advertising.
    c. show property.
    d. submit listings to an MLS.

14. ***Maggie is an unlicensed assistant for broker Baxter, which means that she can***
    a. accept commission from Baxter for each open house she sets up that results in a sale.
    b. go over the terms of the standard lease with a potential tenant.
    c. pick up the keys from a homeowner for an upcoming open house.
    d. work the booth at a local home show.



UNIT 4

REAL PROPERTY

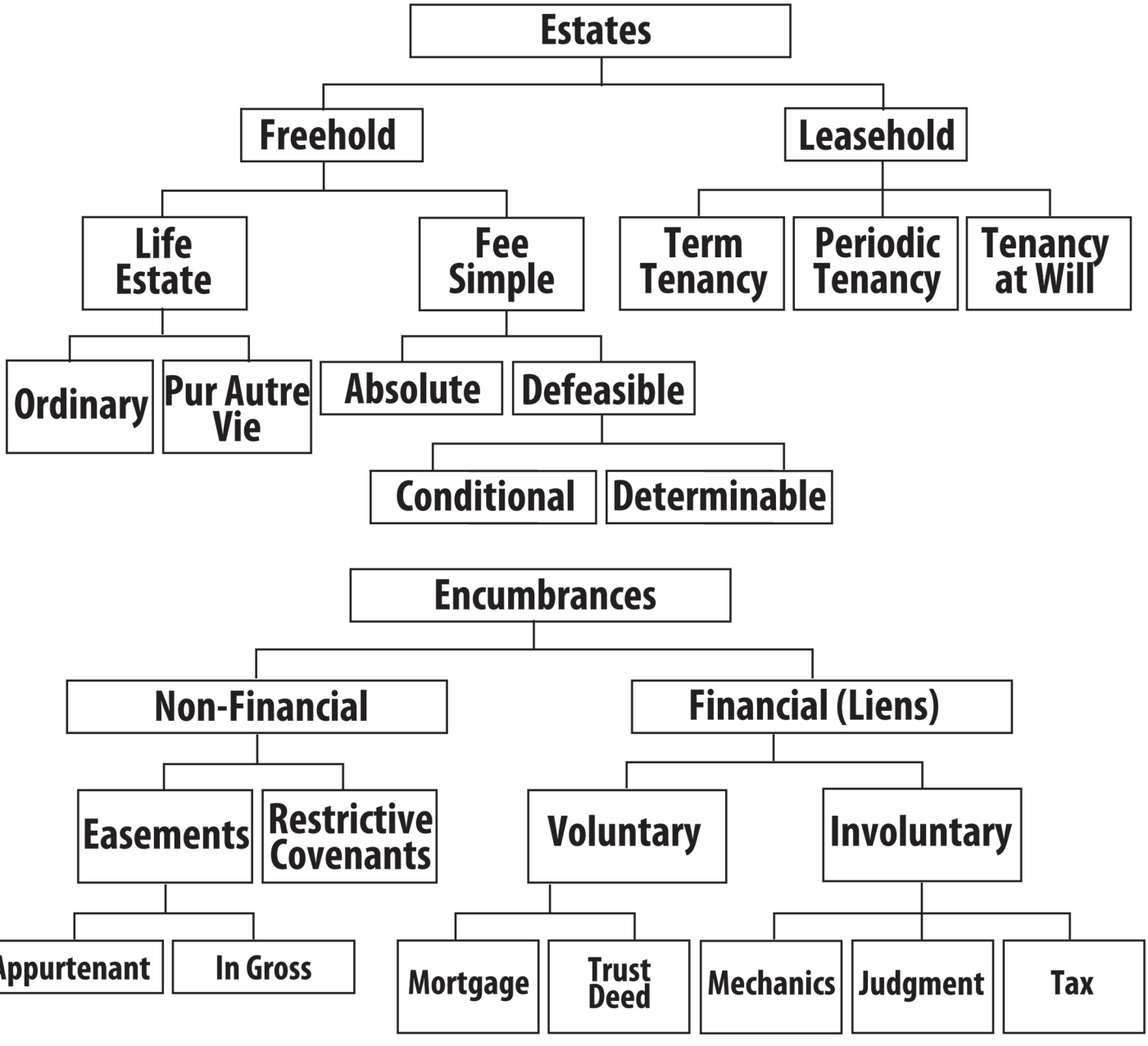
Chapter 9 - Estates and Interests

Chapter 10 – Easements and Liens

Chapter 11 - Land Use

Chapter 12 Environmental Issues

Chapter 13 - Construction Overview


Estates
Freehold
Leasehold
Life Estate
Fee Simple
Term Tenancy
Periodic Tenancy
Tenancy at Will
Ordinary
Pur Autre Vie
Absolute
Defeasible
Conditional
Determinable
Encumbrances
Non-Financial
Financial (Liens)
Easements
Restrictive Covenants
Voluntary
Involuntary
Appurtenant
In Gross
Mortgage
Trust Deed
Mechanics
Judgment
Tax



9

Estates and Interests

You've made the decision to start a new career in real estate. Perhaps you're planning to sell houses. Perhaps you're planning to manage property that is owned by other people. Whatever your plans are, you need to have a clear understanding of exactly what real estate is. After purchasing real estate, people say that they have just bought a house, but the house is only one element that they now own. Other elements include the rights, the land, and the objects attached to the land. In this chapter, you will see key definitions and discuss concepts related to real property and ownership.

You will learn:

- The elements and characteristics of real property.
- What constitutes real property and personal property.
- The difference between freehold and leasehold estates.
- Alternate ways people can take ownership of real property.
- Adverse possession and the requirements necessary for it.

Key Terms

Adverse Possession
Appurtenance
Bundle of Legal Rights
Chattel
Emblements
Encroachment
Fee Simple Estate
Fixture
Joint Tenancy
Land
Leasehold Estate
Life Estate
Life Estate Pur Autre Vie
Littoral / Riparian Rights
Parcel
Partition
Personal Property
Planned Unit Development (PUD)
Possessory Interest
Real Property
Right of Survivorship
Severalty
Tenancy by the Entirety
Tenancy in Common
Trade Fixture
Unities of Possession, Interest, Time, and Title

The Nature of Property

The law classifies all property as either real or personal. Understanding the rights of real property ownership and the distinction between real property and personal property is essential for real estate licensees. Real property rights and laws are important because they determine what is being sold. Some key definitions:

- **Land** is legally considered to include *the surface of the earth, the subsurface to the center of the earth, and the air above the land within reasonable limits* to permit commercial air travel. Land is unique in that no two **parcels**, or *specific pieces of land or lots,* are the same.
- **Real estate** is defined as the *actual physical land (also known as unimproved land or raw land) and everything, both natural and man-made, that is permanently attached to it.*
- **Real property** is *land and its attachments, as well as all of the rights* associated with the property.
- **Personal property** is most easily defined as *any property that is not real property.* It is moveable, thus not fixed to the land.

Bundle of Legal Property Rights

Real property rights that are conferred by ownership are defined in terms of a **bundle of legal rights:**

- **Right of Possession.** The right of possession gives the owner the right to *physically occupy the land and to use the land and make it productive*. Owners can use the land in any way they want, as long as it is legal and does not interfere with other people's rights.
- **Right of Quiet Enjoyment.** The right of quiet enjoyment gives the owner *the freedom to possess and use the land without interference from other people or society*. However, this also includes a responsibility to make sure that their neighbors' enjoyment is not hindered or adversely affected.
- **Right of Disposition.** The right of disposal allows the owner to *transfer all or some of the rights to other people.* For example, landowners normally have the right to sell, lease, give away, divide, and retain part of the land or to dispose of it completely. An example of partial disposition would be someone who sells 10 acres of his 100-acre farm. Another example of partial disposition would be a landlord who rents an apartment, allowing someone else to possess part of the property, even if temporarily.
- **Right of Exclusion.** The right of exclusion, or restriction, allows the owner to *stop others from using the property or even from entering the property*.
- **Right of Control.** The right of control allows the owner to *physically alter or change the property*. For example, a property owner can build a garage, tear down a fence, put in a swimming pool, etc. (Of course, there could be zoning issues related to this.)

Interfering With Real Property Rights

Certain activities can interfere with a property owner's bundle of rights:

- **Trespassing** is a *physical invasion of land by another person who has no lawful right to enter it.* Trespassing interferes with the owner's possessory interest in the land, diminishing the owner's right of use and right of enjoyment since, during the trespass, the owner of the land has less than full possession of it.
- **Encroachment** is a *legal synonym for trespass, but the term refers to physical objects, such as buildings, whereas trespass refers to people.* Thus, a neighbor's driveway built over your property line encroaches on your land. A tree growing over a property line is another example of an encroachment. Legal steps can be taken to force a landowner to remove the encroachment by tearing it down, trimming the tree, or forcing the landowner to buy the land on which it sits. An encroachment is *not* an encumbrance because it is not a right or interest that is held.
- A **nuisance** is anything that *interferes with the quiet enjoyment of land from another person's property* such as loud noises, unsightliness, and obnoxious odors. A nuisance does not involve possessory rights. To be actionable in court, a nuisance must be a continuing unreasonable use of land by the offending landowner, but a court usually will not support an action if a landowner moved there with knowledge of the nuisance.

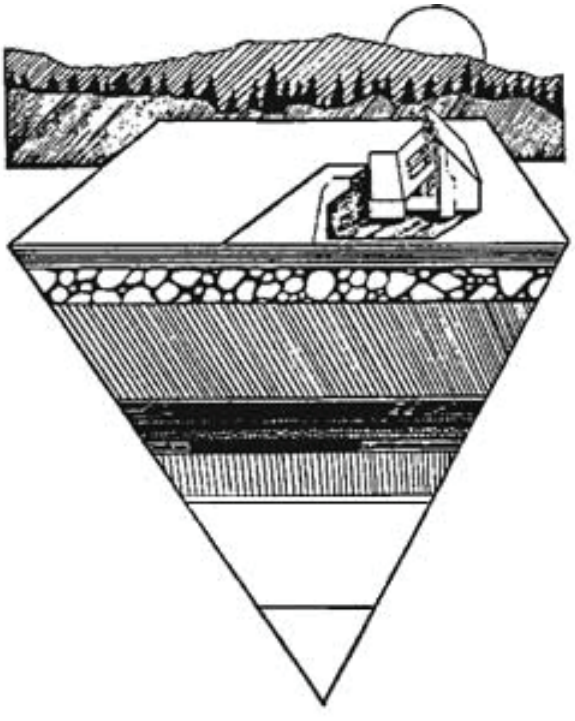
Appurtenances

Appurtenances are *rights that go with real property,* for example, access rights, limited air rights, water rights, mineral rights, etc. When real property is sold, appurtenant rights are usually sold along with it. They can, however, be sold separately and may be limited by past transactions. For example, a property owner sells the mineral rights of her property to a mining company. She keeps ownership of the property. Later, when the land is sold, the mineral rights will most likely stay with the mining company (depending on the wording of the contract involved) even though the rest of the bundle of rights associated with the land is transferred to the new owner. The new owner is limited by the past transaction of the previous owner, and may not sell these mineral rights to another party, nor transfer them in a future sale of the land.

In addition to knowing the boundaries of the land and what attachments are considered part of the real property, buyers also need to understand which appurtenant rights are being transferred in a real property transaction. A lender also must know if the entire bundle of rights is being transferred or if there are restrictions or past transactions that may limit the current transfer of ownership in any way. This is important because it may have a great effect on the value of the real property.

Land

One way to understand the rights that accompany land ownership is to imagine the property as an inverted pyramid, with its tip at the center of the earth and its base extending out into the sky. An owner has rights to the surface of the land within the property's boundaries, plus everything directly over the surface and everything under the land within the pyramid. When defining land in a legal description, only the surface is detailed. The law implies subsurface and air rights are included as part of the land even though they are usually not documented.



Air Rights

A property owner's rights go to the upper limits of the sky. Air rights include the right to undisturbed use and control of airspace over a parcel of land (within reasonable limits for air travel). A property owner may sell air rights over a property separately from the land. Because of air travel, though, the federal government controls U.S. airspace. Property owners still have the right to use the lower reaches over their land, but they may not interfere with air traffic. Owners also have the right not to be harmed by use of the airspace above their property.

Water Rights

Land owners have specific rights to use water on their property. Water rights include:

- **Riparian** and **littoral** rights. The *rights of an owner of land contiguous to a body of water.* If the water in question is flowing, for example, a river or stream, the rights are said to be riparian. If the property is subject to the ebb and flow of the tide, such as an ocean, bay, or large lake, the rights are said to be littoral. The terms riparian and littoral are sometimes used interchangeably, but generally speaking, riparian rights may be defined principally as *the right of access to the water and the right to all useful purposes to which the body of water may be applied.* Ownership rights of the land under the water are usually determined by whether or not the body of water is considered to be navigable.
- **Appropriative** rights. Water rights granted by government permit independent of land ownership. Government permits allow the holder to take water from a particular body of water for a specified use, such as crop irrigation. Appropriated water does not have to be used on riparian or littoral land, but riparian and littoral landowner rights are considered when issuing appropriation permits. Appropriative rights usually cannot interfere with riparian or littoral rights.
- **Percolating** water rights. Involve the *use of underground water*. For example, landowners have the right to install wells to access water for their own use.

Mineral Rights

A landowner owns all the solid minerals in and under the surface of the land. Minerals are considered real property until they are extracted from the earth. Landowners may sell or lease mineral rights separately from the surface land, and many do, especially if they do not have the necessary skill or equipment to mine or drill.

Oil and gas are governed by the **rule of capture**, which says *whoever drills a well on his or her land owns all the oil or gas the well produces even though it may have migrated from under a neighbor's land*. A landowner can drain oil or gas from beneath his or her own land *and* from neighboring land because oil and gas flow toward the point of lowest pressure where the reservoir was pierced by the well.

A landowner also has **supporting rights.** A piece of land is supported by the land that surrounds it. A landowner has a right to the natural support provided by land beside and beneath it. **Lateral support** is support from adjacent land. A neighbor's excavations may make your land shift and settle. In some cases, the neighbor can be held liable for resulting damage if there was negligence. **Subjacent support** is support from the underlying earth. Generally, the mining party is liable for surface damage caused by underground mining even if excavations were performed carefully.

Forces of Nature

Nature can affect ownership of land. As the land itself moves or changes shape through the forces of nature, a transfer of title could result.

- **Erosion** is a gradual wearing away of land by wind, rain, or other natural forces. If eroded soil moves over property lines, X loses title to the soil, and Y gets title to it.
- **Accretion** is a gradual process of waterborne silt being deposited in a river or lakebed or on the shore. These deposits are called *alluvion* or *alluvium*. Riparian or littoral property is increased this way, and the landowner acquires title to the silt.
- **Avulsion** means the land is torn away by flowing water. Avulsion doesn't transfer title if the severed land is identified and reclaimed by the original owner.
- **Reliction** means water recedes exposing more of the bed. In some states, reliction doesn't add to land since owners already have title to the bed to the water's midpoint.

Attachments

The definition of real estate includes **attachments**, the *things attached to the land, whether natural or man-made.* Man-made attachments that are artificially attached to the land are more commonly known as **improvements**, for example, buildings, pipelines, pavements, sewers, roads, driveways, fences.

Fixtures

Fixtures are *items of personal property that have been permanently attached to the land or its improvements*, for example, ceiling fans, built-in bookcases, furnaces, etc. Even items that have been temporarily removed from the real property for servicing (e.g., built-in dishwasher at the repair shop on the day of closing) can still be fixtures. Fixtures start out as personal property but can become real property through one of several methods:

- Becoming **physically attached** to real property, a process called **annexation**
- Becoming attached conceptually because of a **close association** with real property (such as keys to a house)
- Becoming attached through the process of **adoption**, for example, curtains that were custom-made for an unusual window size or shape or even wall-to-wall carpeting
- Becoming part of the real property through **agreement** between the parties involved (such as a landlord and a tenant)

Fixtures can be *detached from the land and so revert back to personal property* through the process of **severance** (such as when a chandelier is removed from the ceiling). Examples of fixtures *may* include ceiling fans, built-in bookshelves, chandeliers, custom-made window coverings, and other similar items. That word "may" is critical. The determination of whether or not something is personal property or a fixture that is attached to the land or its improvements can become very involved. , Since fixtures and improvements are part of the real estate, one might assume that they are included by implication in the description of the real estate. However, it is a best practice to state everything to be included in the sale in the listing agreement.

Trade Fixtures and Leasehold Improvements

Trade fixtures are *any equipment or personal property a* ***commercial tenant installs*** *for* ***business purposes***. While these items may be attached to real property, they remain the **personal property** of the tenant. Unless otherwise indicated in the lease, trade fixtures should be removed by the tenant before the lease ends. For example, a tenant who opens a pizza shop can remove the ovens he installed, even though they are attached to the floor. However, the tenant must repair any damage caused by the removal.

A **leasehold improvement**, on the other hand, is installed by the landlord for the use of the tenant. Since the stove is attached to the house, it would most likely be **considered real property** of the landlord.

Natural Attachments

The definition of "land" also encompasses **natural attachments,** *the plants growing on the land.* Plants such as trees, perennial flowers, and other vegetation are considered to be part of the land, therefore **real property**. Note that plants may be considered to be **personal property** if they are removed. For example, if you plant an apple tree next to your house, it becomes part of the real property and is called *fructus naturales.* However, once you pick an apple from that tree, the apple **becomes personal property**. The proper term for flowers, crops, and other vegetation that are *planted or cultivated annually or seasonally* is *fructus industriales,* meaning fruits of industry. Another word for fructus industriales is **emblements.**

Personal Property

Personal property, also called **chattel,** is *any property that is moveable and not fixed to land.* Personal property can be tangible—something that can be held or touched, such as appliances, cars, furniture, etc.—or intangible—something that cannot be held or touched, for example, savings accounts, stock rights, or intellectual property. The ownership of personal property is generally conveyed in one of two ways:

- When someone sells personal property, its ownership is conveyed by a **bill of sale.**
- When personal property is part of a will, it is conveyed by **bequest**, sometimes referred to as a **legacy**.

The distinction between real property and personal property becomes important when land ownership or possession is transferred. Unless otherwise agreed, all *real property* is included in the transfer, but personal property that happens to be on the land is not necessarily included.

Real Property Interests

A person with a *property right or a claim against property* is said to have an **interest** in the property. An interest may be an ownership right (e.g., a life estate), right to use the land (e.g., an easement), or a financial claim against the title (e.g., a mortgage). An **estate** is a *possessory interest in real property*, which entitles the holder to possess the property now (a present interest) or sometime later (a future interest). In addition to being classified as to the time of enjoyment, present or future, interests are also classified as a freehold or leasehold estate.

Freehold Estates

A **freehold estate** is a *possessory interest of uncertain duration*; it may end, but no one knows when. Some events that will end a freehold estate include the transfer of the property to someone else, the death of the owner, foreclosure, confiscation for back taxes, or condemnation under eminent domain. There are different types of freehold estates: Fee simple, qualified fee, fee on condition, and life estates.

Fee Simple Estate

A **fee simple estate** is the *fullest freehold estate interest that exists in real property*. It is also called fee title or fee simple absolute. A person referred to as the "owner" of land usually holds a fee simple absolute interest. The owner of a fee simple absolute has all the bundle of legal rights. Since the fee simple estate is absolute, this implies there are *no conditions on the title*. It is perpetual, inheritable, and transferable. When a fee simple absolute owner deeds an interest in property to someone else, it is presumed the entire estate is transferred, unless the deed language specifies otherwise. This means that the new owner holds the property in fee simple absolute, too.

Qualified or Defeasible Fee Estate

A **qualified fee estate**, also called a **fee simple defeasible estate**, means that *a grantor puts a condition or requirement in the deed that could terminate the estate if the condition or requirement is not met and revert the title back to the grantor or the grantor's heirs.* A qualified fee estate creates a type of encumbrance on the title because it **runs with the land**, meaning that the restriction is not against the owner but is against the land. Qualified fee estates may be classified as conditional or determinable:

- **Conditional.** A **fee on condition estate** means that a grantor puts a condition or requirement in the deed that gives the grantor the "**right of reentry**" if the condition or requirement is not met. In this type of estate, the grantor (or heirs) has the right to terminate the estate, but this does not happen automatically. Generally, the grantor would need to **prove in court** that the stated event occurred before regaining title to the property. For example, deed language may transfer David's land to Frank, but if Frank builds a bar, the grantor may go to court to regain possession. The grantor could also include a condition where the grantor retains title to the estate **until** a specific condition occurs. For example, Bill will transfer title of the property to his grandson Will ***if*** Will marries before his 25th birthday.
- **Determinable.** A **determinable fee estate** means that a grantor puts a condition or requirement in the deed that gives the grantor a "**possibility of reverter**," which is a right to regain the use and possession of the property **automatically** if the stated event occurs. For example, deed language may transfer Juanita's land to Darlene, as long as the land is used as a park. If Darlene uses the land for another purpose, the title to the property reverts back to Juanita (or her heirs) automatically.

Life Estates

A **life estate** is a *freehold estate that lasts only as long as a specified person, the "measuring life," lives*. The *holder of a life estate* is called a **life tenant**.

With a **conventional** life estate, *the measuring life and the life tenant are the same person*. For example, grantor Jane owns property in fee simple. She decides to deed that property to grantee David "for life." Although Jane still owns the property, David now has the right to occupy and use the property for as long as he lives. The life estate is measured by the lifetime of the **measuring life**, which in this case is David, the life tenant. When David dies, the life estate ends.

A life estate may also be *based on a person's life other than the life tenant*, which is known as a **life estate pur autre vie** (for another's life). With this type of life estate, the measuring life and the life tenant are *not* the same. For example, Paul owns property in fee simple. He decides to deed that property to Sue for as long as Mike lives. Sue is the life tenant, and Mike is the measuring life. When Mike dies, the life estate ends and Sue no longer has the right to occupy and use the property.

Both types of life estate are a present interest that *creates a future interest* for the one who will possess the land upon death of the measuring life holds. This future interest may be reversionary or remainder:

- **Reversionary.** With a reversionary life estate, the property *reverts to the grantor*, or the grantor's heirs, upon the death of the measuring life.
- **Remainder.** With a remainder life estate, the grantor grants the life estate to one person, *then to another person*, the **remainderman,** upon the death of the measuring life.

Case in Point

Joe grants a life estate to daughter Sue, the measuring life. Joe is called the **reversioner** because he has a reversionary interest in the estate. When life tenant Sue dies, the life estate would revert to Joe. In his will, Joe leaves everything to his son, Bill, who now has a reversionary interest in the estate as well. If Joe dies before Sue, she can stay on the property until she dies, at which point the life estate would revert to Bill as Joe's heir, who would own the property fee simple.

Instead, let's say that Joe deeds property "to daughter Sue for life, and then to nephew Tim." Tim has a remainder interest and is known as the **remainderman**. In this case, when Sue dies, Tim (or his heirs) takes title to the property in fee simple. This is because the death of life tenant Sue, the measuring life, ends the life estate. If Joe were to die before Sue, Sue would still have the present life estate, and Tim would still have the future remainderman estate. If a remainderman is **not** specifically indicated in the conveyance, the grantor is assumed to have a reversionary interest.

A life tenant's interest can be sold, mortgaged, or leased. But a person can transfer only the interest he owns. Someone who buys a life tenant's interest has only a life estate, and that interest ends when the measuring life dies. For example, Larry has a conventional life estate, but he gets a job out of state and will no longer live on the property. He sells his life estate to Barb. Barb can live on the property, but she does not own the property. Her interest ends when Larry dies.

A life tenant may not commit an **act of waste** to the property, which means *using the property in a way that damages it or reduces its market value*. Thus, a life tenant has restricted rights of use that are transferred with the life estate.

Leasehold Estates

A **leasehold estate** is an *interest that gives the holder a temporary but exclusive right to possession of the estate without title.* A leasehold estate is more limited than a freehold estate. The *holder of a leasehold estate* is called the **lessee** or **tenant**. A tenant has the right to exclusive possession of the property but only for a limited time. An *owner who leases property to a tenant* is called the **lessor** or **landlord**, and the owner has a **leased fee** estate. Leased fee interest is **reversionary** in that possession reverts to the landlord when the lease ends.

Forms of Ownership

Ownership can be divided into two primary forms, depending on whether the property is held by one person, known as ownership in severalty, or by multiple persons, which is considered co-ownership.

Ownership in Severalty

Ownership in severalty, also known as tenancy in severalty, is the simplest form of ownership. It is a sole form of ownership, meaning that *only one person or legal entity holds the title to that property.* Don't be confused about the word "severalty." It might sound as though it implies "several" people, but it really means that one owner's interest has been *severed from the interests of all others.*

Co-Ownership

Co-ownership, also known as **concurrent ownership**, is *any form of ownership where two or more persons or legal entities share title to real property, with each person having an undivided interest in the property*. **Undivided interest** gives *each co-owner the right to possession of the whole property, not just part of it.* Under the law, any number of persons may join in the ownership of real property.

There are three forms of co-ownership: Tenancy in common, joint tenancy, and tenancy by the entirety. Key distinguishing factors include the method in which the ownership interest is created as well as the method by which ownership is passed. The **right of survivorship** means that *the property passes automatically to other co-owners when one co-owner dies.*

The presence of several conditions, known as **unities**, also defines the form of co-ownership:

- **Unity of Possession**. *All co-owners hold the same undivided right to possess the whole property* (as opposed to a designated portion of that property).
- **Unity of Interest**. *All co-owners hold equal ownership interests.*
- **Unity of Time**. *All co-owners acquired their interests at the same time.*
- **Unity of Title**. *All co-owners acquired their interests by the same deed or will.*

A fifth unity must also be considered: The unity of **person**, which means that all co-owners are *a single, indivisible legal unit*. This unity applies to legal spouses and, in Illinois, to partners in legal civil union.

Tenancy in Common

Tenancy in common is a form of co-ownership with *two or more persons having an undivided interest in the entire land, but no right of survivorship.* Tenancy in common is the most common form of co-ownership and requires **only the unity of possession.** Tenancy in common is the only co-ownership that can be owned in unequal portions. When a tenant in common dies, his interest in the property passes to his heirs.

For example, Mike, Dan, and Sam own a farm. Mike has a 50% interest in the property; Dan and Sam each have a 25% interest in the property. Sam can sell his 25% interest to Mary if he wants. When Mike dies, his 50% interest goes to his heirs, not to Dan and Mary.

In Illinois, if language in a deed does not specify a different type of co-ownership, or if the co-owners are not married to each other, tenancy in common is assumed. If the deed is silent as to the interests of the parties, the shares will be equal.

Joint Tenancy

Joint tenancy exists when *each co-owner has an equal undivided interest in the land and right of survivorship.* Joint tenancy requires the **four unities** of possession, interest, time, and title. A main feature of joint tenancy is that it allows co-owners to take ownership shares of a deceased co-owner automatically. Since survivors take ownership equally and simultaneously, a person can't will or inherit a survivorship estate. A joint tenancy ownership interest may only be conveyed through deed.

For example, Allen, Beth, and Chris take title to property as joint tenants. Each owns a one-third interest in the property. When Allen dies, his interest passes to Beth and Chris automatically, who each now own a half interest.

When a joint tenant *conveys* an interest, the new co-owner is a tenant in common in relation to the other co-owners, and the right of survivorship in that interest ends. For example, Mary, Ted, and Lou co-own a property as joint tenants. Lou sells his share to Rhoda. Mary and Ted are still joint tenants, but Rhoda is a tenant in common, since there is no unity of time and title. If Mary dies, her interest goes to joint tenant Ted. If Rhoda dies, her interest goes to her heirs.

Caution: Generally speaking, joint tenancy assumes the right of survivorship.

Partition

Parties to a joint tenancy or tenancy in common have the **right of partition**, which *allows any co-owner to end the co-ownership*. A **voluntary partition** can be implemented where both parties agree to end the joint venture and divide the property so each owns a piece in severalty, if it can be done equitably. Or, one owner can sue the other to dissolve the co-ownership and divide the property or sell it and divide the proceeds.

Tenancy by the Entirety

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Tenancy by the entirety is a *form of co-ownership that involves only owners who are husband and wife—or, in Illinois, a couple legally joined by a civil union—with each having an equal and undivided share of the property.* This form of ownership includes the right of survivorship, with property automatically going to the surviving spouse or partner. Tenancy by the entirety requires all **five unities**—possession, interest, time, title, and **person** since spouses and civil partners are considered a single, indivisible, legal person.

This type of ownership can be terminated if:

- One spouse or partner dies, at which point the surviving spouse or partner becomes owner **in severalty**.
- Both parties agree to end this type of ownership and both sign a new deed.
- The couple gets divorced but keep the property, at which point they own the property as **tenants in common**.

In Illinois, tenancy by the entirety also requires the following conditions:

- It must be stated specifically in the deed that the grantees will hold title "not as joint tenants or tenants in common, but as tenants by the entirety."
- It can only be applied to the couple's **principal residence**, known as **homestead property.** All other property would have to be owned as joint tenants or tenants in common.

A legal couple can own property independently of their status, assuming that only one individual holds the title. **Separate property**, for example, may be property that was owned prior to the marriage or civil union or that was given or devised by will only to one spouse or partner during the term of the marriage or civil union. If property is otherwise acquired during the marriage or civil union, it is considered to be **marital property**, regardless of whether one or both Individuals hold title.

Co-Ownership				
		Tenancy in Common	Joint Tenancy	Tenancy by the Entirety
Unities	Possession	✓	✓	✓
	Interest		✓	✓
	Time		✓	✓
	Title		✓	✓
	Person			✓
Right of Survivorship			✓	✓

Caution: It is important to remember that although you may be familiar with these different forms of ownership, your role is NOT to be a lawyer, estate planner, or tax advisor to your clients.

Adverse Possession

Adverse possession is when *someone acquires the title to someone else's real property through open, notorious, hostile (adverse), and continuous use of it for a specific period of time as determined by state law.* Adverse possession does ***not*** apply to government-owned land. Adverse possession, also known as **title by prescription**, is similar to easement by prescription, but instead of acquiring an easement or an interest in the property, the actual title is acquired.

In the State of Illinois, the time required to claim adverse possession, like easement by prescription, is **20 years.** A claim of adverse possession generally requires that the property is cultivated or improved or protected by a substantial enclosure.

Title to large parcels of property through adverse possession is not that common. It's more likely to come into play over a disputed property line. For example, homeowner Joe put up a fence that enclosed a small portion of his neighbor's property. Over the years, he planted trees and bushes and enjoyed the use of the property. Twenty years later when the neighbor's property was sold, the new owners discovered that the fence was actually on their property. When the new owners removed the fence, Joe sued to claim title to that specific portion of the property through adverse possession.

Ownership by Businesses

Ownership in severalty and co-ownership can be further categorized into ownership by business entities, which include nonprofit groups and other organizations. Depending on its form, a business association may be a legal entity separate from its members or owners.

Sole Proprietorship

A **sole proprietorship** is a *business owned by a single individual (or a husband and wife for tax purposes) in severalty.* With this, the owner is personally responsible for any business debts, and personal assets could be attached in the event of default (except for property that is owned with a spouse as tenants by the entirety). A sole proprietorship can operate under the sole proprietor's name or under an assumed or fictitious name, if registered with the state, for example, Joe Smith doing business as (dba) Smith Realty or Patsy Davis also known as (aka) Patsy Cakes.

Partnerships

A **partnership** is *an association of two or more individuals as co-owners of a business, as specified in the partnership agreement.* The Uniform Partnership Act, first established in 1914 by the National Conference of Commissioners on Uniform State Laws (NCCUSL) allows a partnership to take title to property in the name of the partnership as **tenants in partnership**, a *form of co-ownership that gives each partner an equal, undivided interest in the property*. In a tenancy in partnership arrangement, property is purchased and owned by the partnership. Partners may also take title to property in the name of **individual partners** as **tenants in common** or as **joint tenants**. Any of the partners may convey partnership property, but all members of the partnership must agree before any party can sell or assign his interest in partnership property. The type of partnership determines how much control and liability each individual will bear:

- A **general partnership** is *an association of two or more individuals as co-owners of a business where all partners share in the financial liability both individually and as a member of the partnership.*
- A **limited partnership** is an *association of two or more persons as co-owners of a business with one or more general partners and one or more limited partners.* The rights and duties of general partners in a limited partnership are the same as in a general partnership, but limited partners have no say in partnership matters. Further, the partners' liability is limited to their original investment.

Corporations

A **corporation** is a *legal entity that is created and operated according to the laws of each state.* A corporation could be public (cities, counties, school districts, etc.), private for profit, or private nonprofit. It is regarded by the law as a legal person *separate from the individual stockholders*, and therefore shareholders are not personally liable for the corporation's debts. Within a corporation, property is owned *in severalty* as the legal person.

- A **C Corporation** must pay corporate income tax. Then when profits are distributed to the shareholders, the shareholders pay income tax on the dividends as well, which leads to a situation of double-taxation.
- A **subchapter S Corporation** functions as a corporation, but like a partnership, it does not pay any corporate income taxes. Instead, the corporation's income or losses are divided among and passed through to its shareholders. The shareholders must then report the income or loss on their own individual income tax returns.

Limited Liability Company (LLC)

A **limited liability company** (**LLC**) is a type of business structure that shares some characteristics of both a corporation and a partnership (or sole proprietorship if just one owner). Owners of an LLC, who are called "members," are protected to some degree because, as with a corporation, they have limited personal liability for the actions and debts of the LLC. LLCs have the added benefit of allowing pass-through income taxation, much like a partnership or subchapter S Corporation. Creating a LLC is generally considered to be less involved than incorporating; however, like corporations, the creation and function of LLCs is dictated by the laws of each state.

Businesses for Owning Real Estate

There are three more types of business organizations that may be formed for the purpose of owning real estate.

- A **syndicate** (or syndication) is a type of joint participation of individuals, partnerships, and corporations in a real estate investment that is not recognized legal entity. A syndicate allows most property ownership forms possible (joint, tenants in common, partnership, corporation, etc.) and is generally used for large-scale, ongoing projects or multiple projects.
- A **joint venture** is an arrangement in which two or more individuals or companies pool resources in order to engage in one project or a series of projects but not as an ongoing business concern.
- A **real estate investment trust** or **REIT**, is a real estate investment business, with at least 100 investors, organized as a trust where one or more trustees manage property for the benefit of the beneficiaries. To create a REIT, a trust document vests title to the property in the trustees, who have only those powers expressly granted to them in the trust document. The beneficiaries have no legal interest in the property, but do have power to enforce performance of the trust. In order to avoid income tax, a REIT must earn 75% of its income from real estate and distribute 95% of its taxable income to its beneficiaries.

Other Forms of Co-Ownership

Condominiums and other housing alternatives physically and legally combine individual ownership with co-ownership.

Condominiums

A **condominium** is a *property developed for co-ownership, with each co-owner having a separate interest in an individual unit, combined with an undivided interest in the common areas.* Most condominiums—or condos—are residential; however, they can also be commercial or retail, such as a multi-unit skyscraper or a community of buildings with three or four units. Condos are considered **real property** and owners hold a **fee simple** deed to their individual condo unit. Condos are structured (physically and legally) to combine individual ownership with co-ownership. Condos are non-controlling and are considered separate entities because the interior space of each condo unit is owned individually. This differs from cooperatives, which are discussed later.

Common Areas

The other areas of the property are common areas. **Common areas**, also called common elements, are the *land and improvements in a condominium, planned unit development, or cooperative that all residents use and own as tenants in common,* such as the parking lot, hallways, and recreational facilities.

Some condominiums also have **limited common areas** *owned* by all but *used* by only one owner. An example of a limited common area is a balcony that extends out into the air owned by all, but is actually used by only the unit owner. Designated parking spaces are another example of a limited common area. The word *designated* or *assigned* informs the owner that this space is exclusively for her use, even though all other unit owners own the land.

When a condominium unit is sold, an undivided interest in common areas and membership in the owners association are automatically transferred, too. Individual units cannot be sold without transferring interest in the common areas.

New Condo Development

Every state has passed laws that create the legal framework for creating a condominium form of ownership. Known collectively as **Horizontal Property Acts,** these laws make it possible to define actual ownership rights. This, in turn, makes it possible for lenders to provide mortgages on condominiums, and for tax authorities to assess property taxes, among other things.

Property can be developed as a condominium, or an existing building can be converted to a condominium. The **sponsor**, also known as the developer, is the *person, corporation, or other entity that is part of the sale and development of the condo or co-op property.* Sponsors (or developers) begin by filing a **condominium declaration**—which may also be called a **Master Deed.** This document must be filed for record when the property is developed as, or converted to a condominium. Each unit owner is bound by the Master Deed, and also has a **unit deed** that documents their ownership of that specific unit.

Bylaws and CC&Rs

Sponsors also record bylaws for the unit owners' association. **Bylaws** are the *rules and regulations that govern the activities of the condominium and cooperative associations.* These include the purpose of the building, rules for elections and voting, and frequency of board of directors or shareholders meetings. Bylaws also set the rules about when sponsors are required to turn over management of the condominium board members.

Condominium developers also establish and record a declaration of **covenants, conditions, and restrictions (CC&Rs),** which *create a general plan of private restrictions for a subdivision.* CC&Rs might stipulate that owners cannot paint their front doors certain colors, cannot install a satellite dish, can use only white holiday lights outside, or can have only a certain type of patio furniture. The purpose of CC&Rs is to keep the community attractive and uniform, and to protect its market value. For a condominium development, CC&Rs dictate the rules unit owners and their guests are required to follow. CC&Rs are binding on all unit owners and are usually enforced by a condominium association. Penalties for violating the condominium's CC&Rs could include fines, lawsuits by the condo association, or forced compliance.

Condominium Associations

The Master Deed provides for the creation of a **condominium association**, sometimes known as a unit owners association or homeowners association. The association:

- Has a membership that is comprised of the unit owners.
- Usually elects a board of directors.
- Enforces the bylaws established by the condominium developers.
- Manages the operation of a condominium, imposing assessments and arranging for the maintenance of the common areas, usually by a property management company.

Association Fees, Taxes, and Insurance

Maintenance fees (also referred to as common area expenses or association fees) are *monthly fees paid by each condo owner for common area expenses* like utilities, management, building maintenance, hazard and liability insurance for the common areas of the property, and upkeep. Unpaid maintenance fees can result in a lien placed by the association against a specific unit. In the event of default on the mortgage, an individual owner's lender can place a lien against the specific unit and undivided interest in common areas. If a lien holder forecloses, only that unit and its undivided interest are affected, not the entire condominium.

Property taxes are also levied against each unit separately and thus do not affect the whole property. In addition, individual unit owners would be responsible for purchasing insurance that covers the interior of their unit and their personal property.

Cooperatives

The purchase of a cooperative is different from other types of real estate transactions. **Cooperatives** (co-ops) are *buildings owned by corporations with the residents as shareholders who each receive a proprietary lease on an individual unit and the right to use common areas.* A **proprietary lease** is *an exclusive, longer-term lease given to a person who lives in and owns stock in a cooperative.* A co-op owner's shares are considered **personal property**. This differs from a condominium purchase, which is a fee simple transaction where the unit owner receives a deed to the property. Like a condo, a co-op is a type of structured ownership known as a legal entity. Unlike a condo, which is a non-controlling entity, a co-op is member-controlled and owned.

A cooperative shareholder pays a **prorated share** of the building's expenses, including property taxes for the whole building. If a resident does not pay her share of expenses, the **entire cooperative** may be threatened with foreclosure, unlike a condo, where one resident's actions do not threaten the entire community.

Title to a cooperative building is held by a corporation formed for that purpose (owned in severalty). Even though shares, rather than property, are sold, the transaction is similar to the sale of real estate. The shares and the apartment are transferred to the purchaser along with assignment of the proprietary lease. However, the co-op agreement may provide that a shareholder cannot transfer an interest without the other shareholders' consent.

Financing a Co-op

Co-op shareholders typically have a **share loan,** which *is a co-op loan signifying a buyer is purchasing shares in a corporation rather than a mortgage for ownership of property.* Co-ops often include a **flip tax,** which is *a fee imposed by the co-op board on the seller for the transfer of ownership during the sale of the unit.*

Before purchasing shares in a co-op, buyers should read between the financial lines to make sure the co-op is in good financial standing. Prospective tenants should look at bills that have not been paid and uncollected maintenance fees. These are signs that the building finances may not be well managed. It's also a good idea to look at reserve funds and the co-op's underlying mortgage.

Cooperative Board Package

Another important part of a cooperative purchase, aside from the financing, is the board package. A **board package** is *presented to the co-op (or sometimes condo) board of directors and often includes financial qualifications, employment verification, letters of reference, and other material requested by the board.* The buyer's real estate agent completes or assists the buyer with the completion of the board package. The package is then forwarded to the managing agent of the building, who confirms it is complete and does any necessary fact checking before forwarding it to the board of directors.

Besides preparing a board package, prospective owners are generally required to interview with the co-op board. A real estate licensee can help prepare a potential shareholder-buyer for the co-op board interview. This is a key part of the process and should not be taken lightly.

Townhomes

Townhomes are *properties developed for co-ownership where each co-owner has a separate fee simple interest in an individual unit, including its roof and basement, as well as the land directly beneath the unit, and an undivided interest in the common areas of the property.* The fee simple ownership may extend to a small patio or lawn outside of the unit.

Timeshares

Timesharing is a form of property ownership in which *several buyers purchase interests in real estate with each party having the right to use the property and facilities for a designated period of time.* Timeshares are often used for vacation or resort properties. Timeshares may also be used for commercial purposes, such as shared doctor's offices.

In Illinois, anyone who accepts compensation for selling time shares **must be licensed** under the Real Estate License Act, with a few exceptions. For example, current timeshare owners may accept a fee for referring prospective buyers if they:

- Refer no more than 20 prospective buyers in a single calendar year,
- Receive less than $1,000 for referrals in a single calendar year,
- Do not discuss sale terms and conditions or negotiate with prospective buyers, and
- Do not show property to prospective buyers.

Sales and marketing of timeshare properties in and out of the state is regulated by the **Illinois Real Estate Time-Share Act of 1999** (765 ILCS 191/). The Act requires the timeshare developer to prepare a **public offering statement** and provide it to each purchaser of a timeshare interest in any timeshare plan in writing prior to signing a contract to purchase that discloses the conditions, terms, liabilities, and responsibilities of ownership. Under the Act, a timeshare purchaser has the right to **void** the contract within **five calendar days** of receiving the public offering statement or signing the contract, whichever comes last, for a full refund, minus the costs of any benefits the purchaser may have already taken advantage of.

Planned Unit Developments (PUDs)

A **planned unit development** (**PUD**) is *a special type of subdivision allowed in some communities, which does not necessarily have to comply with all the standard zoning and subdivision regulations*. For example, nonresidential uses may be combined with residential uses in a PUD. And because a PUD developer does not have to follow all of the setback and lot size rules, the buildings may be clustered close together on undersized lots to create larger open spaces than ordinary subdivisions have. In some PUDs, the lot owners co-own these open spaces as tenants in common. To obtain permission to build a PUD, a developer usually has to submit detailed plans to the planning or zoning commission for approval.

Trusts

A **trust** allows the *owner of property, known as the **trustor,** to transfer ownership to someone else, the **trustee**, in order for them to manage the property for a third party, the **beneficiary***. A trust may be an individual or a company and is often established as a way to reduce inheritance taxes or to direct an estate. The trustee's powers are limited by the terms outlined in the trust. When a trust is ***e**stablished in the trustor's lifetime*, it is known as a **living trust.** A trust *established by will or after the death of the trustor* is a **testamentary trust**. Most states permit real estate to be held in trust, though the laws regarding trusts can be complex and can vary greatly from state to state.

With a **land trust**, the *only* asset is real estate. With these, the beneficiary actually directs control over the property and has the right to posses it and earn income from it or proceeds from its sale. Generally speaking, land trusts are *not recorded in the public record* and, therefore, the beneficiary remains anonymous. In Illinois, however, certain circumstances would legally compel the trustee under the **Illinois Land Trust Beneficial Interest Disclosure Act** (765 ILCS 405/) to disclose the name of the beneficiary, particularly in certain legal matters or if the trustee of beneficiary applies to the state or to any of its agencies or political subdivisions for any benefit, authorization, license, or permit relating to the land which is the subject of the land trust.

Summary

1. **Real property** is land and its attachments, as well as all of the rights associated with the property. The **bundle of legal property rights** includes: The right of possession, the right of quiet enjoyment, the right of disposition, the right of exclusion or restriction, and the right of control. Trespassing, encroachment, and nuisance interfere with these rights.
2. **Personal property**, also called **chattel**, is most easily defined as any property that is not real property. A bill of sale transfers title to personal property.
3. A property owner has rights to the surface of the land within the property's boundaries, plus everything directly over the surface and everything under the land. The law implies **subsurface, air, mineral**, and **water** rights are included as part of the land. Water rights include riparian/littoral (adjacent to bodies or water) and appropriative (government permit to use). These rights usually transfer with land but may be sold separately.
4. Man-made attachments refer to **fixtures**, which are personal property attached to real property that, through the process of **annexation**, becomes real property. Major fixtures are improvements. Fixtures can revert to personal property through the process of **severance.** Natural attachments (plants) are real property when in the ground but personal property, or **emblements**, when picked. Attachments stay with the land; personal property doesn't. **Trade fixtures**, installed by a tenant for business, are personal property and may be removed before the lease ends.

5. A **freehold estate** is a possessory interest of uncertain duration. A **fee simple estate** is the fullest interest in property; it is inheritable, transferable, and perpetual ownership. A **qualified fee estate** has certain conditions that, if not met, revert the title automatically back to the grantor. A **fee on condition estate** has certain conditions that, if not met, may give the grantor the right of reentry. **Leasehold estates** give tenants a temporary right to exclusive possession.

6. A **life estate** is a freehold estate that lasts only as long as a specified person, the "measuring life," lives. The holder of a life estate is called a **life tenant**. With a **conventional** life estate, the measuring life and the life tenant are the same person. A life estate may also be based on a person's life other than the life tenant, which is known as a life estate **pur autre vie** (for another's life). A life estate may revert back to the grantor, or a **remainderman** may be named to whom the life estate will go upon the death of the measuring life.

7. Ownership can be in **severalty** (one person or legal entity) or **co-ownership** (many persons). Types of co-ownership can be defined by the **right of survivorship** and the **five unities**: Possession, interest, time, title, and person. **Tenancy in common** is the undivided interest in land with no right of survivorship and requires only the unity of possession. It is the most common type of co-ownership. **Joint tenancy** is the undivided equal interest and includes the right of survivorship; it requires all four unities. **Tenancy by the entireties** is a form of co-ownership that involves only owners who are husband and wife; it includes the right of survivorship and requires all five unities.

8. **Adverse possession** is when someone acquires title to someone else's real property through open, notorious, hostile (adverse), and continuous use of it for a specific period of time as determined by state law. Adverse possession does not apply to government-owned land. In the State of Illinois, the time required to claim adverse possession or easement by prescription is **20 years**.

9. There are many different types of ownership by businesses**. Sole proprietorship** is ownership in severalty. Business co-ownership includes: **Corporations** (C Corps and subchapter S Corps), and **partnerships** (general and limited). A **limited liability company** (LLC) provides its members with both the benefits of a corporation and a partnership.

10. **Condominiums** are property developed for co-ownership, with each co-owner having a separate interest in an individual unit, combined with an undivided interest in the common areas of the property. Condos have **common areas**, such as hallways and recreational facilities that all tenants own and use. **Limited common areas** are areas outside of a unit that are reserved for the specific use of one unit owner, for example, a parking space. **Maintenance fees** (also referred to as common area expenses) are monthly fees required of each condo owner or co-op shareholder for such expenses as utilities, management, building maintenance, and upkeep.

11. A **cooperative**, referred to as a co-op, is a building owned by a corporation, where the residents are shareholders in the corporation. Each shareholder receives a proprietary lease on an individual unit and the right to use the common areas. A co-op is usually purchased with a **share loan,** which is a type of co-op loan signifying a buyer is purchasing shares in a corporation, rather than a mortgage for ownership of property. To purchase shares in a co-op, a buyer must complete a **board package,** which typically includes complete financial disclosure, including tax returns and credit history, as well as employment history, personal and business references, and an interview. This package is sent to the managing agent and reviewed by the board of directors. Co-op buyers will also need to attend a **board interview**.

12. Sale and marketing of timeshares in Illinois is regulated by the **Real Estate Time-Share Act of 1999.** The Act requires a **public offering statement** and allows a purchaser to void a contract for five calendar days after signing a contract or receiving the public offering statement. Those engaging in the sale of timeshares must be licensed under the Illinois Real Estate License Act, with some exceptions.

Quiz

1. ***Which is an example of personal property?***
   a. custom-made draperies in an arched window
   b. minerals lying under the surface of the land
   c. a picket fence around the yard
   d. wheat just harvested in the field

2. ***Gareth inherits a plot of land from Jessie. A year later, he sells half of the property to Kim. A year later, she gives her half to Alex, who sells the mineral rights. This series of events represents the legal property right of***
   a. control.
   b. disposition.
   c. possession.
   d. quiet enjoyment.

3. ***What transfers title of personal property?***
   a. annexation
   b. bill of sale
   c. deed
   d. severance

4. ***Tenant Pete installs hair-washing sinks in the salon he rents. These would be considered***
   a. attachments.
   b. emblements.
   c. fixtures.
   d. trade fixtures.

5. ***Which is an example of a trespass?***
   a. a car parked on the street that blocks the driveway
   b. children throwing Frisbees and balls into a neighbor's yard
   c. a neighbor continually leaving rotting trash in her backyard
   d. partygoers standing in a neighbor's front yard

6. ***Andrew conveys a life estate to youngest son Bart for as long as his wife Carla shall live. What type of estate does this describe?***
   a. conventional life estate
   b. fee simple
   c. leasehold estate
   d. life estate pur autre vie

7. ***Karen and her friend Sue buy a $200,000 house together as tenants in common. Karen puts up $150,000, and Sue puts up $50,000. The deed indicates that Karen owns a 75% interest, and Sue owns a 25% interest. How much of that property can Sue occupy?***
   a. 25%
   b. 50%
   c. 100%
   d. whatever Karen and Sue agreed to

8. ***Mary, Donna, and Meg co-own a property as joint tenants. Mary and Meg are killed in a car accident. What is Donna's interest in the property?***
   a. Donna is a joint tenant with 100% interest.
   b. Donna owns the property in severalty.
   c. Donna still owns 33%, and the rest is split between the Mary and Meg's heirs.
   d. The estate ends at the death of the majority of the co-owners.

9. ***Lois and Clark are married and decide to buy some investment property together. Lois wants to make sure that if she dies, her daughter from a previous marriage will inherit her interest in the property. How should Lois and Clark take title to the property?***
   a. joint tenants
   b. tenants by the entirety
   c. tenants in common
   d. tenants in severalty

10. ***Blanche has a proprietary lease on one of the residential units in her building. She also has use of the building's common areas. She lives in a***
    a. condominium.
    b. cooperative.
    c. planned unit development.
    d. townhome.

11. ***Real estate owned by a corporation is owned in***
    a. joint tenancy.
    b. partnership.
    c. severalty.
    d. tenancy in common.

12. ***In order to gain title to land through adverse possession in Illinois, someone must show open and notorious, hostile and adverse, exclusive and continuous use of another's land for _____ years.***
    a. 7
    b. 10
    c. 15
    d. 20

13. ***Rachel wants to make sure that her disabled son, Earle, has a place to live when she dies. She also wants to give the property to her daughter, Jane, after her son passes away. Who will own the property when Rachel dies and what is that person called?***
    a. The owner of the property will be Earle and he is the life tenant.
    b. The owner of the property will be Earle and he is the reversionary owner.
    c. The owner of the property will be Jane and she is the remainderman.
    d. The owner of the property will be Jane and she is the reversionary owner.

14. ***Jean gives 20 acres to the city of Edgewood but stipulated that the city can only use it to create a nature preserve and park. If the city uses the land for any other purpose, it will revert to Jean's heirs. What kind of estate has Jean created?***
    a. estate at will
    b. fee simple absolute
    c. life estate
    d. qualified fee

15. ***Patricia is a single mother with terminal cancer. She is going to transfer ownership of her estate to her best friend Mary. Mary will hold the property and act as caretaker until Patricia's daughter, Ellen, turns 25. At that time Ellen will inherit the estate. Who is the trustor in this arrangement?***
    a. Ellen
    b. Mary
    c. Patricia
    d. both Mary and Ellen

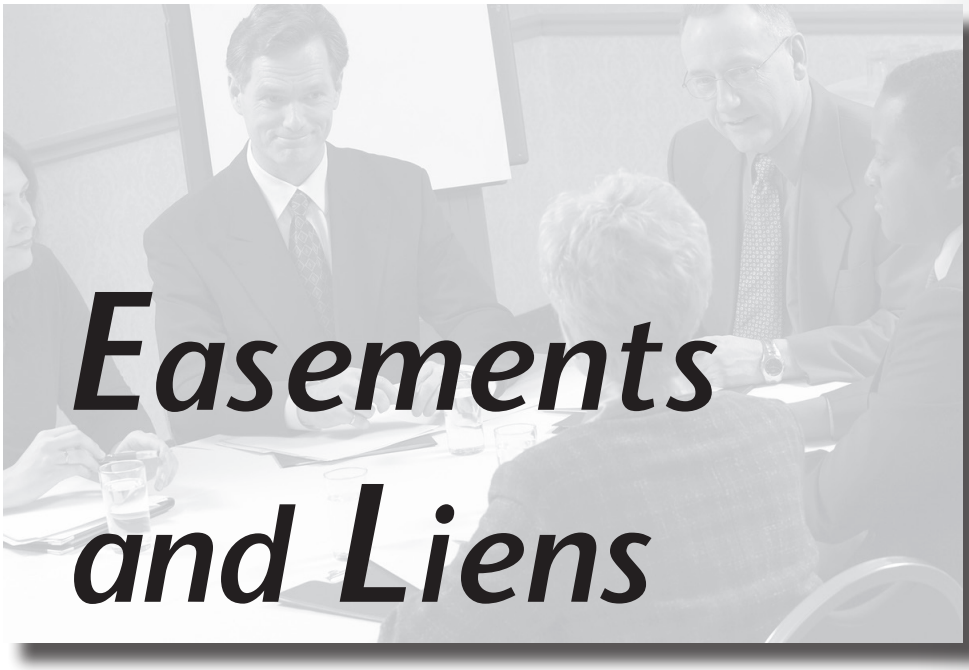
16. ***Mary, Donna, Ralph, and Lou co-own a property as joint tenants. Ralph dies. What is Mary's interest in the property?***
    a. 25%
    b. 33%
    c. 50%
    d. whatever percentage is left after discharging Ralph's will

17. ***Kyle, Eric, and Emily co-own a property as joint tenants. Emily sells her share to Ryan. What form of co-ownership does this represent?***
    a. All are joint tenants.
    b. All are tenants in common.
    c. Kyle and Eric are joint tenants; Ryan is a tenant in common.
    d. Kyle and Eric are joint tenants; Ryan is a tenant in severalty.

18. ***Alice conveys a life estate to youngest daughter Bonnie for as long as her husband Chris shall live, and then to niece Darlene. Whose life is the measuring life?***
    a. Alice
    b. Bonnie
    c. Chris
    d. Darlene

19. ***Landlord Donna has a rental property that's currently unoccupied. Right now, she owns the property _____. She finds a tenant, Jack, to rent the property, and he moves in. Now Donna's interest is _____ .***
    a. fee simple / estate for years
    b. fee simple / leased fee
    c. leased fee / qualified fee
    d. qualified fee / fee simple

20. ***Which estate is NOT inheritable?***
    a. conventional life estate
    b. fee simple absolute
    c. life estate pur autre vie
    d. remainder estate



10

Easements and Liens

Up to this point, we have talked mostly about possessory interests. Now, it's time to talk about **nonpossessory** interests. When someone has a claim or right concerning property but does not have the right to possess the property, they are said to have a **nonpossessory interest.** Nonpossessory interests—claims, limitations, liabilities, or charges—that are attached to real estate are also called **encumbrances**, since they encumber or burden a real property owner's title. We will focus on two types of non-possessory interests in this chapter: Easements and liens. Other types of encumbrances are discussed in the next chapter.

You will learn:

- Different types of easements and who benefits from them.
- How easements may be created.
- The difference between easements and licenses.
- Various types of liens.
- The impact of liens on property.

Key Terms

Attachment Lien
Dominant Tenement / Dominant Tenant
Easement Appurtenant
Easement in Gross
Encumbrance
General Lien
Homestead Estate
Involuntary Lien
Judgment Lien
License
Lien
Lis Pendens
Mechanic's Lien
Nonpossessory Interest
Servient Tenement
Specific Lien
Voluntary Lien

Easements

An **easement** is a *right to use another person's real property for a particular purpose*. Like a lien, an easement is a nonpossessory interest in property that creates limited rights for the easement holder related to the land surface, its airspace, or subsurface. An easement that grants access to property is commonly referred to as a **right of way** (ROW). Also like a lien, an easement is considered an **encumbrance**, since it *encumbers (burdens) a real property owner's title*.

Easements can be either:

- **Public** (e.g., for power lines) or **private** (e.g., for access to a landlocked parcel).
- Put into a **deed** before a transfer of property occurs or created separately as an **agreement** between the parties.
- **Affirmative**, which allows someone to do something (e.g., allowing someone to cross property to reach property with no road access) or **negative**, which prevents someone from doing something (e.g., forbidding a property owner from damming a small stream that runs through his property if it will deprive property owners downstream of the water).
- Classified as **easements in gross** or **easements appurtenant**.

Easements in Gross

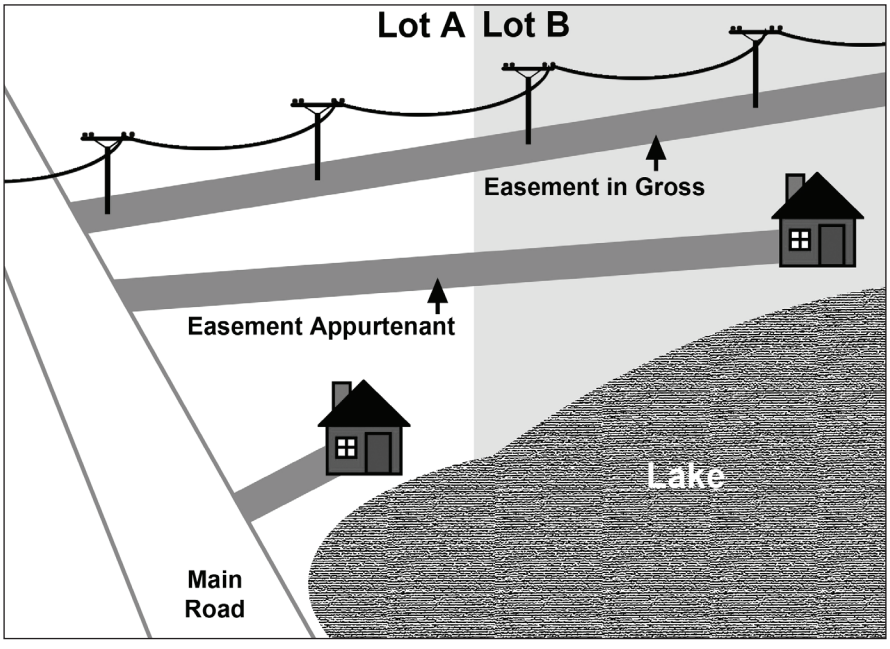
An **easement in gross** involves a *specific parcel of land and benefits a person or company* (called the **dominant tenant**) *not a piece of land.* The *burdened land* is called a **servient tenement**. Easements in gross are most commonly held by the government and public utilities for commercial purposes, for example, a utility easement that a power company has to place power lines over someone's property or that a municipality has to place sewer lines under the surface.

Easements in gross that belong to companies can be assigned to others. For example, if Phone Company A has an easement in gross to place underground lines, they could assign or sell the easement rights to Cable Company B.

Easements in gross can also be granted for noncommercial purposes for example, an easement that allows access to a public beach. These types of easements, called **personal easements in gross**, generally may **not** be conveyed or assigned to someone else and end when the dominant tenant dies.

Easements Appurtenant

An **easement appurtenant** involves *two separately deeded parcels that are owned by different parties. This type of easement burdens one piece of land* (called the **servient tenement**) *for the benefit of the other piece of land* (called the **dominant tenement**).



EASEMENT EXAMPLE: Both Lot A and Lot B border a lake. Only Lot A has access from the Main Road. An easement appurtenant across Lot A allows the owner of Lot B to access his property. Since this easement benefits Lot B, Lot B is the dominant tenement and Lot A is the servient tenement. A utility easement in gross crosses both Lot A and Lot B. Here, both lots are servient tenements to the utility company, which is the dominant tenant.

Appurtenances are rights that go with real property (e.g., air rights), so an easement appurtenant is a *right that goes with land ownership.* A recorded easement (either in a deed or as a separate document) gives notice to third parties, and so usually causes the easement to transfer with the property, which means the easement *runs with the land*. When title is transferred, the new owner owns the easement (if the dominant tenement) or takes title subject to the burden of the easement (if the servient tenement).

Light Rights

An **easement for light and air**, or view easement, is considered *a negative appurtenant easement in that the dominant tenant can prevent the servient tenant from doing something on the land because it could impact the dominant land*. These easements are most frequently seen in relation to solar panels, view restrictions, and aviation. With the use of solar panels becoming more common, the right to light is becoming more of an issue. Many states have passed solar easement laws, zoning laws, or building codes (which may require owners to place certain restrictions or covenants in deeds) geared toward solar issues. Under the statutes of some states, the landowner who first establishes solar panels for power generation has the right to unobstructed and continued use. This means that a neighbor cannot do anything on the property that would interfere with the neighbor's solar panels, such as planting trees or erecting a structure that could interfere with the light.

In Illinois, the **Homeowners' Solar Rights Act** (765 ILCS 165/5) was passed with the intent of encouraging the use and development of solar energy solutions. The Act prevents the adoption of measures, such as deed restrictions, which will have the ultimate effect, however unintended, of preventing the use of solar energy systems on any home that is subject to a homeowners' association, common interest community association, or condominium unit owners' association.

Establishing Easements

Easements can be created a number of ways:

Easement by Express Grant

An easement by express grant means *a landowner divides land and includes deed language, so the seller retains an easement across his former land*. This can also be part of the deed transfer or be in a separate document conveying only the easement.

Easement by Implication

Easement by implication is *created by law when land is divided, and there is a long-standing apparent use reasonably necessary for the enjoyment of the land*. This is also called an implied easement. Generally, easement by implication arises when a tract of land was originally held by one owner and divided into two or more parcels. The original owner would keep an ingress or egress, which is a means to enter or exit property.

Case in Point

For example, Jan owned a large piece of land with a long driveway leading from the main road to her house. Jan sold the south half of her land (the part beside the main road) to Mike, and kept the north half (the part with her house on it). Jan did not reserve an easement for herself in the deed to Mike. Although she could reach her property by a winding back road, the driveway across Mike's parcel was much more direct, so Jan just went on using the driveway as she always had. Mike filed a lawsuit to prevent Jan from using it. The court ruled that Jan had an easement by implication across Mike's parcel. Her use of the driveway was obvious and well-established when the land was divided. Although the driveway was not the only access to her parcel, it was reasonably necessary for the enjoyment of her property.

Easement by Necessity

Easement by necessity (sometimes called easement **of** necessity) is a *special easement that arises if land would be completely useless without the easement, even if there is no long-standing apparent use*. An example is a **landlocked** property with no access. For a court to assign an easement by necessity, the claimant does not have to prove the use was long-established and obvious at the time of the sale, but must prove an easement is strictly necessary (not just reasonably necessary) to use the land; if there is another way to access the land, easement by necessity will not be assigned. This type of easement is not automatic and usually not granted to owners of vacant land.

Easement by Prescription

Easement by prescription is *created by open and notorious, hostile and adverse use of another person's land for a specific time as indicated by state law.* Open and notorious use of the land means the use must be obvious and unconcealed, so if the landowner is kept reasonably informed about the property, she would be aware of the use. Hostile and adverse is use without the owner's permission and against his interests. If the owner gives permission, there is no easement by prescription.

Easement by prescription does not convey title, however. A court would be required to make that decision. Note also that an easement by prescription can rarely be acquired against government property, nor can a negative easement, such as an *easement for view,* be created by prescription.

In Illinois, to claim easement by prescription, continuous use for **20 years** is required. It does not require constant use, just regular use considered normal for that type of property. However, if a property owner posts a notice at the entrance to the property (or at regular intervals) that right of access is by permission and subject to the owner's control, no use of the land, even if continuous, can ever ripen into easement by prescription (735 ILCS 5/).

Easement by Condemnation

Easement by condemnation *occurs through the government's power of eminent domain*. Just as the power of eminent domain allows the government to take title to private property for a public use, the same power allows government entities to impose easements upon private property. These easements are usually for the purpose of future rights of way, visibility, safety, and expansion of existing roadways or utilities and require payment of just compensation to the servient tenant.

Party Wall Easement

Party wall easement is *when a wall is shared between two connected properties*. The ownership of the wall is split between the two, and each has an appurtenant easement in the other half of the wall. An agreement should be expressed in writing outlining the ownership of the wall between the two parties. Each owner shares in the building and maintenance costs of the wall.

Recording Easements

Easements can be created voluntarily or involuntarily. When easements are created voluntarily, the parties involved should put the easement in writing. A document granting an easement should be drawn up and signed just like a deed and should be **recorded in the public records** in the county where the property is located to ensure that anyone who buys the land has notice of the easement. If the buyer doesn't have notice, the easement probably won't run with the land, which has the potential for conflict.

Real Success

As a real estate agent, you can imagine how important it is to know what easements are attached to a property. For example, what if your buyer purchased property because it was large enough to build an in-ground pool, only to discover a gas utility easement across the middle of the backyard when applying for a pool permit?

It should be possible to discover existing easements from a number of public sources. Even if you don't perform that research yourself, at the very least, you may need to be able to explain to your clients any easements that show up on a title abstract, where that gas utility easement would have likely appeared.

Terminating Easements

Easements can be terminated in several ways:

- **Release.** A document *all parties sign releasing the easement holder's interest in the property*. Easement releases should always be recorded. For example, Ellen has an easement by necessity to access the road from her house from Tom's property. A road is built that abuts Ellen's property, so she releases her easement to use Tom's property. If the release is recorded, the person to whom Ellen sells her property would have no right to use Tom's property.
- **Merger.** *Uniting two or more separate properties by transferring ownership of all properties to one person*. If one person owns the property, both the dominant tenement and the servient tenement, the easement is terminated by merger. If the land is later divided again, the easement no longer exists and must be recreated if desired.
- **Abandonment.** The failure *to occupy and use property, which may result in a loss of rights*. An easement ceases to exist if the owner abandons it. Non-use alone, however, is not enough for abandonment. There must be an act or statement that clearly expresses the owner's intention to abandon the easement.
- **Failure or Expiration of Purpose.** An easement terminates when *the purpose for which it was created no longer exists.* For example, an electric company's easement for power lines across a farmer's property can end from failure or expiration of purpose if the company removes the lines. Likewise, an easement can be terminated if the property is involuntarily destroyed. For example, if a dock is destroyed by a hurricane and rebuilt, a previous easement to use it is not automatic; it must be recreated.
- **Court Action.** An easement may be terminated through a quiet title action in the courts.

Licenses

A **license** is *temporary, revocable, non-assignable permission to enter another's land for a particular purpose.* A license is *similar* to an easement because it grants permission to use another's property. Unlike an easement, a license does ***not*** create an interest in property and is not considered an encumbrance. Some other differences are:

- Easements are usually for an indefinite period of time, while licenses are often temporary.
- Easements are created by written agreement or action of law, but licenses may be created by oral contract.
- Easements run with the land, but licenses do not have to.
- Easements cannot be revoked, whereas licenses may be revoked at any time, except where the licensee makes a substantial financial commitment in reliance on the license.
- A license cannot be assigned and becomes invalid if the licensee dies.

Liens

A **lien** is considered to be *a financial encumbrance.* Liens are typically security for a debt that gives the creditor, or lien holder, the right to foreclose on the debtor's property if the debt is not paid. In **foreclosure**, the property is sold and the lien holder collects the amount of the debt from the proceeds of the foreclosure sale. A lien can be:

- **General**, which means it attaches *to all property, personal and real, owned in the county by the debtor*, or
- **Specific**, which means it *attaches only to specific property*.

Liens may also be either voluntary or involuntary.

- **Voluntary liens** are placed against property *with consent of the owner*. The most common form of a voluntary lien is a mortgage (or trust deed or home equity line of credit). A mortgage is a *voluntary, specific* lien.
- **Involuntary liens** arise by *operation of law without consent of the property owner*. These liens are created to protect a property owner's creditors. An involuntary lien may further be described as being either **statutory**, meaning it was created by legislation or rule, or **equitable**, meaning it was created by order of a court.

Mechanic's and Materialman's Liens

Mechanic's liens and **materialman's liens** are liens *claimed by someone who performed work on real property and was not paid*. The property serves as security for payment if property owners do not pay contractors, subcontractors, laborers, or materialmen for improvements to their property. If a property owner does not pay the bills, the holder of this lien can force the sale of the property and collect the debt from the proceeds.

In Illinois, a mechanic's lien must be filed **within four months** of when the labor was completed or the material supplied and is good for **two years**. These are *involuntary (statutory), specific* liens.

Tax Liens

Tax liens are *liens on property to secure the payment of taxes*. **Property taxes** create an *involuntary (statutory), specific* lien against real estate. A property tax lien could result from **ad valorem** taxes assessed by local entities such as municipalities and school districts to raise revenue, or **special assessment** taxes to pay for specific improvements that only affect specific property owners. In order to be enforceable, the taxes creating the lien must be legitimate, which requires them to be properly levied, used for legal purposes, and equitably applied to all landowners.

Unpaid **federal income taxes** also create liens on real property. Income tax liens are *involuntary (statutory), general* liens, and so unlike other tax liens, these can be attached to personal property as well. Another type of *involuntary (equitable)*, *general* tax lien is an **estate or inheritance tax lien.** These liens are placed against a deceased person's property and are generally disposed of in probate court.

Judgment Liens

Judgment liens are liens *against a person's property through court action*. At the end of a lawsuit, if it is determined that one party owes the other money, a judgment is entered. The winner of the lawsuit (judgment creditor) may claim a lien against the other party's (judgment debtor) real property.

To claim a lien, the judgment creditor obtains a certificate of judgment from the court issuing the judgment and files it in the county where the judgment debtor owns real property. A judgment lien attaches to all of a debtor's real property in each county where the certificate is recorded. Judgment liens are usually *involuntary (equitable), general* liens.

Judgment liens that are created by a **confession of judgment**, however, are *voluntary*, *general* liens. A confession of judgment is when someone who owes money permits judgment to be entered against him or her by written statement without necessity of legal proceedings.

Homestead Estates

In Illinois, a **homestead estate** is defined as *property that is occupied as the* ***principal dwelling place*** *by the owner(s).* Since the property must be the principal residence in order to qualify as a homestead estate, a property owner can claim only one homestead estate at any given time, regardless of how many properties he or she owns and/or occupies. The homestead estate designation is similar to a life estate in that it provides the **right of occupancy** to surviving spouses, partners in legal civil unions, and children under the age of 18. Therefore, when executing a listing agreement or a sales contract, a written release of homestead rights must signed by both spouses or legal civil partners, as applicable.

Homeowners who have some record title interest in the property that serves as their family home are afforded certain other benefits and protections on homestead estates under Illinois law. One protection is the exemption of some of a homeowner's equity in real estate in the event of lien foreclosure. For example, if an unsecured creditor, such as a credit card company, sues a homeowner and obtains a **judgment lien** that requires the sale of the home to satisfy, the homestead estate designation protects homeowners to some degree by reserving a specified amount of money. The available homestead protection in Illinois is $15,000 per head of household, up to $30,000 per household.

Note: This protection **does not apply to foreclosure actions** when the homeowner is in default on a mortgage or deed of trust, as such instruments contain a clause by which the borrower waives his or her rights to the homestead equity. This protection also does not apply **to real estate tax liens** on that property nor to **mechanic's liens** against the property.

Attachment Liens

Attachment liens are liens intended *to prevent transfer of property pending the outcome of litigation.* When a plaintiff files a lawsuit, there is a danger that before a judgment is entered, the defendant may sell all property, making a judgment worthless. To prevent this, at the outset of a lawsuit, a plaintiff can ask the court to issue an order of attachment. The order directs the sheriff to seize personal property or to create an *involuntary lien against real and/or personal property*.

A notice of a pending suit, called a **lis pendens**, may also be recorded. Although this is not a lien, it can *serve notice to potential buyers that there is a lawsuit pending*, and the outcome may affect the title to the subject property.

Lien Classification				
Type of Lien	**Voluntary**	**Involuntary**	**General (against individual, all property, personal or real)**	**Specific (against specific real property)**
Property Tax Lien		X		X
Income Tax Lien		X	X	
Mortgage Lien	X			X
Mechanic's Lien		X		X
Judgment Lien	X	X	X	
Attachment Lien		X	X	X

Impact of Liens

Lien holders can **foreclose** on property in the event of default or lack of payment. This forces the property to be sold and the proceeds to be used to repay the debt.

Lien Priority

It is not unusual for real estate to have several liens against it at the same time (e.g., mortgage, mechanic's lien, and property tax lien). Sometimes, the total owed for the liens is more than the land will bring at a sale, so there is an order of priority for paying off liens after the property is sold. Generally, liens are paid **in the order they were attached** to the land. An important exception is **property tax liens**, which are *superior to all other liens*. This is why many mortgage lenders prefer to maintain an escrow account to cover property taxes. The lender is assured that the property taxes will be paid, thus keeping themselves in line as the first position in the priority of liens.

If the sale of the property does not produce enough money to pay off all of the lien holders, later lien holders may get nothing.

Sometimes a lender is willing to change its order of priority with a **subordination agreement**. With this contract, a *lender voluntarily puts its lien in a lower order of priority*. This is usually done if the lender is sure the property is worth enough to pay off the additional liens *and* the mortgage.

Transferring Property with Liens

Liens against property do not prevent a property's transfer, nor does a transfer nullify the lien. The buyer takes the property **subject to the liens**, which means *the buyer takes the property with the lien obligation, but without being personally liable.* The buyer must keep paying the liens to keep the property, but loses the equity only in the event of default. The creditor cannot hold the new owner personally responsible for these debts because the new owner did not assume the debts. In most real estate transactions, therefore, sellers clear their titles of all liens before closing. There are a number of ways in which the debtor could do this:

- The necessary funds could be withheld at settlement to pay off the debt, and a record of satisfaction of the lien should be recorded in the public records to protect the new owner.
- If the seller owes more on the property than the sale of it will generate, the seller might have to come to the settlement table with a check to discharge the additional debt.
- If it's a general lien against the property owner, the creditor could agree to release the property that's being sold if the debtor has other collateral or to switch the lien to a property that the debtor will acquire.

Summary

1. **Encumbrances** are nonpossessory interests in property; a person can have a claim or right to a property without actually possessing it. Thus, they burden a property. Two common encumbrances are easements and liens.
2. **Easements** are the right to use another's property for a particular purpose. Two types are easements appurtenant and easements in gross. **Easements appurtenant** burden one parcel of land (the servient tenement) for the benefit of another piece of land (the dominant tenement). **Easements in gross** burden one parcel of land for the benefit an individual or a corporation (the dominant tenant), such as a utility company. Easements are created by express grant, express reservation, implication, necessity, agreement, or prescription. Easements are terminated by release, merger, abandonment, prescription, or failure or expiration of purpose.
3. A **license** is temporary, revocable, non-assignable permission to enter another's land for a particular purpose. A license is similar to an easement because it grants permission to use another's property. Unlike an easement, a license does not create an interest in property and is not considered an encumbrance.
4. **Liens** are nonpossessory interests and financial encumbrances. Liens are classified as **voluntary** or **involuntary (statutory or equitable)**, and as **general** (attaches to all property) or **specific** (attaches only to the property that incurred the debt).
5. **Mechanic's liens** are placed on property when owners do not pay contractors, subcontractors, laborers, or materialmen for improvements to their property. **Tax liens** are placed on property when owners do not pay property taxes, federal income taxes, estate taxes, or corporate franchise taxes. **Judgment liens** are court-ordered liens. **Attachment liens** are liens intended to prevent transfer of property pending the outcome of litigation and may involve a notice of **lis pendens** to serve notice to potential buyers that there is a lawsuit pending.
6. Lien holders can **foreclose** on property in the event of default or lack of payment. This forces the property to be sold and the proceeds to be used to repay the debt. The priority in which liens are paid is generally based on the order in which liens are recorded. The only exception is a **property tax lien**, which takes priority over all other liens.
7. Homeowners in Illinois automatically have a **homestead estate** on their principal residence. This provides rights of occupancy to surviving spouses, partners, and minor children. It also provides some protection from judgment when property is sold to satisfy liens from non-secured creditors.

Quiz

1. ***A thunderstorm knocks down power lines on John's property. Big City Electric enters John's property without his permission to fix the lines. This is an example of***
   a. easement appurtenant.
   b. easement in gross.
   c. encroachment.
   d. trespassing.

2. ***A similarity between an easement and a license is that both***
   a. can be revoked at any time.
   b. create an encumbrance.
   c. grant someone access to another's property.
   d. run with the land.

3. ***Gina has an easement to drive across her neighbor Fred's property to get to her house. Gina's property is known as a(n) _____ tenement.***
   a. affirmative
   b. appurtenant
   c. dominant
   d. servient

4. ***What is another name for a financial encumbrance?***
   a. adverse possession
   b. appurtenant easement
   c. easement in gross
   d. lien

5. ***Which is an example of a voluntary, specific lien?***
   a. attachment lien
   b. mechanic's lien
   c. mortgage lien
   d. property tax lien

6. ***ABC Construction builds Marcia's new house. Subcontractor Tim delivered lumber and drywall to the building site and ABC did not pay him. Tim filed a materialman's lien against Marcia. This lien is***
   a. general and involuntary.
   b. general and voluntary.
   c. specific and involuntary.
   d. specific and voluntary.

7. ***When Jake purchases a house, he gets a mortgage. The mortgage is recorded May 1. Jake builds a deck in July and then goes to Hawaii for several months. He doesn't pay the contractor or his property taxes. His property goes to foreclosure. Generally speaking, in what order will the liens be paid?***
   a. mechanic's lien, tax lien, mortgage lien
   b. mortgage lien, mechanic's lien, tax lien
   c. mortgage lien, tax lien, mechanic's lien
   d. tax lien, mortgage lien, mechanic's lien

8. ***Utility companies often have easements in gross that allow them to access lines or pipes. In such case, if the gas company digs up a lawn to get to a pipe, the homeowner's property would be the***
   a. dominant tenant.
   b. dominant tenement.
   c. servient tenant.
   d. servient tenement.

9. ***Heather owns a property on the shore. The guest house is on the beach, and the main house is up a hill above the beach. She sells the guest house to Tom. After the sale, she continues to use the gate between the main house and the beach house to cross Tom's property and access the beach. This would most likely be considered***
   a. easement by implication.
   b. easement by necessity.
   c. easement by prescription.
   d. trespassing.

10. ***Which is an example of a negative easement?***
    a. The gas company uses two feet in front of your house for lines.
    b. You and your neighbor share a wall separating your gardens.
    c. Your neighbor goes to court to get the right to drive across your land to get to his.
    d. Your neighbor is unable to add a second story to his house if it blocks your sunlight.

11. ***Which of the situations would LEAST LIKELY be an example of a license?***
    a. Dawn buys a ticket to the theater.
    b. Nate gives John the right to hunt on his property.
    c. Rick gets access to cross his neighbor's property to the lake when he bought his house.
    d. Stacy checks into a hotel for a week.

12. ***Which is NOT an example of an encumbrance?***
    a. a mortgage lender placing a lien for non-payment
    b. a neighbor's shrubs hanging over your property line
    c. a next door neighbor driving across your property to get to the road
    d. a utility company's right to enter your property to fix a gas leak

13. ***Brian has an appurtenant easement that allows him to cross over his neighbor's land to get to the lake. When the neighbor sells this land to Brian, the easement is terminated through***
    a. abandonment.
    b. destruction.
    c. failure of purpose.
    d. merger.

14. ***The city determines that new sewer systems need to be put in your neighborhood. If you don't pay your share of the bill, a lien will be put on your property. What type of lien is this?***
    a. construction lien
    b. judgment lien
    c. special assessment
    d. vendor lien

15. ***Which statement about licenses is true?***
    a. Licenses are inheritable.
    b. Licenses are not revocable.
    c. Licenses are terminated by the death of the licensor.
    d. Licenses grant interest in property.



11

Land Use

It is important for real estate professionals to be aware of land use regulations because they affect the way land can be used and may impact the marketability of property. In this chapter, we'll start by looking at private and public land use regulations, including what powers are available to local, state, and federal governments regarding land. You'll also see how zoning affects land use. We'll start this chapter by seeing how legal property descriptions are necessary to identify and distinguish that property from any and all other parcels of land.

You will learn:

- How to identify and describe three different methods of legal descriptions.
- How restrictive covenants are created and terminated.
- The purpose of zoning and how it is classified.
- How land use regulations are enforced.

Key Terms

Acre
Ad Valorem
Area Variance
Baseline
Block and Lot
Cluster Zoning
Deed Restriction
Eminent Domain
Escheat
Government Survey
Legal Description
Meridian
Millage
Metes and Bounds
Nonconforming Use
Plat
Police Power
Restrictive Covenant
Section
Setback Requirements
Spot Zoning
Topography
Township
Zoning Ordinance

Legal Descriptions

Although street addresses are useful for the purpose of locating property, they do not provide an accurate description of land boundaries for the property. Therefore, real property must be identified by its **legal description,** the *description of the property that provides the ability to identify and distinguish that property from any and all other parcels of land.* Many documents in real estate—such as deeds, mortgage, and title insurance policies—require a legal description to be valid.

There are various methods for providing a legal description: The most common are the government survey system, the metes and bounds system, and the block and lot system. A property's legal description may be based on one or more than one of these methods.

Government Survey System

The **government survey system,** sometimes referred to as the rectangular survey or geodetic survey, is a type of legal description for land referencing **principal meridians** and **baselines** designated throughout much of the country. (Note that not every state uses this system.)

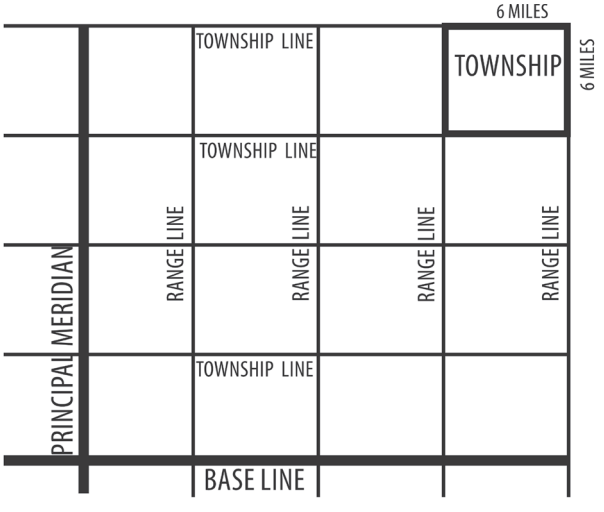
Meridians, which run north and south, are based off of the prime meridian, which is the line of longitude passing through the Royal Greenwich Observatory in England that is defined to be 0 degrees.

In the government survey system, a **baseline** is the principal east-west line that divides survey townships between north and south. The baseline meets its corresponding meridian at the point of origin, or *initial point*, for the land survey.

A particular piece of land is identified by directions and coordinates, which count from these lines as reference points.

Townships

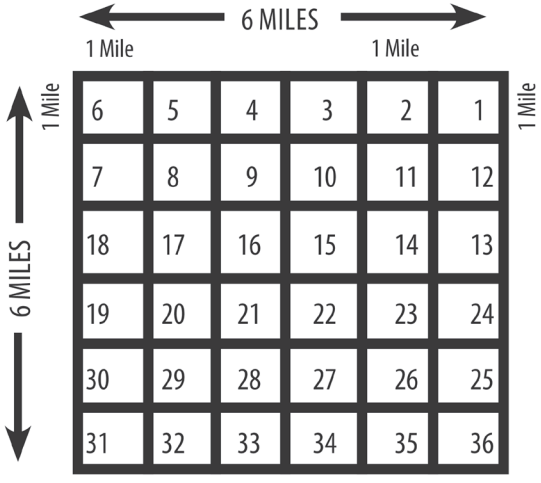
Additional north-south lines, called *ranges* or *range lines,* run parallel to principal meridians at six-mile intervals, and additional east-west lines, called *township lines,* run parallel to base lines at six-mile intervals. This divides land into six-mile by six-mile squares called **townships**.



Township Identification: Using principal meridians and base lines (each principal meridian and base line has a unique name or number.

Sections

The 36 square miles of a township are subdivided into 36 **sections** of one-square-mile, 640 acres, each. Each section in a township is numbered sequentially, so a person can locate land by referring to the section number and subsequent references to half and quarter sections with compass points. Any portion of land that cannot be divided into equal fractional lots is designated as a government lot.



Township: Divided into 36 Sections

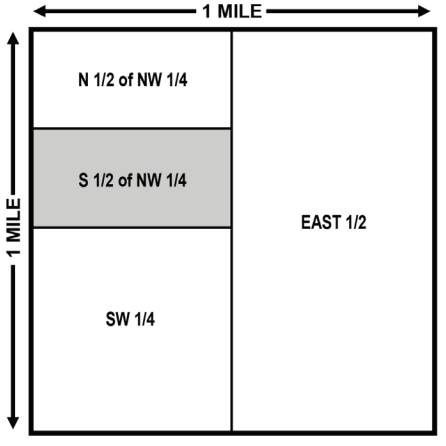
1 Township = 36 Sections

1 Section = 640 Acres = 1 Square Mile

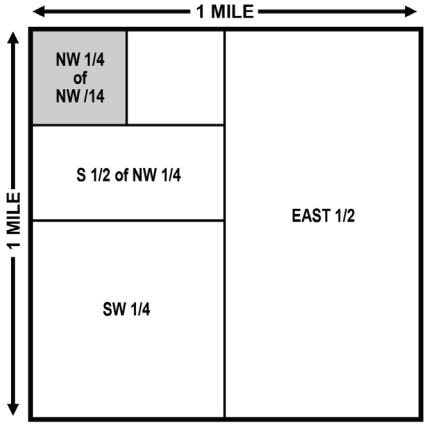
1 Acre = 43,560 Square Feet

Legal Descriptions using the Government Survey System

A legal description might read: S 1/2 of NW 1/4. Always start from the end of the description, and work backwards. We are talking about the NW 1/4, so we look at the upper left corner of the section; then we read the rest of the description to determine which part of the NW 1/4 we are talking about.

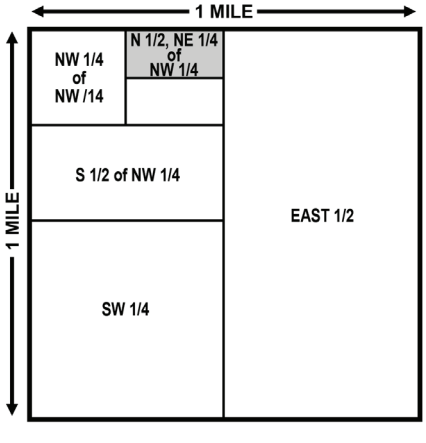


1 Section = 640 Acres = 1 Square Mile



1 Section = 640 Acres = 1 Square Mile

Here is another example, NW 1/4 of NW1/4:



1 Section = 640 Acres = 1 Square Mile

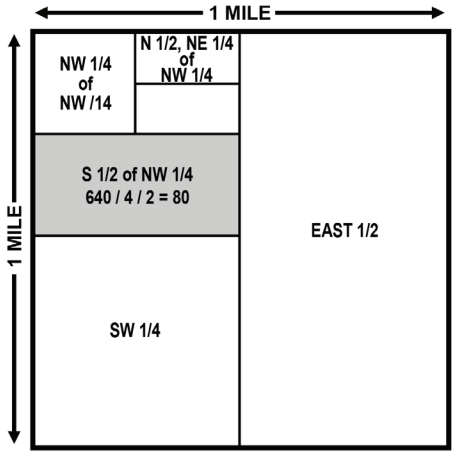
Here is N 1/2, NE 1/4 of NW 1/4.

Remember: Always start from the *end* of the description, and work backwards in the section to find the land being described.

Calculating Acres

To calculate the land acreage for a given parcel of land in the government survey system, start from the end and work backwards. Since we know that the entire section equals 640 acres, we take 640 and divide by the denominators (bottom number) for each fractional part. For example:

For S 1/2 of NW 1/4, we take 640 / 4 / 2 = 80 acres



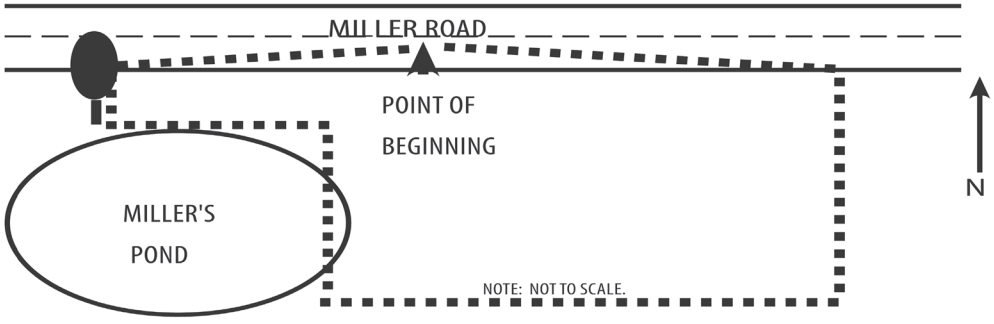
1 Section = 640 Acres = 1 Square Mile

Metes and Bounds System

The metes and bounds system is a complex legal description that is used to define the location, size, and shape of a specific plot of land. One of the oldest methods of describing a specific plot of land, metes and bounds was imported to the 13 original colonies from England and is most typically used in states along the eastern seaboard.

In this system, the **metes** indicate **distance** (you might want to think of the words "metes" and "meters" to remember distance). The distance indicates one **side** of the parcel of land. **Bounds** indicate **compass direction**, also called a course, which is expressed in degrees. Although today the distance is measured in feet, it's possible to find older legal descriptions in which the distance is expressed as **perches** or **rods**, which are synonymous terms for a measurement equal to 16 1/2 feet.

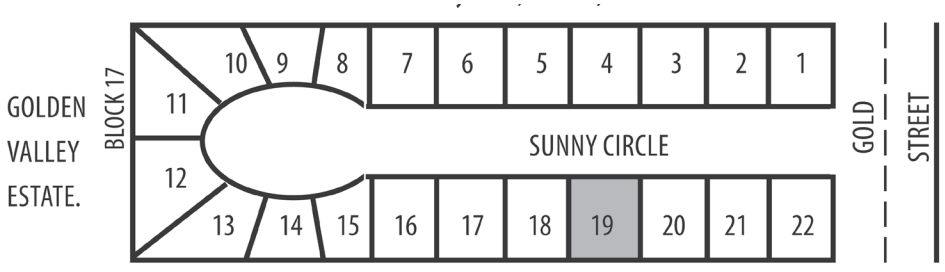
The surveyor starts at an easily identifiable **point of beginning** (POB) and works clockwise to define the boundary until he ultimately returns to the point of beginning. The selection of the POB is perhaps one of the most important aspects of the metes and bounds description. The POB should be easily identifiable and well established, usually a point on a road. Once the POB is identified, the surveyor sights the direction of the next **marker**, which is a *fixed physical object used as a reference point.* In earlier days, a marker or **monument** might have been something natural such as a tree, a rock, a wall, or a specific bend in a river. Now, most markers are permanent physical objects such as rods, sometimes called **pins**, that have been driven into the ground to be used as reference points.



Sample Metes and Bounds System: Beginning at the pin in the center of Miller Road, go SE 300 feet at an angle until the edge of the road meets another pin; then, go due south 250 feet until you hit a pin at the adjoining property's fence; then go due west 350 feet until you hit a pin at the edge of Miller's Pond. Go due north 200 feet to another pin, then due west 100 feet to a pin near the base of an old oak tree; then, go due north until you hit a pin at the edge of the road; then NE at an angle to the point of beginning at the pin in the center of Miller Road.

Block and Lot System

The **block and lot system** is a legal description used for **platted property**, which is *land that has been subdivided into blocks and lots.* To find the exact location of a parcel, one consults a **plat of subdivision**, a *detailed survey map of a subdivision recorded in the county where the land is located*. This plat map may also be called a plot plan or recorded plat. The plat map indicates unique numbers for each lot in each block of the particular subdivision. A legal description using this system might be: "Lot No. 105 as shown on said plan, as found in Plan Book (or liber) Volume 88, page 23." So the legal description indicates both the location of the lot and the location of the plat plan in the public records.

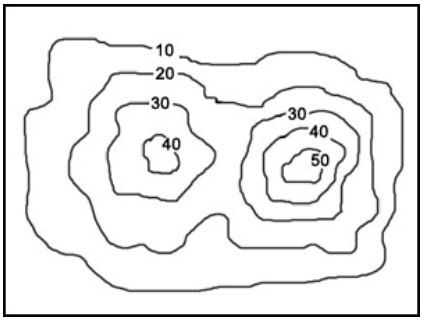


Sample Subdivision Plat Map: Golden Valley Estate, Block 17, Lots 1-22

Illinois Plat Act

Generally speaking, under the **Illinois Plat Act** (765 ILCS 205/) when land is subdivided into two or more parts, any of which is less than five acres, and the subdivision involves new streets or access easements, the owner/developer must have it surveyed and a subdivision plat made by an Illinois Registered Land Surveyor. The plat must describe details about the land such as thoroughfares for public and utilities, parks and playgrounds, other public grounds, and all the tracts, parcels, lots or blocks (numbered). A developer must also submit studies showing topographically and by profile the elevation of the land prior to development and whether that or the flow of surface water will be changed as a result of development.

A **topographic map**, also called a contour map, shows the **elevation** of a particular section of land. **Contour lines** show points of equal elevation at set intervals as determined by the scale of the map. The contour lines in this simple example indicate a 10-foot change in elevation. The closer the contour lines are, the steeper the slope. When the lines are far apart, the slope is more gradual. In this example, the hill on the right is taller and steeper than the hill on the left.



Land Use Regulations

Land ownership can be **absolute**, meaning *the complete bundle of rights belongs to the owner.* Owners have the right to use, enjoy, dispose of, and possess property. However, this does not necessarily mean landowners have the absolute right to use and enjoy the land. How can this be? Restrictions are sometimes placed on the land by the government, private companies, and even individuals in the form of ordinances, deed restrictions, covenants, rules, and regulations. These represent another type of **nonpossessory interest**, or **encumbrance**.

Land use regulations are continually changing. Many regulations relevant today were of little concern six decades ago. And this will be the case six decades from now. It is prudent for real estate licensees to educate themselves in the land use regulation cases being argued before local, state, and federal courts, and in land use legislation being introduced and passed.

Private Land Use Controls

Individual owners and developers can impose controls on their own real property. The controls, or restrictions, can affect individual deeds, or an entire neighborhood. Often, these controls prohibit uses that zoning laws would permit. For instance, a developer may place a restriction on land that only single-family homes may be built on it. Even though zoning in the area supports any type of residential use, the builder has imposed a strict control on how the land may be used--only for single-family homes. And when a deed restriction and zoning law differ, *the more restrictive use prevails.*

To prevent objectionable land use by new owners, a grantor can put *restrictions on the grantee's title*, known as **restrictive covenants,** which may be in a deed or a separate document. This is common practice when land is subdivided. Restrictive covenants are also created by express agreement between two parties, but to make a restriction enforceable against third parties, *it must be recorded*. Once a covenant is in the recorded chain of title, future buyers take title *subject to* the restriction, even if it is not stated in the deed.

Restrictive covenants can run with the land *only if they touch and concern the land.* They must relate to the use, maintenance, or improvement of the real property. A covenant that prohibits a landowner from smoking obviously cannot run with the land. However, a covenant prohibiting smoking *on* the land does; therefore, it is a valid restrictive covenant.

Deed Restrictions

Deed restrictions are simply *restrictive covenants in a deed that apply to all future landowners.* These restrictions run with the land, which means they move with the title in future conveyances. Deed restrictions are one way an owner can exercise control over a property, which is part of the bundle of rights for property owners.

Deed restrictions may or may not be conditional. For example, a deed may state, "The grantee covenants (promises) never to tear down the barn on the property." The covenant does not make the title conditional. Even if a restriction is violated, the property remains under the ownership of the grantee; it does not revert to the original owner, or go to another owner. However, if the barn is razed, a court may order the grantee to rebuild or pay damages to the grantor – but the grantee will not lose title to the land.

Some deed restrictions are accompanied by conditions. When this is the case, if the grantee violates the deed restriction, the land reverts to the grantor. Consider the previous example. If the deed contained a *restriction and condition* that stated, "The grantee covenants never to tear down the barn on the property and if he violates this promise, title to property is revoked," and the grantee does raze the barn, title reverts to the grantor. This is also known as a *qualified fee estate.*

Terminating Restrictive Covenants

Restrictive covenants may be terminated in a number of ways, including:

- Setting a termination date.
- Releasing the owner from the covenant.
- Abandoning the property.
- Changing the circumstances of the property and/or the owner.

Further, restrictive covenants that become illegal after they were written automatically terminate. For example, a deed restriction indicating people of certain religious beliefs or nationalities may not purchase land may have been legal and enforceable in the past. However, when the Civil Rights Act of 1968 was enacted, religion, national origin, and ancestry became protected classes and these deed restrictions became illegal, thus automatically terminating them.

Subdivision Regulations

Subdivision regulations must be complied with before land can be subdivided. These regulations may govern lot size, location of streets and sidewalks, etc., and may also require open spaces or recreational areas. Subdivision regulations can be both private and public. *Private* subdivision regulations *enable property owners to maintain the quality and consistency of the residences in the subdivision*.

A developer often places restrictions on all the lots in a new subdivision by recording a **declaration of covenants, conditions, and restrictions**, better known as **CC&Rs**. Note that even though CC&Rs stands for covenants, conditions, and restrictions, they virtually never make a grantee's title subject to forfeiture. The purpose of CC&Rs is to keep the subdivision attractive and protect the market value of the homes.

Through the CC&Rs, the developer can establish a **general plan** of restrictions for the whole subdivision. When there is a general plan, any homeowner in the subdivision can enforce the CC&Rs against any other homeowner. In other words, it is not just the developer who can enforce the CC&Rs. The lots are mutually burdened and benefited by the restrictions. In many cases, **a homeowners association** enforces the restrictions on behalf of the whole community.

For example, a common subdivision regulation is that improvements meet **setback requirements**, which means the structures *are located a specified distance between the front property line to the building line, as well as from the front, rear, and side property lines.* If a resident does not adhere to the setback requirements, which are covenants, property owners within the subdivision may take legal action. If, on the other hand, property owners do not take legal action to enforce covenants, or they do not take legal action in a timely manner, violators are not subject to a court's orders and the covenant will be terminated. When the *loss of legal rights occurs due to the failure to assert rights in a timely manner*, the **doctrine of laches** has been applied.

Homeowner Associations

Many real estate developers form organizations—often as non-profit corporations—called **homeowner associations (HOAs)** or **property owner associations** for the purpose of managing homes in a residential subdivision and for protecting property values. Generally, homeowners in the subdivision must pay a regular fee (monthly, annually, etc.) to the association for general maintenance and upkeep of the common areas in the subdivision, such as pools, parks, lakes, landscaping, etc.

The duties and powers of the association are usually detailed in **a homeowner association agreement**, which must be signed by the property owners in the subdivision. Most associations have the authority to enforce any CC&Rs imposed by the developer or to impose additional rules and regulations. They may be able to levy special assessments against the property owners to cover the expense of improvements to the shared common areas or even impose fines for noncompliance.

Illinois Land Sales Registration Act of 1999 (765 ILCS 86/)

In Illinois, it is unlawful for any person to engage in the business of offering, selling, or promoting subdivided land that is located outside the State of Illinois to any individual located in Illinois without a certificate of registration issued by the Illinois Department of Financial and Professional Regulation (IDFPR). According to the Act, subdivided land includes:

- Land divided or proposed to be divided into 25 or more lots or parcels.
- Any land, whether contiguous or not, if 25 or more lots, parcels, units or interests are offered as a part of a common promotional plan of advertising and sale.

There are some exceptions, for example, property intended for commercial or industrial use, cemetery lots, a subdivision where the plan of sale is to dispose of it to 10 or fewer persons, or lots of 20 or more acres (10 acres if there is free access to county-maintained roads).

Along with the application for registration, the developer must submit a public property report detailing provisions related to the subdivided land. A copy of the public property report must be given to each prospective purchaser prior to the execution of any binding contract or agreement for the sale of any lot or parcel in a subdivision. Buyers who receive this report prior to signing a contract may cancel by giving notice to the seller any time before midnight of the seventh day after signing the contract. Buyers who did not receive this report before signing a contract may cancel the contract any time within two years from the date of signing.

Government Powers

Public land use restrictions are those *imposed by the government at the local, state, and federal level.* Understandably, the government has a much broader jurisdiction when it comes to land use restrictions than the private sector does. When the government does restrict how land is used, it is an example of its **police power**, which is the *constitutional power of state and local governments to enact and enforce laws that protect the public's health, safety, morals, and general welfare.*

Considering that each county in the state and each municipality in the county have their own land use regulations, it would be impossible to list all of the controls individual municipalities have over land use. Local regulations concern everything from zoning, mobile homes, site plans, and subdivisions to cell towers and shoreline development ordinances.

Power of Escheat

Another power of the state is **escheat.** When a person dies **intestate**—without a will—and has no heirs or creditors, title to property in the state of Illinois reverts back to the **county** in which the property is located through the power of escheat. Escheat assures that land is not ownerless and, therefore, that someone is paying taxes on it.

Eminent Domain

Eminent domain *is the government's constitutional power to appropriate or condemn private property for public use, as long as the owner is paid just compensation.* Eminent domain is the power, whereas **condemnation** is the actual act of *taking the property for public use through the government's power of eminent domain.*

Condemning authorities generally include the state and its authorized agencies, municipalities, school districts, railroads, public utilities, and the federal government. Two conditions must be met before the government can exercise its power of eminent domain:

1. The condemned property is for the use and benefit of the public.
2. The property owner is paid fair market value for the property lost. (If the property owner disagrees with the compensation offered, he has the right to a trial in which the court decides if the compensation is just.)

A **taking** *occurs when the government acquires private property for public use by appropriation.* The difference between a taking and eminent domain is that the property is regulated by a government authority to the economic detriment of the owner, *without compensation*. In 1992, the U.S. Supreme Court ruled that a taking is unconstitutional if it prohibits the building of any habitable or productive improvement on the owner's land and eliminates all economic benefits associated with the land.

Zoning

Cities, counties, subdivisions, and even streets are typically divided into distinct zoning classifications. The kinds of activities permitted in different zones are regulated to protect the public.

The State of Illinois has some responsibility for determining zoning--mainly for public lands and open spaces. In other areas, however, zoning is the responsibility of local governments. This encompasses everything from subdivision development and building codes to budgeting and site plan review.

Planning boards receive numerous requests for zoning actions that can range from minor variances for single-family homes to site plans for major development projects. Requests are assessed by looking at the county's comprehensive plan as well as how the request will impact streets, roads, traffic, parks, services, and the overall well-being of the community and its residents.

Occasionally, planning boards impose a **moratorium** *that temporarily suspends the right of property owners to obtain development approvals while the local legislature takes time to consider, draft, and adopt land use regulations or rules to respond to new or changing circumstances not adequately dealt with by its current laws.* Instances where moratoriums may be instituted include when a comprehensive plan or zoning law is being established and when the municipality cannot provide the services necessary to support the proposed action. It is important to note that when a moratorium is imposed, the municipality is exercising its right of police power. Moratoriums can be used only to protect the public's welfare.

Zoning Ordinances

Zoning ordinances are local laws that divide a city or county into different areas, or zones for the purpose of *setting forth permitted uses under each zoning classification and specifying requirements for compliance.* Zoning ordinances typically have two parts:

1. A zoning map that divides the community into designated districts
2. A text of the zoning ordinance that sets forth the type of use permitted in each zone, including specific requirements for compliance

Each zone generally sets standards on minimum lot size, building height limit, setback requirements (*the specific distance between the front property line to the building line, as well as from the interior property lines)*, and side yard rules governing building position, and may even limit how much of a lot a building can cover. Zoning laws are also likely to set rules for off-street parking, landscaping, outdoor lighting, and other items.

Zoning Classifications

Typical zoning classifications include residential, commercial, industrial, institutional, agricultural, public open space, vacant land, and parkland/recreational. Each classification also has numerous subcategories.

Residential

Residential zones are just that--residential, meaning they are *for residences and not commercial buildings*. Residential zones consist of single-family as well as multi-family dwellings. Even though residential zones consist of homes and apartments, accessory uses are common in these areas. **Accessory uses** are *uses or occupancy incidental or subordinate to the principal use or occupancy of a property*. A **home occupation**, *in which a small business or other occupation is carried out in the residence,* is an example of an accessory use. Another example is an **accessory apartment**, which *is simply an apartment within a primary residence.*

A **group home** is *a residential facility in a residential zone for three or more unrelated people.* Group homes serve the special needs of a group, usually the physically or mentally disabled or those recovering from an affliction or dependency. Foster homes, rehabilitation centers, and halfway houses are all examples of group homes. Because of the nature of group homes, there is controversy over whether they should be allowed in residential zones; however, the Fair Housing Act makes it illegal to deny a permit for a home "because of the disability of individuals who live or would live there."

- **Commercial.** Another common type of zoning is commercial. Hotels, retail shops, restaurants, malls, salons, and a host of other business entities fit this category.
- **Industrial.** Manufacturing facilities are included in industrial zoning. Whether the facility is for the actual manufacturing of goods, or if it is for storing those goods, it is industrial.
- **Institutional.** Institutional zoning includes schools, college campuses, hospitals, correctional facilities, and courthouses. Institutions may appear in residential or commercial zones, depending on local zoning ordinances.
- **Agricultural.** As the name implies, agricultural zoning is for areas where animals may graze and crops may be grown.
- **Public Open Space.** When land is intentionally left undeveloped, it is considered public open space. Forests, public parks, lakes, bays, and shorelines are examples of public open spaces that can be owned either privately or publicly.
- **Parkland/Recreational.** Parklands differ slightly from public open spaces in that they are specifically used for recreational activities and maintained for their ecological, aesthetic, and educational value. Local, state, and federal authorities can all exercise their power over land use when it comes to parklands.
- **Vacant Land.** Vacant land *is unimproved land, or land with no buildings on it*. Land that does have a building on it is not necessarily occupied. It still may be considered vacant if that building (or improvement) does not serve a purpose.

Types of Zoning

Just as there are several classifications of zoning, there are also several types of zoning. Some types are specific to a zoning classification, while others may be applied across the board.

As of Right Zoning

Landowners enjoy the bundle of rights associated with the property they own; as of right zoning is implied in this bundle of rights. **As of right zoning** *prohibits discrimination among landowners in a particular zone*. Simply put, if one landowner is permitted, through zoning ordinances, to build a fence on his land, all landowners in that zone are permitted to do the same.

Cluster Zoning

Cluster zoning *allows developers to provide a varied selection of lot sizes and housing choices within a single area.* A common element to areas with cluster zoning is the incorporation of green spaces, or open spaces to add to the development's beauty and for the entire community's enjoyment. The zone may consist of **abutting properties**, which are *directly contiguous parcels, sharing at least one common boundary.*

Cluster zoning may also take the form of a **planned unit development (PUD)**, which is a special type of subdivision in which developers do not have to comply with all standard zoning and subdivision regulations. For example, nonresidential and residential buildings may be combined in the overall plan. Since PUD developers do not have to follow setback and lot size rules, buildings may be closer together, creating large open spaces for public use and enjoyment.

Incentive Zoning

Incentive zoning is *a system by which developers receive zoning incentives on the condition that specific physical, social, or cultural benefits are provided to the community*. Common incentives include:

- Increases in the permissible number of residential units or gross square footage of the development.
- Waivers of the height, setback, and use provisions of current zoning ordinances.
- Affordable housing, recreational facilities, open space, day-care facilities, and infrastructures.

Spot Zoning

The *illegal rezoning of a single parcel or a small area to benefit one or more property owners rather than carry out the objectives of the master plan* is known as **spot zoning**. Rezoning is a revision in zoning law, usually changing a zone from one type to another. When rezoning occurs, the zoning law is actually changed; it is not a variance or exception. Spot zoning is a perfect example of how the rezoning process can be abused. Isolated zoning changes can be illegal because the law is not applied the same way to all landowners.

Exceptions to Zoning Laws

Zoning laws are often controversial because they can have a big impact on the use and value of property. A zoning law is constitutional only if it applies in the same manner to all similarly situated property owners. To prevent undue hardships, zoning laws usually provide for limited exceptions.

Nonconforming Uses

Nonconforming uses *occur when land use does not conform to current zoning laws, but is legally allowed because the land use was established before the new zoning laws were enacted.* Most nonconforming uses are allowed to continue but may not be expanded or enlarged. Permission to continue nonconforming uses is not tied to the landowner. If the property is sold, the new owner may continue with the nonconforming use. Some localities may have zoning laws that automatically terminate the right to a nonconforming use if the use is discontinued for a certain amount of time, usually one year.

Variances

A **variance** *is a form of administrative relief that allows property to be used in a way that does not comply with the literal requirements of the zoning ordinance.* There are two types of variances: Use and area.

Use variances *allow landowners to use their land in a way that is not permitted under current zoning laws, such as commercial use in a residential zone.* This type of variance is granted only in cases when the current zoning ordinance causes the landowner an *unnecessary hardship*. To prove unnecessary hardship, owners usually must establish that the requested variance meets four statutorily prescribed conditions, including:

1. The landowner is deprived of all economic use and/or benefit of the property and can provide financial evidence to that effect.
2. The landowner did not create the hardship.
3. The hardship is not common to the area or neighborhood.
4. The variance will not change the nature and quality of the neighborhood.

Area variances *entitle landowners to use land in a way that is typically not allowed by the dimensional or physical requirements of the zoning law.* This type of variance is needed when a building application does not comply with the setback, height, lot, or area requirements of the zoning ordinance. This type of variance is granted only in cases when the current zoning ordinance has *practical difficulty* affecting the health, safety, or welfare of a community. In order for an area variance to be granted, landowners must usually demonstrate certain qualifications, including:

- The variance will not create an undesirable change or detriment to neighboring properties.
- The benefit sought cannot be achieved through other means.
- The variance is not substantial.
- The landowner did not create the difficulty.
- The variance would not have an adverse effect or impact on the physical or environmental conditions in the neighborhood or district.

Conditional Uses

When land use does not comply with the general zoning rules for the zone in which it is located, it may be permitted if it in some way benefits the public. This situation, known as a **conditional use**, would generally require a **special use permit**. These may also be called **special exceptions**.

Most zoning laws allow permits to be issued for certain uses that are inconsistent with a neighborhood's zoning designation, but are necessary or beneficial to the community. Common examples include:

- Schools
- Hospitals
- Churches
- Cemeteries
- Gas stations

A zoning ordinance or resolution usually has a specific list of conditional uses that may be allowed in a particular zone. The zoning board grants permits for these uses, subject to conditions that limit their adverse effects on neighboring property.

Property Tax

Local governments impose taxes on real estate to fund their many services and programs. Because real estate is permanently fixed and ownership is nearly impossible to hide, governments naturally assume they will be able to collect the tax money owed to them. Property taxes could be either:

- **Ad valorem**, a Latin phrase meaning "according to value," refers to the property taxes that are based on the assessed value of the property.
- **Special assessments** are taxes that pay for public improvements such as new sewers, streetlights, or curbs in a neighborhood. Only the property owners who benefit from an improvement are required to pay their share of its cost.

Determining Property Taxes

To calculate the amount of taxes that will be imposed on a piece of property, two things must be known:

- The percentage or ratio of assessment to market value used in the area
- The tax rate

A tax assessor does *not* determine the property tax. Instead, a tax assessor estimates the market value of property in order to **proportion the tax burden** over all the property owners in the jurisdiction so that each pays a fair share of the total tax amount. Once an assessor arrives at a determination of market value for a property, that value is converted to the **assessed value**, or assessment.

In Illinois, the assessment reflects the value of real property as of January 1. The actual tax bills are paid **in arrears**, which means that taxes are paid for the previous year, generally in two installments.

Tax rates are a direct result of the tax levy. Each taxing jurisdiction—for example, a county, town, school district, etc.—analyzes all sources of revenue to determine how much property tax revenue is needed to meet the budget. That number determines the tax rate, which can be expressed in any of four ways (all are equivalent):

- Dollars/cents per hundred dollars of assessment, i.e., $5.50 per $100
- Dollars/cents per thousand of dollars of assessment, i.e., $55 per $1,000
- Percent, i.e., 5.5%
- Millage, where 1 mill = $1 per $1,000 or .001

Illinois Homestead Exemptions

In Illinois, when considering **property tax**, there are a variety of **homestead exemptions** that either reduce the assessed value of the property or defer any increases in the assessed value of the property. When property tax is determined, therefore, the amount owed is lowered. A homestead, you'll recall, is the property owner's **principal residence**.

The **General Homestead Exemption** (GHE) is available to residents in every county in Illinois with the exception of Cook County, where an Alternative General Homestead Exemption (AGHE) is available. In some counties, the exemption is automatic, but it must be applied for in Cook and other counties. Other homestead exemptions may be available for disabled veterans, returning veterans, certain homestead improvements, those with disabilities, and senior citizens.

Tax Foreclosures

Tax foreclosures are similar to mortgage foreclosures. Many are **in rem**, meaning they are *lawsuits or legal actions directed toward property, rather than toward a particular person*. Municipalities in foreclosure cases are the lien holders who go to court and subsequently take title to the property for which taxes are delinquent. **Tax sales** are comparable to sheriff's sales. Purchasers in tax sales must pay, at least, the delinquent tax and penalties associated with the delinquency.

Summary

1. A **legal description** is required to identify a specific piece of land in mortgages and deeds. Methods include the **metes and bounds system** (a surveyor starts at an easily identifiable point of beginning and describes the property's boundaries, moving clockwise, in term of direction and distances, ultimately returning to the point of beginning), the **block and lot system** (description states only the property's lot and block number in a particular subdivision plat book), and the **government survey system**, sometimes referred to as the **rectangular survey system**, which divides land into six-mile by six-mile squares called **townships**. Each township contains 36 square-mile **sections**, and each section contains **640 acres**. One acre is equal to **43,560 square feet**.
2. Land ownership can be **absolute**, meaning the complete bundle of rights to the land belongs to the owner. Owners have the right to use, enjoy, dispose of, and possess the land they own; however, restrictions are sometimes placed on the land by individuals, private entities, and the government in the form of deed restrictions, zoning ordinances, and land use regulations.
3. **Private land use controls** are enacted by individual owners and developers. These controls often prohibit what zoning ordinances would typically allow. **Deed restrictions** are restrictive covenants that apply to future landowners. The restrictions **run with the land**, which means they move with the title in future conveyances. Deed restrictions may be conditional.
4. **Restrictive covenants** may be implemented when land is subdivided or when two parties agree. To be enforceable against third parties, they must be recorded. Restrictive covenants can be terminated in a variety of ways, including by: Termination date, release, merger, abandonment, and changed circumstances. If a restrictive covenant becomes illegal after it is written, it is automatically terminated.
5. Private **subdivision regulations** enable property owners to maintain the quality and consistency of the residences in the subdivision. A common regulation in a subdivision is that residences must meet **setback requirements**, which means they are located a specific distance between the front property line to the building line, as well as from the interior property lines. If subdivision regulations are not followed, property owners within the development may take legal action. If legal action is not taken, or if it is not taken in a timely manner, the restriction will be terminated, which means the **doctrine of laches** has been applied.
6. **Public land use restrictions** are those imposed by the government at the local, state, and federal level. When the government restricts land use, it is exercising its **police power**, the constitutional power of state and local governments to enact and enforce laws that protect the public's health, safety, morals, and general welfare. Local powers include restrictions dealing with everything from zoning to shoreline development. State powers involve escheatment (at the county level in Illinois), environmental conditions, transportation issues, filing requirements, and preservation concerns. Federal powers concern eminent domain, environmental protection laws, disclosure, and HUD funding.
7. **Zoning ordinances** set forth the type of use permitted under each zoning classification and specific requirements for compliance. Cities, counties, subdivisions, and even streets can be divided into distinct zoning classifications. The kinds of activities permitted are regulated to protect the public. Zoning is usually the responsibility of local governments.
8. Typical zoning **classifications** include residential, commercial, industrial, institutional, agricultural, public open space (intentionally undeveloped land), parklands, and vacant land (unimproved land). Within these classifications of zoning are **types of zoning**, including as of right (gives all landowners the same rights to do as they wish with their property), cluster zoning (allows developers to provide a varied selection of lot sizes and housing choices within a single area), incentive zoning (gives developers zoning incentives), and spot zoning (illegal rezoning to benefit certain property owners).

9. **Zoning** laws are constitutional only if they apply in the same manner to all similarly situated property owners. To prevent undue hardships, zoning laws provide for limited exceptions. **Nonconforming uses** occur when land use does not conform to current zoning laws, but is legally allowed because the land use was established before the new zoning laws were enacted. **Variances** allow property to be used in a way that does not comply with the literal requirements of the zoning ordinance. The two types of variances are **use variances** (allowing landowners to use their land in a way that is not permitted under current zoning laws) and **area variances** (entitling landowners to use land in a way typically not allowed by the dimensional or physical requirements of the zoning law).

10. **Conditional uses** that don't meet the zoning requirements may be allowed if there is a benefit to the community. **Spot zoning** is the illegal rezoning of a single parcel or a small area to benefit one or more property owners rather than carry out the objectives of the master plan.

11. Property taxes are raised **locally** by counties, cities, towns, and school districts, but not by the state. Real property tax is an **ad valorem** tax, based on the value of real property. **Special assessment districts** are geographic areas designated to pay for infrastructure costs for a specific project, such as sidewalks, curbs, traffic lights, etc. Special assessments are imposed on only those who will benefit from the improvements. A property's **assessed value** is the value placed on land and building by a city, town, or county assessor for use in levying annual real estate taxes. An assessing unit's tax rate is a direct result of a **tax levy**. Real property taxes create an involuntary, specific lien against real property to secure the payment of real estate taxes that are owed and unpaid. Property tax liens **always have a higher priority** over other previously recorded liens.

Quiz

1. ***In a particular suburb of a city, all of the fast food signs are at least 20 feet from the road and no more than 10 feet high. This is a result of***
   a. building codes.
   b. subdivision regulations.
   c. variances.
   d. zoning ordinances.

2. ***It is possible to remove a deed restriction***
   a. after waiting two years for the statute of limitations to expire.
   b. if the deed restriction is in violation of a discriminatory act.
   c. when the current deed owner sells the property to another buyer.
   d. when the original grantor dies.

3. ***The government sends Frank a notice stating that his house and neighborhood will be demolished to build a much-needed water treatment plant. What is the government required to offer Frank in exchange for condemning his property?***
   a. just compensation
   b. nothing, since it is for the public good
   c. whatever Frank asks for
   d. whatever they decide is reasonable

4. ***The concept of escheat means that property***
   a. can be appropriated by the state when there's a public need.
   b. can be confiscated for nonpayment of taxes.
   c. must meet specific zoning requirements before it can be developed.
   d. reverts to the county when a person dies with neither a will nor an heir or creditor.

5. ***Fiona bought a lot to build a home. The zoning for that town said that the lot had to be 100 feet wide, but to Fiona's surprise, she learned that the lot was only 98 feet wide when she applied for a building permit. The land is worthless to Fiona if she cannot build the house for lack of two feet. What does Fiona need from the zoning board?***
   a. buffer zone
   b. conditional use
   c. nonconforming use
   d. variance

6. ***June owns a florist shop in an area that is rezoned residential. What specific exception allows June to still operate her shop?***
   a. area variance
   b. conditional use
   c. nonconforming use
   d. special exception

7. ***The rezoning of a single parcel of land or a small area to benefit one or more property owners rather than carry out objectives of the master plan is known as***
   a. as of right zoning.
   b. cluster zoning.
   c. incentive zoning.
   d. spot zoning.

8. ***As defined in local zoning ordinances, the distances between lot lines and improvements are known as***
   a. buffer zones.
   b. depth.
   c. frontage.
   d. setbacks.

9. ***The authority that state and local governments have to enact and enforce laws that protect the public's health, safety, morals, and general welfare is known as***
   a. constitutional authorization.
   b. general interest license.
   c. police power.
   d. safety mandate.

10. ***"N 1/2 NE 1/4 of NW 1/4 of section 15 …" is an example of what system of legal description?***
    a. government survey
    b. lot and block
    c. metes and bounds
    d. rod and perch

11. ***In the metes and bounds system of legal description, metes indicates _____ and bounds indicates _____.***
    a. direction / distance
    b. distance / direction
    c. distance / reference point
    d. reference point / direction

12. ***How many square miles are there in a township?***

    a. 1
    b. 6
    c. 36
    d. 640

13. ***Happy Acres is a new development in Florida. A total of 120 lots for Happy Acres are being marketed in Illinois. Joe lives in Joliet now but wants to retire to Florida. He is interested in Happy Acres. Which statement about the Illinois Land Sales Registration Act is FALSE?***

    a. Happy Acres must give Joe a public property report before he signs a contract.
    b. Happy Acres must register with the IDFPR.
    c. Joe has until midnight on the 7th day after signing a contract to rescind.
    d. Joe has one year to rescind the contract if he was not given a public property report.

14. ***Which project would NOT justify a special assessment?***

    a. new curbs on Oak Street
    b. new driveway approaches in the River Bend subdivision
    c. new siding on an individual property owner's home
    d. ornamental street lighting in the historic district

15. ***Developer Lenny purchased 20 acres and had a surveyor draw up a plan, subdividing the land into 20 residential lots and two streets. The plan indicates the dimensions and number of each lot, the required setbacks, and the location of easements for utilities. What is this document commonly called?***

    a. a deed
    b. a plat
    c. a PUD
    d. a topographic survey



12

Environmental Issues

In this chapter, you'll see how environmental issues affect real estate. You'll review important federal environmental protection laws and learn to recognize common man-made and natural property hazards. You'll also become aware of your responsibility in disclosing environmental hazards and in ensuring that others do, too.

You will learn:

- Why the EPA was established and what it does.
- How to recognize hazardous substances in the home.
- How to recognize external environmental hazards.
- The real estate professional's obligations related to environmental issues.

Key Terms

Asbestos
Carbon Monoxide (CO)
Chlorofluorocarbons (CFCs)
Electromagnetic Fields
Environmental Impact Statement (EIS)
External Environmental Hazards
External Obsolescence
Groundwater
Mold
Nuisance
Radon Gas
Residential Lead-Based Paint Hazard Reduction Act
Sick Building Syndrome
Underground Storage Tanks (USTs)
Urea-Formaldehyde

Environmental Issues

For many, a property's location determines its value. A buyer who had the choice between a house next to a beautiful lake or a landfill would likely choose the lake because the environment in and around a home is important. However, what if the lake is quietly being contaminated by a company using it as a dumping ground for waste byproducts? Suddenly the property is no longer as attractive, even though on the surface, it appears fine.

Federal and state regulations dictate that specific details must be disclosed when potential environmental hazards could be present in and around a property. Real estate professionals must often advise clients to call in environmental scientists, engineers, or environmental attorneys when hazards are suspected.

Illinois Environmental Protection Agency (IEPA)

The Illinois General Assembly was the first state legislature in the nation to adopt a comprehensive Environmental Protection Act. It was signed into law on July 1, 1970. As a part of that Act, the **Illinois Environmental Protection Agency (IEPA)** was created.

The mission of the IEPA is to safeguard environmental quality, consistent with the social and economic needs of the state, so as to protect health, welfare, property, and the quality of life. The two chief focuses of public and IEPA attention initially were pollution of air and surface water. Some key initiatives include:

- **The 1987 Groundwater Protection Act** (415 ILCS 55/)—Legislation related to the comprehensive protection of groundwater which includes assignment of minimum setback zones for all wells and the identification of contamination sources around well heads. The **IEPA** is responsible for ensuring that public water supplies in the state are safe. Non-community drinking water systems are under the responsibility of the **Illinois Department of Public Health** (IDPH).
- **The 1991 EPA Amendment on Potentially Infectious Medical Waste (PIMW)** (415 ILCS 5/56.2)—Materials generated in connection with: (1) the diagnosis, treatment, immunization of human beings or animals; (2) research pertaining to the provision of medical services; or (3) the production or testing of biological items. Medical waste generated as household waste or treated medical waste are not included in the PIMW category**.**
- **The 2009 Right to Know Law** (430 ILCS 100/)—Requires that the owner/operator of the community water supply notify all users of the supply when water is contaminated or there is a threat of contamination.

Environmental Protection at the Federal Level

In 1970, the **National Environmental Policy Act (NEPA)** was enacted to:

> *Declare a national policy which will encourage productive and enjoyable harmony between man and his environment; to promote efforts which will prevent or eliminate damage to the environment and biosphere and stimulate the health and welfare of man; enrich the understanding of the ecological systems and natural resources important to the Nation; and establish a Council on Environmental Quality (Pub. L. 91-190, Sec. 2 [42 USC § 4321]).*

The NEPA requires federal agencies to prepare an **environmental impact statement (EIS)** for any project that would have a significant effect on the environment. An **EIS** *details a project's impact on energy use, sewage systems, drainage, water facilities, schools, and other environmental, economic, and social areas.* The NEPA applies to all federal development projects, such as dams and highways, and to private projects that require a license or permit from a federal agency or a federal loan.

Prior to 1970, environmental concerns such as air pollution, water, solid waste, and radiation were handled by different federal departments, bureaus, committees, and offices. These entities eventually came together to form one independent agency – **the Environmental Protection Agency** (EPA). The EPA is tasked with creating and enforcing environmental protection standards, helping others with environmental pollution problems, and providing research on environmental issues (such as the effect of pollution on the earth and methods for controlling pollution). Since its inception, the EPA has established many important laws to protect the country's land, air, and water.

The Clean Air Act

The Clean Air Act requires the EPA to develop air quality standards for existing pollutants, along with establishing air standards for new sources of pollution. It also regulates air pollutant emissions, determines acceptable levels for emissions, and sets deadlines for compliance.

The Act established the procedures for how the EPA and individual states work together to set and enforce standards. For example, states are required to prepare a *state implementation plan* (SIP) for meeting national air quality standards. States are also authorized to stop projects that interfere with clean air objectives.

The Clean Water Act

Under the Clean Water Act, national water quality standards are determined by the EPA. The Act also created a regulatory structure for the discharge of pollution into waterways and gave the EPA the right to enact control programs. It also set up a permit system whereby anyone who wants to discharge pollutants from a point source needs a permit, and any discharges with unacceptable amounts of pollutants are prohibited.

During the early years of the Act's enforcement, the EPA and governmental entities focused more on specific pollutants and sources of pollutants, such as municipal treatment plants or industries. In recent years, the focus has been on the bigger picture – protecting clean waterways from pollution and revitalizing contaminated waterways.

Comprehensive Environmental Response, Compensation, and Liability Act

The **Comprehensive Environmental Response, Compensation, and Liability Act**, or **CERCLA**, addresses *what to do with closed or abandoned waste sites*. It created mandatory waste-site requirements and established consequences for when hazardous materials were released at the sites.

Additionally, a tax was created for the chemical and petroleum industries. The tax revenue raised was placed in a trust fund used for cleaning up out-of-control or abandoned hazardous waste sites where no clearly responsible party could be identified. Because of the trust fund, CERCLA is also known as the **Superfund**.

CERCLA gave the federal government broad authority to respond when hazardous materials are released or when there is a threat of release. There were two types of response actions authorized:

- **Short-term** situations require immediate action for removal of hazardous materials because of serious life-threatening issues.
- **Long-term** situations require action to permanently or significantly reduce dangerous exposure to hazardous materials, but are not immediately life threatening.

CERCLA also established that liability for contaminated property be transferred to new owners, thus forcing potential buyers and lenders to conduct **due diligence**, or *an environmental assessment of the property to determine any potential liability*, by having a consultant determine its integrity.

Environmental Assessment

An environmental assessment typically consists of four phases:

- **Phase I**: *Investigative* – Property is inspected and records pertaining to it for a period of 50 years are reviewed. If no problems are found, the process may end here.
- **Phase II**: *Testing* – Done to determine the problem (if any) and the severity. If contamination is found, the next phase is begun.
- **Phase III**: *Cleanup* – At this point, local, state, and federal agencies, and other organizations, may participate in the cleanup effort. After cleanup is complete, Phase IV is initiated.
- **Phase IV**: *Management* of the site – Includes routine checks to prevent new problems.

The Superfund Amendments and Reauthorization Act

Closely related to CERCLA, is **SARA**, or the **Superfund Amendments and Reauthorization Act.** SARA amended CERCLA in 1986 as a result of the administration of the fund. The SARA increased the Superfund to $8.5 billion and required review of the standards and requirements in state and federal environmental laws and regulations. It also established new enforcement authorities, increased state involvement in administration of the Act, and created new settlement tools and procedures.

SARA recognizes that hazardous waste sites cause health problems and stresses the need and importance of permanent remedies along with the development and use of new treatment technologies for waste-site cleanup. The scope of involvement for decision making in site cleanup was broadened by the SARA, encouraging greater public participation in determining how sites should be cleaned up. Finally, the Act required the EPA to revise its assessment of the risk to public health and the environment for uncontrolled sites and revised how those sites are ranked for cleanup.

The Act also created a concept called "innocent landowner immunity," which does not hold landowners liable if they did not create the contamination and were not present on the site when the title was taken, providing there is proof—preferably an environmental audit.

The Resource Conservation and Recovery Act

The **Resource Conservation and Recovery Act** (RCRA, pronounced "rick-rah") gave the EPA the authority to control hazardous waste throughout its entire life cycle, including its generation, transportation, treatment, storage, and disposal. In 1984, Hazardous and Solid Waste Amendments to RCRA required land disposal of hazardous waste to be phased out. Additional amendments in 1986 enabled the EPA to address environmental problems that could result from underground tanks storing petroleum and other hazardous substances. RCRA focuses only on active and future facilities and does not address abandoned or historical sites, which are covered by CERCLA.

The Safe Drinking Water Act

The **Safe Drinking Water Act** (SDWA) established standards for water intended for human consumption that include the amount of contaminants permitted, and how frequently public water sources are tested and reported. The Act requires that public water suppliers report violations to consumers. Public water supplies are tested for different types of bacteria, chemical pollutants, and mineral levels.

Property Hazards

Devastating environmental accidents like Chernobyl, Three Mile Island, and Love Canal had serious repercussions for community members, such as increased incidences of cancer, and even death. It is clear that any property located near a perceived threat could be negatively associated with external environmental hazards. However, external factors are only half the picture.

Internal threats within a property might not be visible, but they can cause health problems. Many consumers research internal environmental threats before they consider buying a particular home or property. Real estate salespeople also need to stay current on environmental issues.

An **environmental hazard** is *a situation that exists with potential for harm to persons or property from conditions that exist outside or within a property.*

External Environmental Hazards

External environmental hazards are *those concerns that exist outside the boundaries of a property, which can have a significant impact on its value*. Visible signs of environmental damage give buyers a fear of contamination and make a property or neighborhood less desirable. Examples include toxic substances in nearby landfills, waterways with high levels of pollution, or thick smog from nearby factories.

Other less-quantifiable hazards may still pose a problem for a property or neighborhood, such as proximity to nuclear power plants or the presence of high-tension power lines. Regardless of the fact that scientific research has not produced conclusive evidence of risk, there is a strong perception among some buyers that these environmental factors are, at best, undesirable, and at worst, unsafe.

Internal Environmental Hazards

For many people, external environmental concerns might be a more serious issue, especially if a property is near a hazard that causes public concern, such as a nuclear power plant. However, **internal environmental hazards** or *hazards within a property* can be as dangerous, or more dangerous, than external hazards. The good news is that property owners and potential buyers have some power over fixing these problems, thus minimizing or eliminating them.

Liability

Any potential environmental hazard can cause great fear among sellers, buyers, and real estate professionals. In addition to concerns about associated health issues, there is also concern about liability. Buyers and sellers must consider future liability if a home is sold with a hazardous condition.

Presently, sellers are generally not held liable if they, in good faith, did not know adverse conditions existed. However, this could change, because some sellers have recently been held liable for environmental hazards they did not know about. Sellers must disclose any known hazard. In some situations, it may be appropriate to call in experts to evaluate the situation.

Man-Made Environmental Hazards

In addition to being external or internal, environmental hazards can be man-made or naturally occurring. Although there is usually a distinction between man-made and natural environmental concerns, some hazards fall into both categories. For instance, asbestos, lead, and electromagnetic fields occur naturally; however, the manipulation and use of these materials by man has made them hazardous.

Asbestos

Asbestos is a *fibrous material derived from a naturally occurring group of minerals.* The mining and use of asbestos began in the U.S. in the late 1800s and became more widespread during World War II. In the past, asbestos was commonly found in many building materials because of its insulating and heat- and fire-resistant properties. It was also embedded in various construction materials, such as cement and plastic, and was used to insulate pipes and duct-work in older buildings and ceiling tiles. These **friable** materials, which are *easily crumbled or become powdery when manipulated by hand*, are some of the most dangerous asbestos-containing materials.

Dangers of Asbestos

As the small particles of asbestos are breathed in, they can become trapped in lung tissue or the digestive tract. Over time, the accumulation of particles causes inflammation and scarring. This, in turn, can lead to a variety of breathing problems and an increased risk for developing many different illnesses. Asbestos is no longer used in construction, but the U.S. Department of Health and Human Services continues to classify it as a known carcinogen.

Testing

Typical testing procedures to determine the presence or level of asbestos (or other airborne contaminants) include:

- **Air testing.** Requires moving a determined amount of air across a filter, then examining captured particles under a microscope.
- **Bulk sampling.** Involves a certified asbestos handler removing a small piece of the suspect material and sending it to a laboratory.
- **Wipe sampling.** Involves gathering particles from a common surface, such as the floor or countertop, by wiping the area with a piece of filter paper.

Management

There is some debate over whether existing asbestos should be removed or left alone. Since it is thought to be a problem only when it becomes airborne, some people believe it is best not to disturb asbestos. Removal is an expensive process and must be done by EPA-licensed contractors. Some choose the option of monitoring and maintaining the asbestos product because, as long as it is kept in good condition, it is not a threat. Removal of asbestos-containing materials is the only permanent solution to an asbestos problem. However, if the asbestos is in good condition and not likely to be disturbed, there are other methods of managing it in place:

- **Encapsulation** is the *process of applying a sealant to the asbestos-containing material, which penetrates the material's surface, preventing the release of the dangerous fibers.* Encapsulating with a penetrating sealant can make future removal of the asbestos-containing material more difficult. And because the encapsulant may begin to deteriorate, it must be regularly inspected.
- **Enclosure** involves *isolating asbestos material by using a sturdy, airtight barrier and is a possible temporary remedy for some asbestos problems.*

Carbon Monoxide

Carbon monoxide (**CO**), *a natural byproduct of fuel combustion, is a colorless, odorless gas released as fuel sources break down to produce heat*. Thus, CO is emitted by appliances such as furnaces, space heaters, fireplaces, water heaters, and stoves. When these appliances function properly, small, regulated amounts of CO are emitted and then dissipate. Unfortunately, if malfunctions occur, unacceptable levels of CO can be released. Larger amounts of CO can also be released when ventilation is inadequate.

Symptoms of Carbon Monoxide Poisoning

People begin to experience adverse effects as CO enters the bloodstream because it stops the blood from carrying oxygen throughout the body. Overexposure to CO, or CO poisoning, can cause the following:

- Dizziness
- Headache
- Blurred vision
- Drowsiness
- Nausea
- Slowed response time
- Unconsciousness
- Death

CO Detection

Because CO is invisible to the senses, it is difficult to detect and can easily be absorbed into the body. The most effective method to keep track of CO is with a CO detector. The **Illinois Carbon Monoxide Alarm Detector Act** (430 ILCS 135/1), effective in 2007, requires homeowners and landlords to install carbon monoxide detectors within 15 feet of every room used for sleeping in all buildings containing bedrooms and sleeping facilities.

Prevention

Appliances that produce carbon monoxide as a byproduct should be checked routinely to make sure they are functioning properly, and ventilation should be checked for adequacy. Homeowners with an attached garage should never leave cars running in it. Even with the garage door open, CO can enter the home at deadly levels.

Chlorofluorocarbons

Chlorofluorocarbons (CFCs) are *chemical compounds containing chlorine, fluorine, and carbon atoms, and are known to deplete the ozone layer*. Sold under the trademarked name of **Freon** for many years, the compound was *used as a coolant in refrigerators, air conditioners, and dehumidifiers*. CFCs were also commonly used as a propellant in aerosol cans and in fire suppression systems and devices.

Use of these compounds began to be banned in the 1970s, when their detrimental effects on the earth's atmosphere were determined. Scientists therefore added hydrogen to create **hydrochloroflourocarbons** (HCFCs) as a substitute. While HCFCs break down before reaching the ozone layer, they still release some chlorine into the atmosphere, and are considered by the EPA to be a class II ozone-depleting substance and so they, too, are being phased out. These compounds have been replaced by **hydrofluorocarbons** (HFCs) in many current refrigerant/cooling systems. HFCs are less of a threat to the atmosphere since they do not contain chlorine.

Property managers and owners must comply with Clean Air Act regulations regarding these compounds, or face substantial fines. These laws include following proper disposal procedures for old appliances that contain CFCs or HCFCs. Owners must also maintain equipment to prevent coolant leaks. Fines have been assessed to owners who knowingly allow CFCs or HCFCs to leak from damaged equipment. Certified service personnel are required to work on such equipment, and the coolant must be recaptured while working on a unit. Service workers who allow these compounds to freely vent into the air can also face large fines, and even prison time.

Electromagnetic Fields

Electromagnetic fields (**EMFs**) *are invisible fields produced by electrically charged objects*. An electromagnetic field is similar to a magnet except an electrical current is needed to produce the field. Small electronic equipment in the home, such as hair dryers and computers, produces small electromagnetic fields.

Electromagnetic fields can affect other charged objects nearby. Small appliances are not usually a problem. High-tension power lines (large transmission cables carrying electrical energy), transformers (transferring power from one circuit to another), and secondary distribution lines create larger electromagnetic fields.

Suspected Health Risks

The larger electromagnetic fields created by high-tension power lines are suspected as the cause of hormonal changes, cancer, and behavioral abnormalities. The evidence for these health risks is controversial and, in some cases, contradictory. Still, there is a public perception of health issues related to EMFs and high-tension power lines. Because, to some people, properties near power lines are stigmatized, property values may be reduced.

Lead

Until 1978, lead was added to exterior and interior paint as a drying agent and for pigmentation. Also, lead pipes and solder were commonly used in plumbing systems in homes and businesses prior to the 1930s. Research found that digesting or inhaling lead or lead dust caused various health issues in children and adults.

Lead poisoning occurs via the nose and mouth--it must be breathed in or ingested. You cannot get lead poisoning by skin contact. Still, it is estimated that nearly one million children in the U.S. between the ages of one and five suffer from a high level of lead in the bloodstream.

Suspected Health Risks

The human body cannot differentiate between lead and calcium, so lead acts as calcium in the body and can stay in the bloodstream for weeks. From there, it can be absorbed by the bones, as calcium is, and remain permanently. Lead can cause serious, irreversible health problems. That is why it is discussed so much in the real estate business, and why disclosure is required.

In children, the list of symptoms associated with high or even low levels of lead poisoning is extensive. Some early signs of lead poisoning include chronic fatigue or hyperactivity, loss of appetite or weight loss, difficulty sleeping, irritability, and reduced attention span.

Adults also face serious dangers from lead poisoning, including fertility problems, high blood pressure, nerve damage, memory loss and concentration problems, muscle and joint pain, and birth defects in their children.

Water Contamination

Lead present in water is colorless, odorless, and tasteless. In older homes, it is wise to be alert for lead pipes. There is no remedy other than replacement. Water from lead pipes should be considered non-potable, or undrinkable. Another danger to the water supply in homes is well water contamination. Older pumps made of brass or bronze can leach lead into the water. Also, some wells were once packed with a lead collar, lead shot, or lead wool.

Homes built before 1988 often have copper pipes soldered together with lead-based solder, which can leach into the water. Water from this type of piping is usually considered safe if the water is not stagnant for more than six hours. If this kind of piping is in a home built prior to 1988, it is advised to let the water run for one to two minutes before using it for consumption. This ensures fresh water, less likely to have been contaminated from lead leaching.

In urban locations with municipal water supplies, many people do not realize that the pipe in the yard from the home to the water main is the responsibility of the homeowner. Often, when water pipes are replaced in older homes, the water main pipe is overlooked and should be inspected to ensure it is not made of lead.

Soil Contamination

Issues arise when lead-based paint begins to chip or flake. Paint peeling from the exterior of a property can fall into soil, contaminating it. Then, the soil can be tracked and deposited within the home as dust. Because of the damaging effect of lead and the potential exposure to lead from lead products used in home construction, the Residential Lead-Based Paint Hazard Reduction Act, or Title X, was passed.

Residential Lead-Based Paint Hazard Reduction Act

The **Residential Lead-Based Paint Hazard Reduction Act** *requires real estate licensees, property management companies, sellers, and landlords to disclose known lead paint hazards for homes built before 1978*. EPA and HUD regulations issued to implement these disclosures include:

- Disclosure of any known lead-based paint hazard in homes, including any reports available from prior lead tests.
- A pamphlet about how to protect families from lead in homes must be given to buyers and renters.
- Homebuyers have a ten-day period (or other mutually agreed to time) to conduct a lead paint inspection or risk assessment at their own expense.
- Sellers, landlords, and real estate professionals must include certain language in sales contracts and/or lease contracts to ensure disclosure and notification actually take place (included in most standard board of real estate contracts).

Compliance with Title X

Sellers, landlords, and real estate licensees share responsibility for ensuring compliance with lead paint disclosure rules. According to HUD, **real estate *licensees must comply with the law if the seller or landlord fails to do so*.** Licensees are not responsible, however, if owners conceal information or fail to disclose it. As long as they inform the sellers or lessors of their obligations to disclose, they cannot be held liable.

In addition to the lead paint notification language included in many standard contracts brokers and licensees use, the contracts also contain additional lead-based paint disclosure forms as a way to prove compliance with HUD and EPA requirements. This is wise, since the penalty for failure to disclose lead hazards is a fine of up to $10,000 and up to one year in jail plus triple damages. For convenience, brokers and agents frequently use the HUD disclosure form.

HUD Lead-Based Paint Hazards Disclosure Form

The HUD disclosure form concerning lead-based paint is divided into three sections:

1. **Seller's Disclosure** – A place for **sellers** to disclose known lead-based paint issues and any reports
2. **Purchaser's Acknowledgment** – A place for **purchasers** to acknowledge whether they received any reports, the pamphlet, and the right to an assessment period
3. **Agent's Acknowledgment** – A place for **agents** to acknowledge their role in compliance and affirm they informed the sellers of their obligations

Disclosure of Information on Lead-Based Paint and/or Lead-Based Paint Hazards

Lead Warning Statement

Every purchaser of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women. The seller of any interest in residential real property is required to provide the buyer with any information on lead-based paint hazards from risk assessments or inspections in the seller's possession and notify the buyer of any known lead-based paint hazards. A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

Seller's Disclosure

(a) Presence of lead-based paint and/or lead-based paint hazards (check (i) or (ii) below):

(i) _____ Known lead-based paint and/or lead-based paint hazards are present in the housing (explain).

_____

(ii) _____ Seller has no knowledge of lead-based paint and/or lead-based paint hazards in the housing.

(b) Records and reports available to the seller (check (i) or (ii) below):

(i) _____ Seller has provided the purchaser with all available records and reports pertaining to lead-based paint and/or lead-based paint hazards in the housing (list documents below).

_____

(ii) _____ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Purchaser's Acknowledgment (initial)

(c) _____ Purchaser has received copies of all information listed above.

(d) _____ Purchaser has received the pamphlet *Protect Your Family from Lead in Your Home.*

(e) Purchaser has (check (i) or (ii) below):

(i) _____ received a 10-day opportunity (or mutually agreed upon period) to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards; or

(ii) _____ waived the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

Agent's Acknowledgment (initial)

(f) _____ Agent has informed the seller of the seller's obligations under 42 U.S.C. 4852(d) and is aware of his/her responsibility to ensure compliance.

Certification of Accuracy

The following parties have reviewed the information above and certify, to the best of their knowledge, that the information they have provided is true and accurate.

Seller	Date	Seller	Date
Purchaser	Date	Purchaser	Date
Agent	Date	Agent	Date

SAMPLE

The "Protect Your Family From Lead in Your Home" Pamphlet

Sellers and landlords are required to give potential buyers or tenants the pamphlet titled "Protect Your Family from Lead in Your Home," produced by the EPA. The pamphlet explains the facts related to lead hazards, how lead can be ingested, associated health problems, responsibilities of a landlord, seller, or remodeler, and general information about remodeling or removal. **Real estate agents are required to ensure seller compliance in providing the pamphlet.**

Real Success

Sellers are not required to test for or remove lead paint and/or other lead hazards. The contingency language in a purchase contract should explain what happens if lead paint or lead hazards are found. For example, the contract may allow a buyer or tenant to rescind the contract if unacceptable levels of lead are found, or a seller or landlord may have the right to remove the lead. Other times, lead hazards are negotiated (as a price reduction) like any other property defect or contingency.

Exempt Properties

Some properties are exempt from lead paint disclosure rules:

- Zero-bedroom units, such as lofts or dormitories
- Units leased for less than 100 days
- Housing exclusively for the elderly
- Housing for the disabled (unless occupied by children)
- Rental units inspected and found to be lead free
- Houses sold by foreclosure

Management

The only way to find out for sure if water, soil, or paint is contaminated by lead is to send samples to a laboratory for testing. Lead paint in good condition should be left alone and painted over to seal it. The easiest way to deal with chipping or peeling paint is to cover it up – by installing vinyl siding over the exterior of a house or adding a thin layer of drywall to interior walls, for example. Surfaces with lead paint should not be sanded or scraped, to avoid releasing lead dust into the air.

Poor Air Quality

A building's poor air quality may not exactly be considered hazardous, but it can create problems and discomfort for those who must spend time inside. You may hear the term **sick building syndrome**, which refers to a situation *where people suffer from headaches, fatigue, nausea, sore throat, nose and eye irritation, and other symptoms present only while in a building with poor air quality.*

Poor air quality is usually found in buildings sealed for energy efficiency and lacking adequate ventilation systems, allowing air pollutants to build up. Chemicals released from carpets, furnishings, copy machines, paint, and cleaning products all contribute to indoor air pollution. Adding to the problem are contaminants people bring into the building, such as animal dander, hairspray, dust, etc. The best remedy for poor air quality is to improve airflow throughout a structure.

Underground Storage Tanks

Underground storage tanks (USTs) *store a variety of substances such as heating oil, gasoline, chemicals, and hazardous waste*. The EPA has enacted tough standards for USTs, imposing additional steps that owners and property managers must take to protect USTs against corrosion, spills, leaks, and overfills. What was once a common practice for the storage of fuel or chemicals in rural areas may now be an expensive process of ensuring that tanks do not leak or digging them up and removing them altogether. This can pose even bigger environmental dilemmas for commercial properties, where costs can be much higher.

Exemptions

Some types of tanks are exempt from federal regulations, including:

- Tanks with a capacity of less than 110 gallons.
- Tanks used on farms and residential properties that store less than 1,100 gallons of motor fuel for noncommercial use.
- Heating oil tanks, where the fuel is burned at the location.
- Tanks that are aboveground or at ground level; these might be in basements or tunnels.
- Septic tanks and tanks that collect storm water and wastewater.

State UST Laws

Some states have more stringent laws for the use of underground storage tanks than the federal government does. In those cases, the stricter laws prevail. Illinois requires every owner or operator of an underground storage tank to obtain an installation permit and register the UST with the **Illinois Office of the State Fire Marshal** (OSFM). Buyers who purchase property with an underground storage tank should transfer the registration so that they might be eligible to receive assistance from the state's **Underground Storage Tank Fund** (430 ILCS 15/4). This fund acts as an insurance pool to assist underground tank owners and operators in meeting the stringent financial responsibility requirements for operating underground tanks and, if necessary, cleaning-up material from leaking tanks. The fund receives its resources from fees charged to tank owners/operators when they register with the OSFM. In return for the fee paid, tank owners' liability is limited in the event of any leakage. The **Leaking Underground Storage Tank Program**, under the direction of the Illinois Environmental Protection Agency, provides oversight of clean-up activities.

Urea-Formaldehyde

Urea-formaldehyde is *a clear chemical used in manufacturing.* It can be used in the production of building materials and home products such as particleboard, plywood paneling, carpeting, and ceiling tiles. Many of these products use urea-formaldehyde resin in adhesives. The EPA regulates the use of formaldehyde and determines appropriate emission levels, especially in the construction of prefabricated and mobile homes.

The biggest concern is the use of urea-formaldehyde foam in insulation. **Urea-formaldehyde foam insulation (UFFI)** is *a type of insulation that can be blown into an existing structure*. The EPA now recommends UFFI *not* be used in residential homes because of potential health risks. Over time, the fumes and release of formaldehyde from the product dissipate, so insulation installed several years ago should not pose a health risk now.

Foam insulation is not the only source of formaldehyde inside a home. Building materials such as plywood and fiberboard also use the chemical. Formaldehyde is commonly used in many household products, including furniture cushions, carpet, cabinetry, mattresses, fabric finishes, and cosmetics.

Naturally Occurring Internal Hazards and Pests

Environmental hazards are not always created by man. Internal environmental hazards can also occur naturally. Mold and termites can have extremely destructive effects on a property. It is important to understand these types of hazards, what types of harm they can cause, and how they can be remedied or addressed.

Mold

Mold is *a fungus that can grow anywhere and on any organic material.* In order to grow, mold requires three components:

1. Moisture
2. Oxygen
3. Food source

A leaky roof that goes undetected or serious water damage creates a perfect atmosphere for mold growth. New construction, which creates tightly sealed homes, can pose a problem by allowing moisture to remain trapped in the home. If not found in time, mold can actually consume the substance on which it is growing.

Some molds produce *toxic substances* known as **mycotoxins**. One of these types of mold is **stachybotrys,** or **black mold**, *which is greenish-black in color and grows on materials with high cellulose content such as drywall, ceiling tiles, and wood that is chronically moist*. In some situations, mold can even grow behind the surface of walls or wallpaper.

Health Risks of Mold Exposure

There are many different varieties and types of molds, but not all molds are created equal – some are dangerous to humans; some are not. Mold can produce allergens, which can trigger reactions such as wheezing, eye and skin irritation, and a stuffy nose. For some people, mold can cause asthma attacks, chronic fatigue, digestive problems, and even neurological problems.

Awareness

The EPA has not specifically required mold disclosure or set standards to measure contamination. Some states, including California and Texas, have passed their own legislation regarding mold issues, and some states now require real estate agents to conduct a thorough visual inspection of properties for the existence of mold. Some signs indicating a presence of moisture in the home and thereby increasing the likelihood of finding mold are:

- Visible mold growth.
- Plumbing leaks.
- Leaking roofs or windows.
- Strong, musty odors.
- Water stains on ceilings, walls, or floors.
- Warped wood.
- Cracked or peeling paint.
- Peeling dry-wall tape.
- Clogged gutters.

In Illinois, a **mold disclosure form** is typically included in real estate transactions. Still, licensees must be careful not to act as experts or make claims they cannot verify. They should merely inform clients of any suspicions and advise them to seek further information from a specialist or home inspector. Sellers should be encouraged to disclose any problem or potential problem.

Real Success

There is no proven method of protecting a client from unwittingly ending up with a mold-contaminated property; however, there are some steps licensees can take to help, including:

- Advise homebuyers to purchase separate mold protection insurance policies.
- Have the property inspected specifically for mold and any related problems by a specialist.
- Add a mold protection clause as part of a standard purchase contract.
- Encourage the government to expand required disclosures to include toxic mold.
- Encourage the government to pass state standards and licensing for mold inspection and cleanup.

Homeowners also must be diligent in keeping property thoroughly maintained to prevent mold growth.

Pests

Rodent and insect infestations can cause major physical damage to a property. When working with a client on these issues, it is best to adopt an empathetic and a proactive approach. Experience regarding the proper professional to contact may be the only solution clients need. Licensees should personally check companies' credentials, and it is always wise to recommend three or more.

Termites

Termite problems come in all shapes and sizes. The most common type of termite found in homes is the subterranean termite. The good news is that most termite infestations are relatively easy to identify by a trained termite technician or home inspector and, if caught in the early stages, are treatable. Major problems result when termite infestations proliferate over several years. This may even threaten the structural integrity of a home. There are numerous preventive measures available to homeowners, the most inexpensive being the inspection.

Short of a professional inspection, there are some signs that indicate a termite problem. If termites or shed wings are visible inside the home, there is likely an infestation somewhere. As is the case with most pests, for every termite seen, there are typically many more not seen. Termites can be hard to detect, as they work underneath the wood surface and do not leave behind any sawdust as carpenter ants do. Termites hollow out the wood, leaving the surface appearance intact. Tapping on a suspicious area to see if it sounds hollow is one way to see if termites might be present. Another clue is to look on the outside of the structure's foundation. Termites will leave mud tubes, typically one-quarter to one inch wide, on the foundation. These tubes act as a protective barrier from the ground into their access point.

Carpenter Ants

Many real estate licensees are incredibly relieved when no termites are found during a home inspection, only to discover there is an infestation of carpenter ants. Carpenter ants can be just as destructive as termites, chewing into wood, creating a living habitat, which causes damage. Carpenter ants look just like the average ant for the most part, only they are very large. If you see an ant that is black, or black and red, and is one-quarter to one-half inch long, it is probably a carpenter ant. Carpenter ants typically get into a house through openings in the foundation. One sign of carpenter ants is the sawdust they leave behind. Slit-like holes in wood, especially around windows and doors are also indications of an infestation. Remediation at the colony source is the preferred treatment to extinguish these pests.

Pest Solutions

What can be done to remedy a rodent or an insect problem? As in most areas discussed here, a proactive approach is more effective than a reactive one. One of the most important services the real estate licensee can provide is recommending a number of reliable termite or pest control companies to clients. If a seller thinks there may be an insect problem, a licensee may counsel the seller to be proactive and have the problem exterminated prior to marketing the home. Illinois law requires insect damage or infestations to be disclosed. It is better to take care of a problem and disclose than it is to:

- Negotiate around a problem.
- Conceal, or fail to disclose a latent defect.

Unless a real estate licensee is a licensed exterminator, or the homeowner is willing to tackle the infestation problem without a warranty for the repair, a reputable professional should be contacted and all written documentation and receipts should be kept.

Radon

Radon is *a naturally occurring radioactive gas that emanates from rocks, soil, and water because of the decay of uranium.* It is the densest gas known and is odorless, colorless, and tasteless. Since it is radioactive, it has been identified as a cancer-causing agent. Lung cancer is the primary health concern of extended exposure to radon. There is also the possibility it could contribute to other health issues, such as allergies, asthma, hypertension, diabetes, and birth defects.

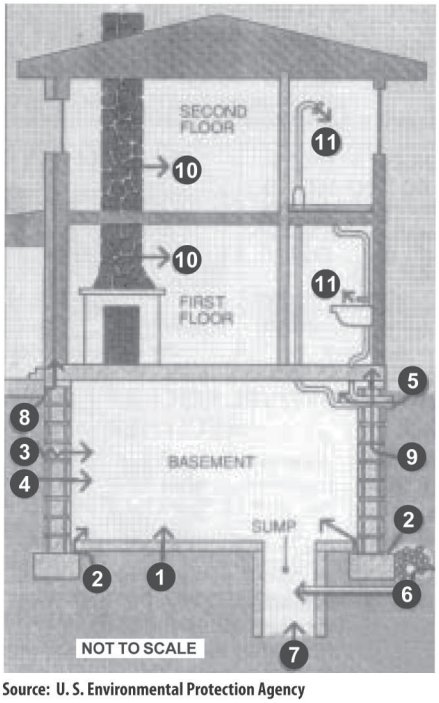
The presence of radon can vary from location to location, and from house to house. Thus, one house might have a radon problem, while another on the same street might not. The levels within a house can also vary depending on weather conditions and time of year. Radon enters a home from the ground, usually through cracks or holes in the foundation, but can also creep in from uncovered sump pumps and crawl spaces. It can actually be more of a problem in newer homes, which are built to be more airtight. It is recommended that every house in a radon-prone zone have a radon test every two years.

Radon can enter a home from the soil beneath it, through cracks in walls or the foundation, or even through the water supply if a home has well water. The following EPA diagram shows many of the ways radon can enter the home.

EPA RADON DIAGRAM:

How Radon Can Enter A Home

1. **Cracks in solid floors or slabs**
2. **Construction joints (between floors and walls)**
3. **Cracks in walls (especially concrete walls)**
4. **Mortar joints**
5. **Gaps around service pipes**
6. **Drainage system (with interior, exposed sump)**
7. **Exposed dirt in sump pump area**
8. **Gap between exterior brick or siding and top of foundation wall**
9. **Open top of concrete blocks in foundation wall**
10. **Some building materials (e.g. stone, block pores)**
11. **Water supply (usually with well water systems)**



Source: U. S. Environmental Protection Agency

Testing for Radon

Home radon test kits can also be purchased at most home improvement stores. Tests are sent to a certified lab for results. Another common way to test for radon is with continuous electronic radon monitors, which cost more but are more accurate. These tests should be set up and conducted by professional certified testers. Because they are also more tamper resistant, they are typically used for pending real estate transactions.

Illinois Radon Awareness Act

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Radon testing is not required in Illinois, however, the Illinois Emergency Management Agency-Division of Nuclear Safety recommends that buyers have a test performed by a licensed measurement technician prior to completing the purchase transaction. The **Illinois Radon Awareness Act**, which went into effect in 2008, requires sellers of **one to four units** to give buyers a copy of the "Radon Testing Guidelines for Real Estate Transactions" pamphlet as well as the Illinois Disclosure of Information on Radon Hazards. The disclosure form includes a section for the **real estate agent to sign and initial**, acknowledging that the agent has properly **informed the seller** of these disclosure obligations under Illinois law. The Act does not require the seller to test for radon.

While new construction is *not* exempted, there are some real estate transactions that do not require a seller to provide this information, such as property transferred to a mortgagee through foreclosure, transfers between co-owners, spouses, or heirs, or condominium and cooperative units that are **three stories** or higher above ground level.

Remedy and Prevention

If radon or another hazardous substance is found, remediation options are dictated and controlled by the purchase contract. First and foremost, these options must be in accordance with EPA, state, and local guidelines and standards. If not currently covered, an addendum may be used, which should be in accordance with the policies of the real estate office, local real estate board, and local laws.

The actual cost of purging a house of radon gas is relatively inexpensive—often less than the cost of eliminating termites. In fact, with low levels of radon, simply sealing cracks may be enough. With higher levels of radon, it may be necessary to install a fan or blower to bring in fresh air and keep air moving through the house. It might also be necessary to vent the radon. Radon remediation systems should be installed by an experienced, licensed remediation company. It is highly recommended that testing be performed after the installation of the removal system, and checked periodically through the years.

Many homes built since 1990 in radon-prone zones have incorporated radon proofing into the design. A commonly used construction technique is to place a four-inch layer of clean gravel under a plastic sheathing, then pour a concrete slab foundation on top. The gases cannot penetrate the plastic cover. A vent pipe penetrates through the layers to the gravel, to vent any gases up and out through the roof. This type of construction also includes sealing and caulking all foundation openings.

Groundwater Contamination

Groundwater is *found in subterranean crevices or spaces*. Since groundwater is naturally occurring, it is included here with other naturally occurring hazards. However, most of the time, groundwater contamination is from man-made sources. Dumping toxic waste, such as meth cooking byproducts, can contaminate underground water and the water supply. Groundwater contamination may also come from faulty septic tanks, leaky underground storage tanks, contaminated soil washed into lakes, rivers, and streams, and toxic surface spills. It is also possible for groundwater to be contaminated by naturally occurring elements such as radon, lead, and arsenic.

The contamination of groundwater can also affect people who use private wells as a water supply. Also, many public water systems use groundwater as a water source. On some disclosure forms, sellers are required to indicate where the property's water supply comes from, and some buyers will ask whether the water supply has been tested for contaminants.

Liability for Environmental Hazards

Property owners are being held to a higher standard than ever before when it comes to environmental hazards. With regard to property found to be contaminated with environmental hazards, not only can the past producers and/or dumpers of the contamination be held liable, but so can an innocent, current owner.

Current and past owners might be required to pay for clean-up costs, even if they did not contaminate the property, or even know of the contamination. The law specifically includes liability for owners who knew or should have known of the contamination. Even the lender in a management capacity can be held liable.

Given today's legal climate, it is important for everyone involved in a transaction to take steps to protect themselves. Although real estate licensees are not required to be technical experts with regard to environmental issues, they do need to understand environmental issues and know how to look for signs of trouble. They also need to stress the need for sellers to be honest and thorough when completing disclosure forms. Improper disclosure can result in a real estate agent being responsible, if it is decided the agent should have known, or helped to conceal information.

Other real estate professionals, such as appraisers, must make an extra effort to ensure they are aware of any potential environmental hazards to a property because the value of a property, and properties in the immediate area or an entire neighborhood, can be severely affected. When in doubt, an expert should be contacted.

Summary

1. The **Illinois Environmental Protection Agency** (IEPA) was created initially to focus on pollution of air and surface water. Its mission is to safeguard environmental quality as needed to protect the health, welfare, property, and quality of life of the citizens of Illinois. The federal **Environmental Protection Agency** (EPA) is responsible for creating and enforcing environmental protection standards, and providing support and research on environmental issues.
2. Important federal environmental laws to be aware of include:
   - **National Environmental Policy Act (NEPA)** – Promotes methods to prevent or eliminate damage to the environment and educate the public of the importance of our natural resources and ecological system.
   - **Clean Air Act (CAA)** – Regulates air pollutant emissions.
   - **Clean Water Act (CWA)** – Sets national water quality standards, and penalties for water pollution violations.
   - **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)** – Creates requirements for closed or abandoned waste sites, and establishes taxes and fines that provide money for the Superfund.
   - **Superfund Amendments and Reauthorization Act (SARA)** – Amended CERCLA and increased the monetary size of the Superfund.
   - **Resource Conservation and Recovery Act (RCRA)** – Gave the EPA the authority to control hazardous waste throughout its life cycle, including its generation, transportation, treatment, storage, and disposal.
   - **Safe Drinking Water Act (SDWA)** – Established by the EPA; sets standards for water intended for human consumption.
3. Common **man-made hazards** are:
   - **Asbestos** – A fibrous, heat-resistant material once commonly used as insulation. Inhaled asbestos particles can cause lung cancer.
   - **Carbon monoxide (CO)** – A colorless, odorless gas that is released when fossil fuels are broken down to produce heat. Illinois requires all housing with sleeping rooms to have CO detectors. Overexposure to CO can cause dizziness, nausea, and death.
   - **Chlorofluorocarbons (CFCs)** – A chemical compound, commonly known as Freon, used as a coolant in refrigerators, air conditioners, and dehumidifiers. EPA regulates use and handling of CFCs, and sets fines for misuse.
   - **Electromagnetic fields** – Invisible fields created by moving electrical currents. High-tension power lines, transformers, and secondary distribution lines create large electromagnetic fields suspected of causing hormonal changes, cancer, and abnormal behavior. Evidence is controversial and no remedies have been established, other than to maintain a safe distance from EMF-emitting appliances and power lines.
   - **Lead** – A bluish-white metal added to exterior and interior paint as a drying agent and for pigmentation. Also used in pipes and solder in the plumbing systems in homes and businesses. Digesting or inhaling lead or lead dust causes neurological disorders and learning disabilities; can contaminate soil. The **Residential Lead-Based Paint Hazard Reduction Act,** or **Title X**, requires disclosure of known lead-based paint dangers. For houses built before **1978**, a lead paint brochure must be given to buyers and tenants; buyers must be given time to conduct lead tests if they desire.
   - **Urea-formaldehyde** – A chemical used in adhesive for household materials (particleboard, plywood paneling, carpeting, ceiling tiles), and blown-in foam insulation. Health risks include shortness of breath, wheezing, asthma, and skin and eye irritation; suspected to cause cancer.
   - **Underground storage tanks (USTs)** – Buried tanks that store heating oil, gasoline, chemicals, and hazardous waste. Registration of USTs is required in Illinois.

4. Other common environmental concerns are derived from nature. Common **naturally occurring hazards** are:

   - **Mold** – Many different varieties of fungus; dangerous mold is black mold (stachybotrys). Lawsuits regarding mold issues have branched beyond builders and insurance companies to include sellers, brokers, management companies, and licensees.
   - **Radon** – A naturally occurring, odorless, colorless, and tasteless radioactive gas that emanates from rocks. Radon can build up in a home due to inadequate ventilation; prolonged exposure to the gas can cause cancer.
   - **Groundwater contamination** – Groundwater is found in subterranean crevices or spaces. Dumping of toxic waste into soil, faulty septic tanks, leaky underground storage tanks, and toxic surface spills can contaminate groundwater, which results in the pollution of private wells and public water systems. It is also possible for groundwater to be contaminated by naturally occurring elements found in the earth's soil.
   - **Pests**, including rodent and insect infestations, can cause major physical damage to a property. It may be necessary to engage a certified exterminator. Records should be kept to prove that remediation has taken place.

Quiz

1. ***Radon gas***
   a. can indicate the presence of a toxic uranium dump close to the property.
   b. can seep into the basement of a home through cracks in the foundation.
   c. is a man-made waste byproduct.
   d. makes a house worthless because it must be condemned by the EPA.

2. ***If a listing agent is aware of an insect infestation in a home, she should***
   a. advise the homeowner to paint the floorboard to disguise the damage.
   b. disclose the information to potential buyers and try to negotiate around the problem.
   c. keep quiet until the transaction is closed.
   d. put out bait and not mention the problem to anyone.

3. ***Based on Title X, will a real estate broker be held liable if lead-based paint is NOT disclosed?***
   a. No, only landlords and sellers are responsible for compliance with the regulation.
   b. Yes, if the broker knew the lead-based paint hazard existed but helped to conceal that fact.
   c. Yes, brokers will be held responsible if they do not fill out the disclosure form.
   d. Yes, brokers will be held responsible, regardless of whether they knew lead-based paint was in the property.

4. ***What statement about electromagnetic fields is FALSE?***
   a. They are created by moving electrical currents.
   b. They are produced by small appliances, such as computers and hair dryers.
   c. They can affect other charged objects.
   d. They have been proven to cause cancer.

5. ***What is NOT an exception to federal underground storage tank regulations?***
   a. heating oil tanks, if the fuel is burned on site
   b. septic tanks
   c. tanks above ground
   d. tanks over 200 gallons

6. ***Which two federal Acts directly address the issue of hazardous waste?***
   a. CERCLA and CWA
   b. CERCLA and SARA
   c. EPA and CEQ
   d. NEPA and SARA

7. ***What chemical, when leaked into the environment, contributes to the depletion of the ozone layer?***
   a. chlorofluorocarbons
   b. polychlorinated biphenyl
   c. radon
   d. urea-formaldehyde

8. ***Which component does NOT contribute to the growth of mold?***
   a. darkness
   b. food source
   c. moisture
   d. oxygen

9. ***When a home inspector finds tube-like formations made of mud on the foundation of the garage of a home, they are most likely signs of***
   a. carpenter ants.
   b. honeybees.
   c. rats.
   d. termites.

10. ***Title X requires real estate licensees to disclose known lead paint hazards for homes built before***
    a. 1964.
    b. 1978.
    c. 1986.
    d. 1990.

11. ***Gretchen is purchasing a condominium. The seller does not have to provide her with the mandated radon awareness pamphlet if the unit is on the _____ floor or above.***
    a. second
    b. third
    c. fourth
    d. fifth

12. ***Which statement about asbestos is TRUE?***
    a. It can contaminate the house further when removed improperly since it is the airborne particles that are the issue.
    b. It is dangerous only when it is wet and thus it should be encapsulated in waterproof material.
    c. It is inexpensive to remove.
    d. It is required to be removed if it is found in a residential property.



13 Construction Overview

Clients look to real estate professionals for help in understanding the many issues surrounding their property purchases. For example, clients may ask about the renovation needs of an older property they're considering or the steps in the construction of a new build. A basic knowledge of construction allows real estate agents to have conversations with clients about the features of a particular existing home as well. In this chapter, you'll be introduced to some basic elements of home construction. Then we'll conclude this section with an overview of how to measure square footage and count rooms.

You will learn:

- The purpose of building codes.
- The requirements to complete a construction project.
- The major systems that run a home, including heating, cooling, plumbing, electrical, and waste systems.
- How to measure square footage of lots and houses.
- Issues related to counting rooms.

Key Terms

Acre
Blueprint
Building Codes
Building Permits
Concrete Slab
Footer
Foundation
Framing
Gross Living Area
Sheathing
Square Foot

Land Use and Construction

It is important for licensees to understand how land use controls pertain to the construction process. Land use controls are any public or private restrictions on how land may be used and are usually government-enacted zoning laws. You cannot construct just any building on any property. Builders must follow specific zoning regulations when developing a property. They also develop specifications, ensure adherence to codes, and obtain the necessary permits.

Specifications

In construction, planning and pre-construction begin with documents called **specifications**, which are *written documents explaining the requirements for the scope of the work, including materials, standards, and expected quality of the finished product.*

Once a lot or parcel has been chosen, a **blueprint**, which is a *detailed building plan used to evaluate design, determine feasibility, and guide construction of a structure,* can be used for obtaining quotes from prospective builders.

Decisions for the finish materials and components for the entire project must also be made. Things such as hardwood floors versus carpet over a subfloor, and type and brand of cabinetry, are detailed in a materials list. After all, a builder cannot bid on a project, nor can an appraiser perform a new construction appraisal assignment, if the quality, type, and quantity of materials have not yet been decided.

Building Permits and Requirements

The next step is getting approval of the building specifications and blueprints by local authorities. A plot plan may also need to be submitted, showing the proposed layout of the property site, including the building's position. This is the first step in obtaining the necessary building permits.

Permits, issued after approval of the builder's initial plans, are *official government documents* obtained from the appropriate government authority that acknowledge that the proposed work meets the department's standards, and grant permission for it to be performed. They also prompt government authorities to monitor projects and follow up with appropriate inspections. In some areas, one building permit may cover the entire new construction, building addition, or renovation project. In other areas, however, separate permits may be needed for the building itself as well as the electrical and plumbing systems. In those cases, different inspectors may be utilized.

Codes and Compliance

Building codes *protect the public by setting minimum standards and requiring builders to use certain construction standards, including particular methods and materials, sanitary equipment, electrical wiring, and fire prevention techniques.* In Illinois, as with every other state, there are numerous building codes that must be followed when performing any type of construction work. It is important to note that states have minimum building standards, and local jurisdictions could have stricter standards.

Building codes are established locally and permits are issued through local government authorities. Typically, an owner who wants to build or remodel a building must submit plans to a local building department for approval. A **building permit** is issued only if the plans comply with the codes. Local inspectors, who can stop work if necessary, inspect the project several times throughout the construction process.

Building Inspections

It is critical for licensees to know why building inspections are important. **Building inspection** is the *process whereby government authorities, usually state or local, are charged with ensuring compliance with prevailing building codes*. Since building codes are written to ensure buildings are safe, enforcement of these codes, through inspection, is in the community's best interest. Building inspections, though, differ from home inspections in that building inspectors do not inform a prospective buyer of potential problems with a building, but ensure compliance with current building standards. A **Certificate of Occupancy** is issued to builders after all inspections have been made and the property is deemed fit for occupancy.

Structure

While a real estate licensee is not expected to have the knowledge of construction that a general contractor or architect has, it is important to recognize and understand the fundamental components of a basic structure, including the foundation, framing, roof, exterior finish work, and interior finish work.

Foundation

The **foundation** is *the basic structure on which the rest of the house sits.* A typical foundation system is usually concrete slab, pier and beams, crawl space, or basement**.** The foundation supports the rest of the structure, so it is important that it is strong and dry. **Foundation walls** are the *side walls that support the structure.* They are typically made of poured concrete, concrete block, or brick. Elements of the foundation include:

- **Footer.** This is the *underground base, usually concrete, that supports a foundation.*
- **Slab-on-Grade Construction.** This is a *concrete foundation built directly on the ground*. A slab-on-grade house or building does not have a basement.
- **Crawl Space.** This is the *unfinished space below the first floor of a house or other structure, but less than a full story in height.*
- **Basement.** A **basement** is *part of a house or building partially or entirely below grade, and is used to support the rest of the structure*. Basements are at least one full story in height and are formed as a result of space excavated before a house or building is erected. The walls of a basement sit on concrete footers, and serve as the foundation for the structure.

Framing

The term "building envelope" may be mentioned when a structure is being developed. The **building envelope**, sometimes called a building shell*, refers to the exterior elements* (walls, windows, floor, roof, etc.) *that enclose the interior.*

The framing is the basic, load-bearing skeleton of a structure to which the interior walls, exterior walls, and roof system are attached. Framing also includes the solid support structure surrounding window and door openings. When interior framing is complete, it is possible to walk around the floor plan and experience the structure's layout.

Roof

Roof framing is also an important part of a structure**.** A **rafter** is a *sloped support beam that follows the pitch of the roof and serves to hold the outer roof covering.* The rafters are fastened to the roof ridge beam**,** a horizontal beam at the top of the roof.

Exterior Finish Work

Exterior finish work, which protects the exposed surfaces from the elements, is completed as soon as final framing is finished. In most cases, *sheathing* is used. **Sheathing** is a *structural covering, often made of plywood, placed over a building frame's exterior wall studs or roof rafters.* For the roof, sheathing is added and covered by a roofing paper and then roofing material, such as asphalt shingles. Once the sheathing has been placed on the exterior of the property, siding can be added. **Siding** is the *outer covering for a building's exterior walls, designed to shed water and protect the building from the elements.* It is often made of vinyl, wood, steel, or aluminum. Many other types of exterior coverings are available, including stucco, brick, and stone.

Interior Finish Work

After the exterior finish work is complete, interior finish work begins. Interior finish work includes such elements as:

- **Rough-Ins.** Items hidden later by finished walls, but are vital to the operation of the house, such as electrical wiring, plumbing, and heating and air-conditioning elements.
- **Wallboard.** Gypsum plaster sandwiched between two layers of coarse paper, also known as **drywall** or **sheetrock,**
- **Wall and Floor Coverings.** Flooring includes wood, carpet, laminate, vinyl, and ceramic tile. Light fixtures, electrical switches and outlets, plumbing fixtures, and cabinetry are also installed at this point.
- **Finishing.** All interior trim along with other items such as porches, decks, and other exterior components.
- **Insulation.** Energy efficiencies that may be regulated by building codes.

Major Systems

Real estate licensees might hear questions like, "This furnace looks old. How many years do they last?" and "What are those vents on the roof used for?" The major systems of a well-functioning structure—electrical, plumbing, ventilation, heating, and cooling—are begun in the next phase of the construction process.

Ventilation Systems

Interior air can contain high levels of pollutants and irritants, including dust, pet dander, and chemicals, as well as high moisture levels. These can have a serious health impact on those living in the home, and can also cause problems to the structure itself. Properties need effective ventilation for the occupants' and the building's well-being**.** *Effective ventilation* means both a controlled ventilation rate and a means of distributing fresh air to habitable spaces.

Ventilation systems are often comprised of an exhaust fan and ducts to remove stale and polluted air from the building. **Natural ventilation** is achieved when properties rely on windows and natural airflow through cracks in the building for ventilation.

Heating and Air Conditioning Systems

The heating system of a house is comprised of several elements depending on what is in use. These elements can include a boiler, registers, radiators, furnace or heat pump, flue, thermostat, and ducts and ductwork. Depending on the type of fuel the system uses, there may also be electrical connections, gas lines, or oil/fuel storage. Today there are many alternative heating systems available, and solar and radiant heating are becoming popular. The three most common heating systems are:

- **Hot Water System.** This system consists of a boiler, pipes, and convectors or radiators. It relies on a process of heating and cooling liquid to heat a home.
- **Steam System.** Like the hot water system, the steam system needs a boiler, pipes, and convectors or radiators to operate. Steam is produced in the boiler and moves through the pipes to convectors or radiators that transfer heat into the room.
- **Forced Warm Air System.** Most buildings today include forced-air furnaces. The components of this system include a furnace (with a blower), a heat source (i.e., gas, oil, wood, electricity, etc.), distribution ducts, and return air ducts. In this system, air is heated in the furnace and moves through ductwork to warm each room. Cool air is then recirculated through return air ducts.

Air Conditioning Systems

Air conditioning in a home is less of a luxury and more of a "must have" item. It is standard in new buildings, and older buildings are often retrofitted to include air conditioning. Components of an air conditioner include a condenser, condenser fan, compressor, evaporator and blower, and a liquid refrigerant. The condenser needs outside air to operate, thus, air conditioning units are found outside. Basically, to make cool air, the compressor moves the liquid refrigerant to the evaporator where it absorbs heat from air passing over the coils, thereby cooling the air forced through the room.

Heat Pumps

Electric heat pumps are an alternative to traditional heating and cooling systems. Heat pumps are more energy efficient than furnaces, and only one unit is needed instead of two. A distinct disadvantage to heat pumps is that they are sometimes less effective in cold climates.

Plumbing Systems

The plumbing system of a building is comprised of many elements, including piping, sinks, drains, toilets, tubs, vents, showers, valves, hot water tank (gas or electric), and faucets. The piping includes cold water lines, hot water lines, and wastewater lines (sewer lines). Gas lines are often included as part of the plumbing system.

Water Heating

There are a variety of appliances that can bring hot water into a building, including hot water heaters and tankless water heaters. Most hot water heaters are tank-type heaters in which water is continually kept heated and ready for use. Recently, tankless water heaters have become popular. They do not retain water in a traditional tank. Instead, water is heated by a heating coil when it is needed. Tankless heaters are more energy efficient since they do not heat water continuously, only when hot water is needed.

Domestic Water

Water comes into a building from a series of pipes. The specifics on how the water gets to a home depend on where the home is located. Homes in a metropolitan city or a suburb near a city likely get water through the public water supply. Water is brought into the pipes through pressure from the main water supply. In some suburbs and more rural areas, homes may depend on a well water supply.

Waste Systems

One of two types of sanitary waste systems is usually found in a residential property:

- **Septic System.** Includes a septic tank and soil absorption system. It acts as a sewage treatment system that moves wastewater to an underground storage area where solid waste matter decomposes.
- **Municipal Wastewater System.** Wastewater is drained from the house through pipes into a sewer. The sewer carries the waste to a local wastewater treatment facility.

Electrical Systems

Utility companies supply power to buildings by providing electricity through power lines. Power cables are located either underground or aboveground. **Service lateral** is an underground power supply line, and **service drop** is the aboveground supply line going from the service pole to a building. For the most part, homeowners are responsible for everything else (upgrading a breaker box, for example).

A building's electrical system is comprised of several elements, including wiring distribution box; circuit breaker box and circuit breakers; fuses; lights, lighting fixtures, and light switches; and wall outlets.

Functional Layouts

Functional layouts serve to describe a home. Some of these are associated so closely with an architectural style, they share a common name. There are a variety of possible combinations of architectural styles and functional layouts.

HOUSE LAYOUT EXAMPLES

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One-Story

One-story residences have one level of living area. The roof structure has a medium slope. The attic space is limited and is not intended for living area.



One-and-One-Half Story

One-and-one-half story residences have two levels of living area. Characterized by a steep roof slope and dormers, the area of the upper level, whether finished or unfinished, usually equals 40% to 60% of the lower level.



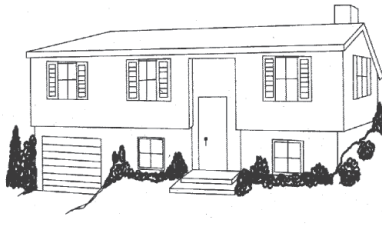
Two-Story

Two-story residences have two levels of finished living area. The area of each floor is approximately the same. The roof structure has a medium slope. The attic space is limited and not designed for usable living area.



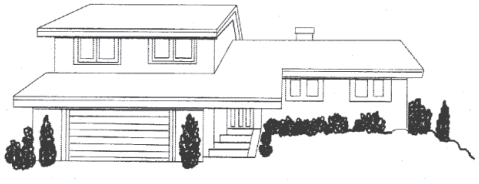
Two-and-One-Half Story

Two-and-one-half story residences have three levels of living area. Having a steep roof slope with dormers, the area of the third floor, whether finished or unfinished, usually equals 40% to 60% of the second floor.



Two-Story Bi-Level

Two-story bi-level residences have two levels of living area. Unlike a conventional two-story, the lower level, which may be partially below grade, is partially unfinished. A distinguishing characteristic is its split-foyer entry.



Split-Level

Split-level residences have three levels of finished living area—lower level, intermediate level, and upper level. The lower level is immediately below the upper level, as in a two-story. The intermediate level, adjacent to the other levels, is built on a grade approximately four feet higher than that of the lower level.

Determining Property Size

There will be times when it's necessary to calculate the area related to property. For instance, when figuring market values of properties in the area, some properties may list the square footage of a bedroom, others may just provide dimensions. Real estate licensees will have to convert one or the other to make a comparison. The same is true for lot dimensions. Perhaps the dimensions of a lot are listed, but the client wants to know the size in acres. Some very basic measurements for property are covered here. ***Other calculations and examples are included in Chapter 37: Real Estate Math.***

Measurements

Here is some key information:

Linear Measurement

12 inches	=	1 foot
3 feet	=	1 yard

Cubic Measurement

27 cubic feet	=	1 cubic yard

Square Measurement

43,560 square feet	=	1 acre

Area Measurement

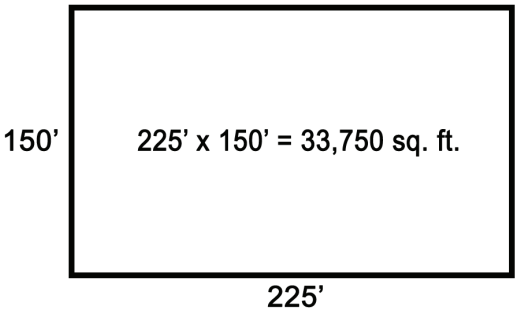
To determine the area of a square or rectangular parcel,

Area = Width x Length (AWL)

Area / Width = Length

Area / Length = Width

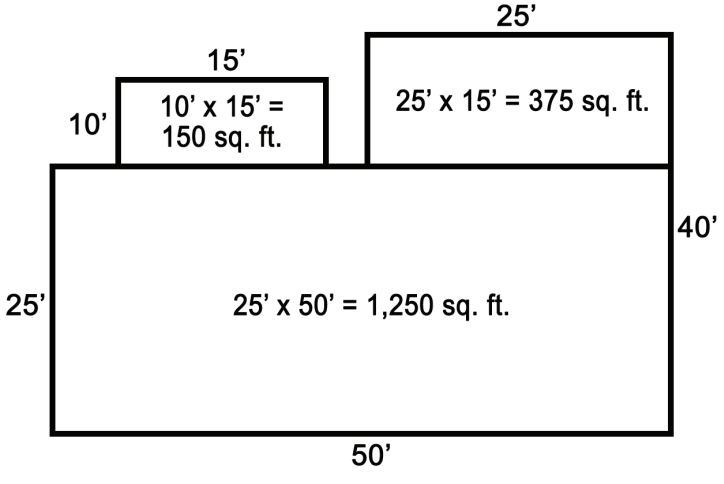
If given the area and length and asked to find the width, for example, divide the area by the length:



33,750 square feet ÷ 225 feet (length) = 150 feet (width)

Irregular Shapes

Houses tend to be a collection of many squares, rectangles and sometimes triangles. In the most basic sense, the total square footage can be determined by separating the house into individual shapes, figuring the square footage for all parts, then adding them together. In this simple example, the total measurement would be 1,775 square feet (1,250 + 150 + 375).



Acreage

There are **43,560 square feet** in an acre. To find the acreage of a lot:

Square Footage / 43,560 = Acres

For Example:

George and Judy are looking for an empty lot to build a custom home, and they want at least half an acre. You have found a lot that you think is suitable for them. It measures 120' x 200'. Will this lot meet their size request?

First, find the total square footage:

120 x 200 = 24,000 total square feet

Then divide to find the acreage:

24,000 / 43,560 = .55 acres

Yes! This lot is just over half an acre. George and Judy should be pleased.

Gross Living Area (GLA)

When determining the square footage of a house, the American National Standards Institute (ANSI) guidelines assume that houses are measured from the **outside** and include only **heated, finished living areas above grade** in the square footage. This will give you the **gross living area** or GLA. You may also see this referred to as **livable area**. Finished attics may count as GLA if they have heat and electricity, finished walls, and normal ceiling height.

For the purposes of a listing, however, the square footage is often found by adding the total square footage of the *interior rooms*, which would be smaller. Because there's an opportunity for discrepancy, in some areas, the total square footage of a property does not even appear in a Multiple Listing Service listing.

Room Count

Similarly, the standards for what is and what isn't a "room" tend to be different from area to area and are typically set by real estate boards or the MLS. For example, in some locales, hallways, laundry rooms or mud rooms, and loft space may be considered a "room," while other areas would not include those spaces in the total room count. While bathrooms are never counted as rooms, what counts as a "room" for listing purposes might not count in an appraisal. For example, rooms that are below grade, such as a finished basement, do not typically count as rooms in an appraisal.

Generally speaking, living rooms, kitchens, dining rooms, dens or family rooms, and bedrooms would be allowable as rooms. But even then, you may find some discrepancy. Does kitchen space need to be enclosed by walls to be counted as a room? Does a bedroom need to have a closet? Does a sun room need to have a source of heat or air conditioning? Can an alcove off the main living room be counted as a room? A half a room? Does an area need to have a minimum number of square feet to be counted as a room?

Obviously, it's important for you to understand the local factors that determine whether or not a particular space in a home should be counted as room. You will need to be able to explain this to seller clients, who think that all living space should count toward the square footage or as a separate room. You'll also need to understand this so that you can show your buyer clients properties that meet their specific requirements.

Summary

1. **Building codes** protect the public by setting minimum standards requiring builders to use certain construction standards, including particular methods and materials, sanitary equipment, electrical wiring, and fire prevention standards.
2. Builders should take factors such as drainage, landscaping, appurtenances, shading, walkways, and zoning into consideration when constructing or renovating a building. These are examples of **site use**.
3. The foundation, which typically consists of walls and footers, is the basis for a structure. A **foundation** can be concrete slab, pier and beams, crawl space, or basement. Footers are always below the frost line. Framing, the load-bearing skeleton of a structure, can be made of wood, concrete block, or metal. The roof is typically added after framing.
4. Exterior finish work includes **sheathing**, a structural covering, often made of plywood, placed over a building frame's exterior wall studs or roof rafters, and **siding**, the outer covering for a building's exterior walls, designed to shed water and protect the building from the elements. **Flashing** is added to cover joints where two or more materials join together.
5. Interior finish work comes near the end of construction. It includes **rough-ins**, such as the addition of electrical wiring, plumbing, and heating and air-conditioning elements.
6. Ventilation systems are often comprised of an exhaust fan and ducts to remove stale and polluted air from the building. Common types of heating systems include: Hot water system, steam system and forced warm air system. Furnaces are either electric, oil, or gas. Air conditioning units are either cooled by air or water, or a combination referred to as evaporative cooled condensing units. Electric **heat pumps** are an alternative to traditional heating and cooling systems.
7. Plumbing requires a system of pipes for water supply and drainage. Water is normally brought to homes through municipal water systems or well water supply.
8. Electricity is brought into a home through aboveground or underground cables. **Service lateral** is an underground power supply line and **service drop** is aboveground wire line. The electrical system is comprised of several elements, which include the wiring distribution box, circuit breaker box, circuit breakers, fuses, lights and lighting fixtures, light switches, and wall outlets.
9. To determine the **area** of a square or rectangular parcel, the equation is: Area = Width x Length. There are **43,560** square feet in one acre. **Gross living area (GLA)** usually includes only **heated, finished living areas above grade** in the square footage.

Quiz

1. ***A rectangular living room is listed as being 176 square feet. If the front and back walls of the room are 16 feet, how long are the side walls?***
   a. 8 feet
   b. 11 feet
   c. 16 feet
   d. 28 feet

2. ***Which is LEAST LIKELY to be counted as a room?***
   a. bathroom
   b. den
   c. kitchen
   d. laundry room

3. ***In Julie's area, the homes generally do not have basements. This means they have what type of construction?***
   a. balloon
   b. platform
   c. post and beam
   d. slab-on-grade

4. ***The degree of a roof's slope is called the***
   a. fascia.
   b. pitch.
   c. slant.
   d. soffit.

5. ***There are two types of sanitary waste systems commonly found at residential properties. One is a municipal wastewater system. The other is a***
   a. septic system.
   b. sewage treatment system.
   c. underground storage area.
   d. well.

6. ***When builders discuss drywall, they refer to it by many names. Which of these is NOT another term for drywall?***
   a. plasterboard
   b. sheathing
   c. sheetrock
   d. wall board

7. ***Joe is looking at two rectangular lots that are adjacent. According to the plat map, Lot A has a square footage of 46,060, and Lot B has a square footage of 43,005. The common boundary they share is 235 feet long. What is the width of Lot B?***
   a. 183 feet
   b. 186 feet
   c. 189.5 feet
   d. 196 feet

8. ***A lot is 150' x 600'. The owner is asking $2.80 per square foot. What's the asking price?***
   a. $90,000
   b. $252,000
   c. $300,000
   d. $420,000

9. ***Pete bought a 120-acre farm with plans to subdivide it into lots. The local zoning commission tells him that the density for residential zoning in that area is 2.5 homes per acre. Assuming each lot is of equal size, what is the square footage of each lot?***
   a. 14,520 square feet
   b. 17,424 square feet
   c. 18,144 square feet
   d. 30,000 square feet

10. ***A 1.75 acre lot sells for 40 cents per square foot. What is the selling price?***
    a. $17,424
    b. $21,780
    c. $30,492
    d. $76,230



UNIT 5

CONTRACTS

Chapter 14 – Contracts Overview

Chapter 15 – Brokerage Agreements

Chapter 16 – Contracts for Selling Property

Chapter 17 – Real Estate Closings

Chapter 18 – Leases



14

Contracts Overview

Contract law is important to understand because it touches many aspects of real estate. The basic concepts and requirements are the same whether talking about a listing agreement, a purchase agreement, or any other type of agreement. In fact, ***agreement*** is simply another word for ***contract***. A contract does not need to be a lengthy document, but to be enforceable in a court of law there are some rules for contract formation, which are discussed in this chapter.

You will learn:

- Basic concepts of contract law.
- The essential elements of a valid contract.
- How the statute of frauds applies to contracts.
- How contracts may be terminated.
- How options may be exercised in contracts.
- Provisions for using electronic contracts.

Key Terms

Acceptance
Assignment
Bilateral / Unilateral
Consideration
Executed / Executory
Illinois Electronic Commerce Security Act
Liquidated Damages
Material Breach
Meeting of the Minds
Novation
Offer
Option
Rescission
Right of First Refusal
Specific Performance
Statute of Frauds
Time is of the Essence
Void / Voidable

Contract Classifications

A **contract** is an *agreement between two or more parties to do, or not do, something*. Contracts are legally enforceable promises, with the law providing remedies for breach. There are several key terms that are used to more specifically classify contracts.

Classification		Definition	Example
Contract Creation	Express	An agreement expressed in words, either spoken or written	Signing a work order at the garage to have your car repaired in exchange for payment
	Implied	An agreement that has not been put into words, but is implied by actions of the parties	Eating in a restaurant – it is understood you will pay the bill, even if it is not explicitly discussed before sitting down and eating
Contract's Promise	Unilateral	Only one party makes a binding promise to the other party	An option is an example of a unilateral contract because one party has the right to do something within a designated amount of time, without obligation to do it
	Bilateral	Each party makes a binding promise to the other	A sales agreement – the seller agrees to give up possession of the property and the buyer agrees to pay the specified amount of money
Contract Status	Executory	One or both parties have not yet completed performance of their contractual obligations, though may be in the process	Party A and Party B sign a listing agreement; the broker is actively seeking a buyer but has not yet fulfilled his side of the contract
	Executed	Both parties have fully performed their contractual obligations (not to be confused with executing a contract, which is merely the act of signing it)	Party A and Party B sign a listing agreement; after a buyer is found, the seller pays the broker's commission at closing
Contract Validity	Valid	The contract is binding and legally enforceable, meeting all the essential elements for contract formation	A sales contract that includes all essential elements binds both parties to the terms of the contract
	Void	Not enforceable because it lacks one or more of the essential elements for contract formation or is otherwise defective	A listing agreement to sell a house does not include the signatures of both owners of the property and is therefore lacking an essential element
	Voidable	One party can disaffirm the agreement without liability because of lack of legal capacity or other negative factor such as fraud or duress	A sales contract signed by a minor is voidable by the minor, but not the other party to the contract
	Unenforceable	A contract that may have been valid between the parties but that a court would refuse to enforce	An oral contract for the sale of real estate when one party does not follow through, or a vaguely worded contract whose intent cannot be established

Essential Elements of a Contract

For a contract to be valid and enforceable, it must have these essential elements:

1. Contractual capacity
2. Lawful and possible objective
3. Consideration
4. Mutual agreement

A contract could be valid if it contains only elements 3 and 4. To be enforceable in court, however, it must contain all four elements. These requirements apply to all contacts. Also, certain contracts—such as those for the sale of real property—must be **in writing** and **signed** to be enforceable. In addition, a contract must include a **description** of what is being contracted. For real property, it could be a legal description or simply the property's address.

Contractual Capacity

Contractual capacity (also called contractual ability) is *the legal ability to enter a contract*. For a contract to be valid, each party must be **legally competent**. This requires:

- Legal **age** of majority (18 years old).
- **Mental** competence (sober, mentally sane, etc.).
- Proper **authorization** (when signing a contract on behalf of a corporation or other entity).

When an adult enters into a contract with a minor, the contract is voidable by the minor only. Even if the minor pretended to be over 18, the minor can disaffirm the contract at any time before turning 18 or within a reasonable time thereafter. The minor may choose to enforce the contract and require the adult to perform. The adult does *not* have the power to disaffirm the contract.

If a person has been declared incompetent by a court (because of mental illness, retardation, or senility), any contract he or she enters into is considered **void** and unenforceable by either party.

Case in Point

Stewart was only 17 when he signed a contract to buy a house from Pete, who did not realize Stewart was a minor. A few weeks later when the sale was ready to close, Stewart changed his mind and told Pete the deal was off. Pete cannot sue to enforce the contract. But, if the tables were turned and Pete wanted to back out, Stewart could sue him to enforce the contract.

An adult who is incapable of understanding the nature and consequences of a contract also does not have the capacity to enter into a contract. Once a person has been declared incompetent by a court (because of mental illness or senility, for example), any contract this person enters into is considered void and neither party may enforce it. To be enforceable, the contract would have to be signed by the incompetent person's court appointed guardian or power of attorney.

Even if a person has not been declared legally incompetent, if it can be proven he was not of sound mind when the contract was signed, the contract may still be voidable by that person. When that occurs, a court may rule in different ways, depending on the circumstances in each case. The contract may be voidable by the incompetent person but, if the other party acted in good faith without notice of the incompetency, a court might decide to enforce the contract.

Lawful Objective

Lawful objective means the *purpose or objective of a contract must be lawful at the time the contract is made*. When one person promises to pay someone for committing an illegal act, the contract is void. A court may also refuse to enforce an otherwise legal contract if its objective violates public policy.

Many contracts have more than one purpose and are often **severable**, meaning *one part or provision of a contract can be held unenforceable without making the entire contract unenforceable.* The unenforceable part is severed, or cut, from the agreement, but the rest is enforced.

Consideration

Consideration, also called **valuable consideration**, is *anything of value such as money, services, goods, or promises given to induce another to enter into a contract.* Consideration for most contracts is a *promise* to give something of value. Thus, the parties to a contract are sometimes referred to as the **promisor** *(one making a promise)* and the **promisee** *(one who gets the benefit of a promise)*. Consideration can also be *a promise to refrain from doing something*, where it is referred to as **forbearance**.

The exchange of consideration is what distinguishes a contractual promise from the promise of a gift. The courts will not enforce a gift (although it may not be socially acceptable to promise someone a gift and then break the promise, the law will not get involved). A promise is not enforceable in court unless it is a contractual obligation for which both parties exchanged consideration. In a typical real estate contract, the buyer promises to pay the seller money and the seller promises to transfer title to the buyer. These promises create an executory contract; when they are fulfilled (buyer pays seller; seller gives buyer a deed), the contract is executed.

Adequacy

The value of the consideration one party gives does *not* have to be equal to the value of what the other gives. In other words, even if one party struck a bad bargain, both still have an enforceable contract. Of course, grossly unequal consideration may mean there was fraud, undue influence, duress, or a mistake involved. But the contract is enforceable unless any of these things are proven.

Case in Point

Jay's house appraised at $200,000. He is eager to sell it quickly because he thinks he may have to leave the country in a hurry. When Kay offers $75,000 for the house, Jay accepts, and they execute a written contract. As it turns out, Jay will not have to leave the country. He wants to back out of the sale, but Kay will not let him. Although Jay's consideration is worth more than twice what Kay is giving, their contract is binding.

Mutual Agreement

Before any contract can be formed, there must be **mutual agreement**, which generally involves an **offer and acceptance**. Acceptance of the terms of an offer indicates a **meeting of the minds**. In general terms, an offer is *one party (the offeror) proposing a contract to another party (the offeree)*. To create a binding contract, an offer must be accepted before it terminates. When an offer is accepted, a contract is formed and both parties are legally bound. Neither can back out without legal excuse unless the other is willing to end the contract.

Genuine Assent

Consent must be freely given to create a binding contract. Offer and acceptance as an expression of mutual agreement are not freely given under any of these circumstances:

- **Fraud.** *Intentional* or negligent misrepresentation of material facts. The fraud results in a contract that would not have been completed had the truth been known.
- **Undue Influence.** *Excessive pressure on someone, preventing him from making a rational or prudent decision*. A contract is voidable if a person is persuaded to sign it by taking advantage of another's trust or weakness of mind (exhaustion, senility, etc.).
- **Duress.** *Threatening violence against or unlawfully confining a person, or any member of that person's family, to force him to sign a document.* Duress can also be a threat of injury to reputation. Economic duress (also called business compulsion) is a threat of taking action that will be financially disastrous to the victim.

- **Mistake.** Occurs when *one or more parties to a contract are mistaken about a fact or law.* Usually, bad faith and ill will are not involved. If both parties are mistaken about something important to the contract (mutual mistake), either may disaffirm it. If only one party is mistaken (unilateral mistake), the contract is not voidable unless the other party knew of the mistake and did nothing.

In Writing

810 ILCS 5/

The **statute of frauds** is *a law that requires certain types of contracts to be in writing and signed in order to be enforceable*. This same name is used for similar laws in other states because the term was adopted from English common law. As the name suggests, the writing requirement is intended to prevent fraudulent claims and perjury (false testimony). The parties to an unwritten contract are likely to later disagree about exactly what each agreed to do—or whether they agreed to do anything at all.

The **Illinois Statute of Frauds** is codified in the Uniform Commercial Code and applies to contracts:

- For the sale of goods for $500 or more,
- That convey an interest in real property (e.g., purchase agreements, deeds, mortgages), and
- That cannot be performed within one year from the time it is made (such as a lease).

All of these kinds of contracts must be in writing and signed in order to be enforceable in a court of law.

Oral Contracts

The **Doctrine of Part Performance** allows a court to enforce an oral agreement that should have been in writing if the promisee has taken irrevocable steps to perform her side of the bargain, and failure to enforce the contract would result in an unjust benefit for the promisor. Part performance minimizes unfairness in some cases because one party began to perform his side of the contract, relying on the other party's promises. However, the rule of **parol evidence** provides that *the written agreement overrides any oral agreements.*

Power of Attorney

The statute of frauds also applies to any power of attorney authorizing someone to sell another's real estate. A **power of attorney** is *an instrument authorizing one person* (called an attorney-in-fact) *to act as another's agent to the extent stated in the instrument.* Unlike an attorney at law, an attorney-in-fact can be anyone. An attorney-in-fact may be a universal or general agent and his authority is restricted to those things specifically stated in the power of attorney.

A power of attorney conferring the right to sell another's real property must be in writing, signed, witnessed by two competent witnesses, acknowledged before a notary, and recorded with the county recorder in the county where the land is situated to become effective.

Performance and Discharge of Contracts

Once a contract is formed, there are any number of things that affect how it is carried out, or *not* carried out. If one party to a contract performs his or her contractual obligations, the other party is also required to perform.

- **Tendering Performance.** A **tender offer,** or simply a **tender,** is an unconditional offer by one party to perform his part of a contract. If a party to a contract sees that the other party is not taking the steps necessary to fulfill the contract, he must *offer* to perform his side of the deal before suing for breach of contract.
- **Anticipatory Repudiation.** When a party to a contract clearly and unequivocally states that he doesn't intend to perform, that party is said to have **repudiated** the contract. Once one party has repudiated a contract, the other party may immediately file a lawsuit for breach of contract without making a tender offer.

Breach of Contract

A **breach of contract** occurs when *one party to a contract fails to perform with no legal cause.* The breach does not terminate the obligations of the breaching party. Further, the non-defaulting party may take legal action against the breaching party.

It is not always easy to determine whether a breach of contract has occurred. For example, Curtis does all the things he promised, but Amy feels they were not done well. Or, Curtis does nearly everything promised, but some details are not finished and he takes longer to do it than agreed. In these cases, there is room for argument about whether the contract was breached and whether Amy is required to perform her obligation, which is to pay Curtis. Amy's obligation to perform depends on whether there has been *substantial performance* or a *material breach*.

- **Substantial performance** means a *promisor does not perform all contractual obligations but does enough so that the promisee is required to fulfill her obligation.* If Curtis has not fulfilled every detail of a contract but has carried out its main objectives, then it may be treated as substantial performance. Although Amy may be able to sue for damages because of the unfulfilled details, she still must perform as agreed.
- **Material breach** is a *breach of contract important enough to excuse the non-breaching party from performing any contractual obligations.* If Curtis fails to perform some important part of the contract or performs very badly, it is treated as a material breach. If he commits a material breach, Amy may be able to sue for damages and be excused from fulfilling her promises.

Clauses

Contracts may include certain clauses and conditions that impact whether a breach is considered material.

Time Is of the Essence

Many contracts state **"time is of the essence."** The purpose of this phrase is *to emphasize timely performance as an essential part of the contract, and failure to perform on time is a material breach.* When a contract does not provide a "time is of the essence" clause, usually performance within a reasonable time after a stated deadline is not a material breach.

Thus, if "time is of the essence" is *not* in the contract and the buyer was late in performing, then the seller could give the buyer a reasonable time to perform even though the deadline in the contract has passed. The contract is voidable at that point by the seller, and the seller could terminate the contract at any time.

If "time is of the essence" *is* in the contract, then the contract is void as soon as the deadline has passed; there is a material breach. Depending on the customs of the local market, when a deadline passes, it could be the buyer who is in breach of the contract, or the seller. The only way to save the contract is for the buyer and seller to agree to extend the contract before the deadline passes.

Conditions

Conditions, also called **contingency** clauses, are *contract provisions that make the parties' rights or obligations dependent on the occurrence (or nonoccurrence) of certain events*. Contracts often include one or more conditions. If the event does not occur, the promisor can withdraw without liability for breach of contract. For example, a purchase agreement may be contingent upon the sale of the buyer's current home or the buyer qualifying for financing.

When a contract is conditional, the promisor must make a good faith effort to fulfill the condition. The promisor cannot deliberately prevent its fulfillment to get out of the contract. However, a condition can be waived by the party it was intended to benefit or protect.

Remedies for Breach of Contract

If one party to a contract does not perform her contractual obligations, or breaches the contract, the non-defaulting party may take legal action by filing suit against the defaulting party in a court of law. Remedies include the following:

- **Cancellation.** The *termination of a contract without undoing acts that have been performed under it.* This can be done without going to court if both parties agree they prefer to cancel the contract. When a contract is canceled, all further obligations are terminated.
- **Compensatory Damages.** Intended to *compensate the plaintiff for harm caused by the defendant's act or failure to act.* This is the most common remedy for breach of contract. The award is usually the amount that will put the non-breaching party in the same position he would have been in, if the other party had fulfilled the contract.
- **Liquidated Damages.** Reflect *the amount of money specified in a contract to be awarded in the event the agreement is breached.* A liquidated damages clause is included in some contracts to lessen the chance of expensive litigation. Since the parties have agreed in advance to damages of a certain amount or figure using a specified formula, the non-breaching party must accept liquidated damages instead of suing for actual damages. If the breaching party refuses to pay, the case will go to court.
- **Injunction.** A *court order that requires a party to do or refrain from doing a certain act* (or acts) as opposed to a monetary award.
- **Reformation.** When a *court or a judge changes or modifies a contract to reflect the true intent of the parties.* Reformation usually occurs when the parties to the contract enter into it without realizing it contains a clerical error.
- **Rescission.** The *destruction, annulment, or termination of a contract and all parties to the contract must give back anything acquired under it to the other party.* This occurs when one party does not want to enforce the other party's promise; one party did not provide the promised consideration, or a voidable contract is disaffirmed. When a contract is **rescinded**, all contractual obligations are terminated. This normally occurs as a result of a court action.
- **Specific Performance.** A *legal remedy in which a court orders someone who has breached a contract to perform as agreed, rather than simply paying damages*. This occurs most often when the non-breaching party to a contract cannot be compensated for harm that resulted from the other's breach. In such a case, the non-breaching party has the right to compel the other party to do what was promised in the contract. This is also referred to as a *forced sale.*

Discharge of Contracts

Contracts can be discharged, or terminated, in a number of ways:

- **Agreement of the Parties.** When all parties to a contract agree, any executory contract can be discharged; this is also known as **release of contract**.
- **Partial Performance.** When both parties agree to accept something different than the terms of the original contract, the original obligation is extinguished.
- **Full Performance.** When all parties to a contract have fulfilled their contractual obligations, the contract is executed, and thus released.
- **Impossibility of Performance.** When the performance of a contractual obligation becomes illegal because of a change in the law after the contract was created, the contract is terminated.
- **Operation of Law.** When the rights and liabilities of the contracting parties are changed by application of the law, a contract can be terminated through:
  - **Alteration of Contract.** Intentionally cancelling or altering a contract discharges the agreement.
  - **Bankruptcy.** Contracts in existence as of the date of the bankruptcy filing are terminated.
  - **Statute of Limitations.** According to Illinois law, the time limit to bring legal action regarding a real estate contract is **10 years** for a written contract and **five years** for an oral contract.

Assignment and Novation

In an **assignment**, *one of the parties* (assignor) *transfers rights or interests under a contract to another person* (assignee). Generally, either party can assign the contract without the other's consent, unless the contract states that consent is required. When a contract is assigned, the assignor is ***not*** relieved of liability under the contract. The assignor remains secondarily liable to the other party, and can be sued if the assignee does not perform. This rule applies even when the other party consents to the assignment.

Contracts are generally assignable unless the contract explicitly states otherwise. One exception concerns **contracts for personal services**. **Listing agreements**, for example, are considered personal service contracts and, therefore, cannot be assigned. A party to a personal service contract can assign the contract only with the consent of the other party.

Novation is the *substitution of a new contract for an earlier contract.* The new contract cancels the original contract. A novation may also involve the substitution of a new party for an original party.

Options

An **option** is a contract giving one party the right to do something within a designated time period, without obligation to do so, meaning that contracts for options are **unilateral** contracts. The prospective purchaser is referred to as the **optionee**; the property owner is the **optionor**. An option is simply another type of contract. Usually, the optionee is interested in the property, but won't exercise the right to complete the purchase unless certain problems are resolved or questions are answered beforehand. Some instances in which an option might be used are:

- **Qualifying.** The optionee can't qualify for a loan now, but believes circumstances will change shortly (e.g., a raise at work), leading to qualification.
- **Time to Acquire Cash.** The optionee needs time to save for the down payment, sell another property, or otherwise get the cash needed to close.
- **Comparison.** The optionee thinks the property is a good deal, but wants to investigate other properties before making a final decision.
- **Profit.** The optionee plans to sell the option for a profit (option must be assignable).
- **Speculation.** The optionee thinks the property will increase in value, perhaps waiting for a zoning change to occur.
- **Investment.** The optionee thinks the property is a good investment, but wants to find other investors willing to share the risk.

Like all contracts, an option must be supported by **consideration** to be enforceable. Once paid, the option money is *not* refundable, regardless of whether the optionee proceeds with the purchase. If the optionee chooses not to exercise the option to buy, then the optionor gets to keep the money as compensation for keeping the property off the market and not selling it to anyone else during the option period. In many instances, though, both parties agree that if the purchase actually goes through, the option money will be credited toward the purchase price, much like a good faith deposit in an ordinary purchase agreement.

This is not always the case, however, so such an arrangement should be clearly spelled out in the option contract. In fact, if optionee and optionor have not clearly agreed in the written option contract to credit the option money against the purchase price, it's presumed that the balance due is the full price stated in the option (not including option money).

Option to Purchase

An **option to purchase** is a contract that gives the optionee the right to buy the property of another (the optionor) at a specified price within a limited time. Within that period, the optionee may choose to exercise the option—that is, enter into a contract to buy the property—but the optionee is under no obligation to exercise the option.

Case in Point

Eric wants to open up a business. He drives around town and finds a lot that is exactly perfect. It's the right location, it's the right size, and Eric wants to buy it. Eric checks the public records to find out who owns the lot, and discovers that it's actually two lots. Lucy owns one, and Chris owns the other. Neither lot is large enough to meet Eric's needs, so if he can't get both lots, he doesn't want either. Eric offers to pay Lucy $10,000 for the option to purchase her lot for $100,000 anytime during the next 90 days. Then he goes to Chris and offers to buy his lot. Chris refuses to sell at any cost. Eric could still exercise his option to buy Lucy's lot before the expiration date, but he is not obligated to do so. He is, however, out the $10,000 whether he buys her lot or not.

Lease with Option to Purchase

A **lease option** is *when a seller leases property to someone for a specific term, with an option to buy the property at a predetermined price during the lease term.* The lease/option plan is comprised of two elements—a lease and an option. An optionor and optionee may agree to credit any portion of the rent that is **above the established market rent** for a comparable property toward the down payment, loan amount, or sales price, thus reducing the cost and making it easier to buy the property later. For example, if the tenant is paying $1,200 a month in rent and the established market rent for a comparable property is $1,000 a month, the optionor would allow the $200 per month of above-market rent to be applied toward the future purchase.

Right of First Refusal

The **right of first refusal** is another type of option that gives someone the right to have the first opportunity to buy or lease property **if** the owner decides to sell or lease it. This is also called the **right of preemption**. This right of first refusal cannot be exercised until the owner gets a **bona fide offer** from a third party. At that point, the owner must make the property available first to the one holding the right at the **same terms** as the bona fide offer.

Electronic Contracts

Today, it seems that most business takes place through smart phone calls, e-mail, fax, online forms, etc. The **Uniform Electronic Transactions Act** (UETA) was developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to support electronic commerce. This act provides a legal framework for the use of electronic signatures and records in government or business transactions. It establishes that electronic records and signatures are **legally equivalent** to paper writings and manually-signed signatures, removing barriers to conducting business through electronic means. Illinois has its own statutes regarding electronic transactions.

Illinois Electronic Commerce Security Act

The **Illinois Electronic Commerce Security Act** is intended to:

- Facilitate electronic communications by means of reliable electronic records.
- Facilitate and promote secure electronic commerce by:
  - Eliminating barriers related to writing and signature requirements.
  - Promoting development of necessary legal and business infrastructures.
- Facilitate electronic filing of documents with state and local government agencies.
- Promote efficient delivery of government services and reliable electronic records.
- Minimize the incidence of forgery, alteration, and fraud in electronic records.
- Establish uniform rules/standards for authentication and integrity of electronic records.
- Promote public confidence in reliability and integrity of electronic records.

Provision	Description	Exemptions
Electronic Records	An electronic record legally satisfies the requirement for information to be "written," "in writing," or "printed" even when there are certain consequences specified if information is not in written form.	• Any rule of law that is inconsistent with the manifest intent of the lawmaking body. • Any rule of law governing creation or execution of a will, trust, living will, or healthcare power of attorney. • Any record that serves as a unique and transferable instrument of rights and obligations including, without limitation, negotiable instruments and other instruments of title wherein possession of the instrument is deemed to confer title.
Electronic Signatures	An electronic signature legally satisfies when a rule of law requires a signature or a consequence if a document is not signed.	
Originals	An electronic record satisfies the legal requirement that information be presented or retained in its original form as long as there can be reliable assurance the information has remained completed and unaltered from the time when it was first generated in its final form. An electronic record will suffice even when there are certain consequences specified if information is not presented or retained in its original form.	• Any record that serves as a unique and transferable instrument of rights and obligations including, without limitation, negotiable instruments and other instruments of title wherein possession of the instrument is deemed to confer title.

Retention of Electronic Records

5 ILCS 175/

When a rule of law requires that certain documents, records, or information be retained, that requirement is met by retaining electronic records as long as:

- The electronic record and its contents are accessible and/or usable for the designated time period for retention.
- The information is retained in the format in which it was originally generated, sent, or received (or is an acceptable facsimile of the original).
- The identification of the information's origin/destination, authenticity/integrity, date/time sent or received is retained.

Summary

1. Contract law touches many aspects of real estate, although real estate professionals cannot give legal advice. A real estate license also does not grant the right to draft legal documents, such as sales contracts.

2. **Contracts** are agreements between two or more parties to do, or not do, something. Contracts are legally enforceable promises that can be classified as: **Express** (agreement expressed in words, spoken or written) or **implied** (agreement not put into words but implied by actions of the parties); **unilateral** (one party makes a binding promise to the other) or **bilateral** (each party makes a binding promise to the other); **executory** (one or both parties have not yet completed performance of contractual obligations) or **executed** (both parties fully performed contractual obligations).

3. A contract can be **valid** (binding and legally enforceable), **void** (not enforceable; lacks one or more requirements for formation or defective in some other respect), **voidable** (one party can end without liability because of lack of legal capacity or other factor), or **unenforceable** (court would refuse to enforce). The **essential elements of a valid contract**: (1) Competent parties (2) Lawful and possible objective (3) Mutual agreement (4) Consideration. The Illinois **Statute of Frauds** is a law requiring certain types of contracts to be in writing, contain all essential elements of a valid contract, and be signed to be enforceable.

4. When a party fails to perform with no legal cause, it is a **breach of contract**. A breach may be either **substantial performance** (promisor does not perform all contractual obligations but does enough so promisee is required to fulfill his obligation) or **material breach** (breach of contract important enough to excuse the non-breaching party from performing the contractual obligations). An example of a material breach is not complying with a **time is of the essence** statement. Breach of contract **remedies** include: Cancellation, injunction, liquidated damages, reformation, rescission, and specific performance.

5. Contracts can be terminated by: Agreement of parties, partial performance, full performance, impossibility of performance, and operation of law. When a contract is **assigned**, the assignor transfers her rights or interests under a contract to another party (assignee). When a contract is assigned, the assignor is not relieved of liability under the contract. **Novation** is the substitution of an original contract with a new contract, or the substitution of one party to the contract to another person, relieving the withdrawing party of liability.

6. The **Illinois Electronic Commerce Security Act** (5 ILCS 175/) provides guidelines for the use of electronic contracts, including requirements for electronic signatures and record retention. The Act allows for certain electronic contracts to meet the requirement for contracts to be "in writing." Exceptions include wills, healthcare powers of attorney, and documents whose possession is deemed to confer title, such as a deed.

7. **Options** are unilateral contracts that give one party the right to do something, without obligating him to do it. An option is a unilateral contract. The most common type of real estate option is a **lease with an option to purchase**, which gives one party (optionee) the right to buy the property of another (optionor) at a specified price within a limited time. Optionees have the **right of first refusal** in an option to purchase—the right to the first chance to buy or lease if the owner decides to sell or lease it.

Quiz

1. ***Yvonne posts a flyer around town offering a reward of $100 for the return of her lost dog. This is an***
   a. express bilateral contract.
   b. express unilateral contract.
   c. implied bilateral contract.
   d. implied unilateral contract.

2. ***Agent Leo and his client Hannah have just signed an open listing agreement that will pay Leo a 6.5% commission if he finds a willing and able buyer for her house. Which option best describes this agreement at this time?***
   a. express, bilateral, executed
   b. express, bilateral, executory
   c. express, unilateral, executory
   d. implied, bilateral, executed

3. ***You sign a contract agreeing to buy a piece of property from Bob, but Bob does not actually own the property. This contract is***
   a. unenforceable.
   b. valid.
   c. void.
   d. voidable.

4. ***Tom tells Betty that he will buy her house. She tells him that she'll sell the house to him for $149,000, and they shake on it. This oral contract is***
   a. unenforceable.
   b. valid.
   c. void.
   d. voidable.

5. ***Broker Kelly, eager to get her first listing, talks her elderly neighbor, Ann, into signing an agreement that would pay Kelly a 10% commission if she finds a buyer. Kelly finds a buyer and the sale concludes. Kelly wants her commission, but Ann's family contests, saying Ann, diagnosed with dementia, was coerced. Is Kelly likely to get her 10% commission?***
   a. yes, because the property transferred, the contract was successfully executed
   b. yes, because Kelly performed as indicated in the listing agreement
   c. no, because the listing agreement is void
   d. no, because the listing agreement is voidable by Ann

6. ***A landlord and the area real estate manager of a national retail corporation both sign a lease, and the corporation fails to occupy the premises. What might prevent the landlord from enforcing the terms of contract?***
   a. The broker did not have a written listing.
   b. The corporation never granted "signing authority" to the real estate manager.
   c. The economy declined and the retailer was closing other stores.
   d. The real estate manager had authority to make the deal.

7. ***The Illinois law that requires all real estate contracts to be in writing to be enforceable by the courts is the***
   a. doctrine of part performance.
   b. parol evidence rule.
   c. specific performance.
   d. statute of frauds.

8. ***John and Mary are getting a divorce. John tells Mary that unless she agrees to sell their home immediately and split the proceeds, he will institute legal proceedings to gain custody of the children. If she agrees, the sales contract may then be voidable because of***
   a. duress.
   b. fraud.
   c. legality of object.
   d. mental incapacity.

9. ***Jess has a one-year lease on office space. Her husband is transferred, and she has to move six months into the lease. She assigns the lease to Owen. When Owen does not pay the rent, whom can the landlord go after?***
   a. Jess only
   b. Owen only
   c. Owen first, then Jess
   d. both Owen and Jess equally

10. ***Karen contracts with Dave to paint her house and garage. She gives him $500 before he begins the job with a promise of $2,000 more when he finishes. Dave paints the garage first, but then an early blizzard hits. Dave is not going to be able to get to the house before he moves out of state. Karen and Dave agree that he can keep the $500 just for painting the garage. She won't pay him any more, and he won't be obligated to paint the house. She'll find someone else to paint the house next year. This could now best be described as an example of***

    a. cancellation.
    b. novation.
    c. partial performance.
    d. rescission.

11. ***Lester signs a contract to buy Kathy's house. The contract is conditional on Kathy installing new carpet throughout. Kathy installed the carpet at a cost of $12,500. Before closing, Lester tells Kathy that he does not want to buy the house. Kathy sues Lester for $12,500 and wins. The court awarded her***

    a. collateral damage.
    b. compensatory damages.
    c. liquidated damages.
    d. punitive damages.

12. ***An electronic signature would be valid on a***

    a. deed.
    b. healthcare power of attorney
    c. listing agreement.
    d. will.



15

Brokerage Agreements

Sellers and buyers secure the services of a real estate professional using either listing agreements or buyer brokerage agreements, also called buyer representation agreements. As **employment contracts**, these agreements establish the agency relationship between the seller or buyer and the sponsoring broker and other licensees affiliated with the sponsoring broker. In this chapter, you will have a chance to look at several different examples of brokerage agreements. You will also learn about a broker's duties when handling moneys from clients and customers.

You will learn:

- The purpose for each type listing agreement and Illinois-specific requirements.
- The purpose of a buyer agency agreement and Illinois-specific requirements.
- Common provisions found in brokerage agreements.
- The requirements for a rental finding service agreement.
- Rules for handling earnest money.

Key Terms

Buyer Agency Agreement
Commingling
Conversion
Escrow Moneys
Escrow Account
Exclusive Agency Agreement
Exclusive Right to Sell
Listing Agreement
Minimum Services
Multiple Listing Service
Net Listing
Open Listing
Procuring Cause
Rental Finding Service

Listing Agreements

Listing agreements, also called **service provision contracts,** are written agency contracts between a seller and a real estate sponsoring broker stipulating the conditions under which the broker will be paid a commission with regard to the seller's property. As you know, they are **employment contracts** between a seller and a real estate brokerage. The seller hires the broker to find a buyer and, in exchange for the broker's services, the seller will pay a commission. The language in the listing agreement should never be viewed as the seller's offer to a buyer. There are several types of listing agreements. Each type outlines the specific rights and obligations of the parties, including a broker's right to a commission:

Illinois Requirements

Rules: Section 1450.770

As we discuss the different types of listing agreements, note how the examples show how the terms of a listing agreement are **negotiable**. There is no specifically prescribed form for listing agreements or buyer brokerage agreements mandated by the State of Illinois. Brokers may use their own form or a form furnished and endorsed by members of professional trade organizations such as a local association of REALTORS®. However, all written listing agreements in Illinois, whether exclusive or non-exclusive, must contain the following elements:

- The **list price**
- The agreed basis or amount of **commission** and the time of payment of the commission
- The **duration** of the listing agreement, with a **definite termination date** clearly set forth
- The **name** of the sponsoring broker and seller
- The identification of **property** involved (address or legal description)
- The **signatures** of the owners and an authorized signator on behalf of the sponsoring broker
- The **duties** of the listing broker
- The **designated agent**, unless some other form of agency relationship is agreed to

Since disclosure of the potential for **dual agency** is required in Illinois, listing agreements often contain this disclosure. In this way, an agent is not required to present a separate disclosure document.

Real Success

Note that a real estate listing is ***not*** a property owner's offer to sell. By listing the property, the seller is merely soliciting offers from potential buyers. A buyer does ***not*** create a contract by accepting the seller's listing. Instead, a buyer makes an offer to purchase and the seller accepts or rejects the offer. The listing is an independent contract between a seller and a real estate broker, not a part of the contract between the seller and buyer.

Exclusive Right to Sell Agreement

An **exclusive right to sell** listing agreement is an agency agreement between a seller and broker that *gives the broker the exclusive right to represent the seller in the sale of the seller's property*. The broker is compensated if *the broker, the seller, or any other person or entity* produces a purchaser in accordance with the terms specified in the listing agreement, or if the property is sold during the term of the listing agreement to anyone other than to any specifically exempted persons or entities. This type of listing agreement requires the listing brokerage to work the property and actively promote its sale.

Under an exclusive right to sell listing agreement, the listing broker has earned a fee **regardless of who sells the property**. If the seller happens to sell the property himself, the broker still has earned a fee. However, the seller may choose to exclude certain parties from the terms of the listing agreement for all or a portion of the listing period. Most brokers prefer to use this type of listing agreement as it provides them with the greatest opportunity to earn commission. An exclusive right to sell agreement **must be in writing.**

ILLINOIS ASSOCIATION OF REALTORS®
EXCLUSIVE RIGHT TO SELL CONTRACT
(DUAL AGENCY DISCLOSURE AND CONSENT INCLUDED)

EQUAL HOUSING OPPORTUNITY

1. In consideration of the services to be performed by _____, (Brokerage Company, hereinafter referred to as "Broker") and the commissions to be paid by _____, ("Seller"), the parties agree that Broker shall have the exclusive right to market and sell Seller's property upon the following terms and conditions:

   Property Address:_____
   City: _____, Illinois Zip: _____
   Marketing Price: $_____
   Marketing Period: From _____ 2_____ through 11:59 p.m. on _____, 2_____.

2. Broker agrees to provide those brokerage services set forth in Section 15-75 of the Illinois Real Estate License Act of 2000.
3. If during the term of this Contract Broker obtains an offer to purchase the property from a ready, willing, and able buyer at the marketing price, or if Seller enters into a contract or receives an offer that results in a contract for the sale or exchange of the property at any price and upon any terms to which Seller consents, Seller shall be obligated to pay Broker a commission of _____ percent (___%) of the total purchase price of the sale or exchange. The full commission is to be paid at closing, which in the case of a sale on contract for deed shall be at the time buyer and Seller execute the initial contract or agreement for deed.
4. Seller agrees that such a commission shall be paid if the property is sold or exchanged by Seller within a protection period of _____ (__) days following the term of this Contract or any extensions thereof to anyone to whom the property was presented during the term of this Contract. However, this provision shall not apply if Seller has entered into a valid, written listing agreement with another licensed real estate broker during the protection period.
5. In the event a purchase contract is entered into and buyer defaults without fault on the Seller's part, Broker will waive the commission, and this agreement shall be continued from the date of default through the date provided in paragraph 1. Should Seller default on any contract for the purchase or exchange of the property, any commission owed under this agreement shall become payable immediately.

   [5. ALTERNATE TO BE SUBSTITUTED IN LIEU OF THE ABOVE ¶5.] In the event a purchase contract is entered into and buyer defaults with or without fault on the Seller's part, any commission owed under this contract shall become payable immediately. Should Seller default on any contract for the purchase or exchange of the property, any commission owed under this agreement shall become payable immediately.

6. When a contract to purchase is entered into for the purchase of Seller's property, the buyer may deposit earnest money with Broker. Broker will hold any such earnest money in a special, non-interest bearing escrow account on behalf of the buyer and Seller. At closing, the earnest money will be disbursed according to the terms of the contract to purchase. If the transaction fails to close:

   (a) due to fault of the Seller, the earnest money shall be returned to the buyer.

   [AS TO ¶S (b) THROUGH (d) BELOW, THE PARTIES SHOULD CHECK THE ONE PARAGRAPH WHICH APPLIES].

☐ (b) DUE TO FAULT OF THE BUYER, THE EARNEST MONEY SHALL FIRST GO TOWARD PAYING THE COMMISSION BROKER WOULD HAVE EARNED IN THE SALE, AND THE BALANCE, IF ANY, SHALL GO TO SELLER.

☐ (c) DUE TO FAULT OF THE BUYER, THE EARNEST MONEY SHALL BE DISTRIBUTED TO THE SELLER, LESS ANY COSTS OF ADVERTISING OR REASONABLE EXPENSES INCURRED BY BROKER.

☐ (d) due to fault of the buyer, the earnest money shall be distributed to the Seller.

7. Seller agrees that for the purpose of marketing Seller's property, Broker shall place Seller's property in the Multiple Listing Service(s) in which Broker is a member.
8. Seller makes the following elections with regard to having Sellers's property displayed on any Internet site: (circle YES or NO to all that apply)
   - Display listing on any Internet site: YES NO
   - Display Seller's property address on Internet: YES NO

Seller understands and acknowledges that if seller circles "NO" for the above two options, consumers who conduct searches for listings on the Internet will not see the corresponding information about Sellers' property in response to their searches.

Seller's Initials **Seller's Initials** **Date**

   - Allow for automatic valuation tools to be used for Seller's listing: YES NO
   - Allow for blogging or comments to be used or made regarding Seller's listing: YES NO

9. Seller(s) acknowledge(s) that they have been informed of the responsibilities imposed upon sellers under the Residential Real Property Disclosure Act. Seller agrees to comply with the requirements of this Act to the best of Seller's ability and to not knowingly give any false or inaccurate information regarding the disclosures required by that Act.

SAMPLE

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10. Broker designates _____ , ("Seller's Designated Agent"), a sales associate(s) affiliated with Broker as the only legal agent(s) of the Seller. Broker reserves the right to name additional designated agents when in Broker's discretion it is necessary. If additional designated agents are named, Seller shall be informed in writing within a reasonable time. (ADD IF DESIRED: Seller acknowledges that Seller's Designated Agent may from time to time have another sales associate, who is not an agent of Seller, sit an open house of Seller's property or provide similar support in the marketing of Seller's property.) Seller understands and agrees that this agreement is a contract for Broker to market Seller's property and that Seller's Designated Agent(s) is (are) the only legal agent(s) of Seller. Seller's Designated Agent will be primarily responsible for the direct marketing and sale of Seller's property.
11. Seller has been informed that potential buyers may elect to employ the services of a licensed real estate broker or sales associate as their own agent (buyer's agent).
12. **DISCLOSURE AND CONSENT TO DUAL AGENCY**

    NOTE TO CONSUMER: THIS SECTION SERVES THREE PURPOSES. FIRST, IT DISCLOSES THAT A REAL ESTATE LICENSEE MAY POTENTIALLY ACT AS A DUAL AGENT, THAT IS, REPRESENT MORE THAN ONE PARTY TO THE TRANSACTION. SECOND, THIS SECTION EXPLAINS THE CONCEPT OF DUAL AGENCY. THIRD, THIS SECTION SEEKS YOUR CONSENT TO ALLOW THE REAL ESTATE LICENSEE TO ACT AS A DUAL AGENT. A LICENSEE MAY LEGALLY ACT AS A DUAL AGENT ONLY WITH YOUR CONSENT. BY CHOOSING TO SIGN THIS SECTION, YOUR CONSENT TO DUAL AGENCY REPRESENTATION IS PRESUMED.

    The undersigned _____, ("Licensee"/"Seller's Designated Agent"), may
    (insert name(s) of Licensee undertaking dual representation)
    undertake a dual representation (represent both the seller or landlord and the buyer or tenant) for the sale or lease of property. The undersigned acknowledge they were informed of the possibility of this type of representation. Before signing this document please read the following:

    Representing more than one party to a transaction presents a conflict of interest since both clients may rely upon Licensee's advice and the client's respective interests may be adverse to each other. Licensee will undertake this representation only with the written consent of ALL clients in the transaction.

    Any agreement between the clients as to a final contract price and other terms is a result of negotiations between the clients acting in their own best interests and on their own behalf. You acknowledge that Licensee has explained the implications of dual representation, including the risks involved, and understand that you have been advised to seek independent advice from your advisors or attorneys before signing any documents in this transaction.

    WHAT A LICENSEE CAN DO FOR CLIENTS WHEN ACTING AS A DUAL AGENT

    1. Treat all clients honestly.
    2. Provide information about the property to the buyer or tenant.
    3. Disclose all latent material defects in the property that are known to the Licensee.
    4. Disclose financial qualification of the buyer or tenant to the seller or landlord.
    5. Explain real estate terms.
    6. Help the buyer or tenant to arrange for property inspections.
    7. Explain closing costs and procedures.
    8. Help the buyer compare financing alternatives.
    9. Provide information about comparable properties that have sold so both clients may make educated decisions on what price to accept or offer.

    WHAT LICENSEE CANNOT DISCLOSE TO CLIENTS WHEN ACTING AS A DUAL AGENT

    1. Confidential information that Licensee may know about a client, without that client's permission.
    2. The price or terms the seller or landlord will take other than the listing price without permission of the seller or landlord.
    3. The price or terms the buyer or tenant is willing to pay without permission of the buyer or tenant.
    4. A recommended or suggested price or terms the buyer or tenant should offer.
    5. A recommended or suggested price or terms the seller or landlord should counter with or accept.

    If either client is uncomfortable with this disclosure and dual representation, please let Licensee know. You are not required to sign this section unless you want to allow the Licensee to proceed as a Dual Agent in this transaction.

    By initialing here and signing below, you acknowledge that you have read and understand this form and voluntarily consent to the Licensee acting as a Dual Agent (that is, to represent BOTH the seller or landlord and the buyer or tenant) should that become necessary.

    _____ _____ _____
    Seller's initials Seller's initials Date

13. Broker is authorized to show the property to prospective buyers represented by buyer's agents, and Broker, in its sole discretion, may pay a part of the above commission to buyer's agent or other cooperating agents. Broker is authorized in its sole discretion to determine with which brokers it will cooperate, and the amount of compensation that it will offer cooperating brokers in the sale of Seller's property. Seller acknowledges that the compensation offered to such cooperating brokers may vary from broker to broker.

SAMPLE

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14. Seller understands that Broker and/or Designated Agent may have previously represented a buyer who is interested in your property. During that representation, Broker and/or Designated Agent may have learned material information about the buyer that is considered confidential. Under the law, neither Broker nor Designated Agent may disclose any such confidential information to you.
15. Seller understands and agrees that other sales associates affiliated with Broker, other than Seller's Designated Agent(s), may represent the actual or prospective buyer of Seller's property. Further, Seller understands and agrees that if the property is sold through the efforts of a sales associate affiliated with Broker who represents the Buyer, the other sales associate affiliated with Broker will be acting as a buyer's designated agent.
16. Seller agrees to immediately refer to Seller's Designated Agent all prospective buyers or brokers who contact Seller for any reason and to provide Seller's Designated Agent with their names and addresses.
17. Broker and Seller's Designated Agent are authorized in their sole discretion, to place a for sale sign on the property, if permitted by law, to remove all other such signs, to place a lockbox on the property, to have access to the property at all reasonable times for the purpose of showing it to prospective buyers, to cooperate with other brokers and to use pictures of the property and to expose property information and/or images to the Internet for marketing purposes.
18. Seller agrees to provide a limited home warranty program from _____ at a charge of $_____ plus options, if any. Seller acknowledges that the home warranty program is a limited warranty with a deductible. Seller acknowledges receipt of the application for such home warranty program. [STRIKE THROUGH IF NOT OFFERED].
19. Items such as wall-to-wall carpeting, garage door openers, smoke detectors, built-in appliances, light fixtures, landscaping and many indoor and outdoor decorative items may legally be "fixtures" and if so they must remain with the house unless specifically excluded in the Purchase Agreement. (Discuss this matter with Seller's Designated Agent to avoid uncertainty for all parties regarding what you may take and what should remain with the house, and make specific provisions for these items in the Purchase Agreement.)
20. Seller understands that the information which Seller provides to Seller's Designated Agent as listing information will be used to advertise Seller's property to the public, and it is essential that this information be accurate. SELLER HAS EITHER REVIEWED THE MLS LISTING INPUT SHEET AND REPRESENTS THAT THE INFORMATION CONTAINED IN IT IS TRUE AND ACCURATE TO THE BEST OF SELLER'S KNOWLEDGE, OR SELLER UNDERSTANDS THAT THEY HAVE AN OBLIGATION TO PROVIDE ACCURATE, TRUTHFUL INFORMATION TO BE PUT IN THE MLS INPUT SHEET AND HEREBY PROMISES TO FULFILL THIS OBLIGATION. Although Seller is listing Seller's property in its present physical condition ("as is" condition), Seller understands that Seller may be held responsible by a buyer for any latent or hidden, undisclosed defects or concealed defects in the property which are known to Seller but which are not disclosed to the buyer.
21. Seller agrees to save and hold Broker harmless from all claims, disputes, litigation, judgments, and costs (including reasonable attorney's fees) arising from Seller's breach of this agreement, from any incorrect information or misrepresentation supplied by Seller or from any material facts, including latent defects, that are known to Seller that Seller fails to disclose.
22. This contract shall be binding upon and inure to the benefit of the heirs, administrators, successors, and assigns of the parties hereto. This contract can only be amended by a writing signed by the parties.
23. THE PARTIES UNDERSTAND AND AGREE THAT IT IS ILLEGAL FOR EITHER OF THE PARTIES TO REFUSE TO DISPLAY OR SELL SELLER'S PROPERTY TO ANY PERSON ON THE BASIS OF RACE, COLOR, RELIGION, SEX, NATIONAL ORIGIN, ANCESTRY, AGE, ORDER OF PROTECTION STATUS, MARITAL STATUS, PHYSICAL OR MENTAL HANDICAP, MILITARY STATUS, SEXUAL ORIENTATION, UNFAVORABLE DISCHARGE FROM MILITARY SERVICE, FAMILIAL STATUS OR ANY OTHER CLASS PROTECTED BY ARTICLE 3 OF THE ILLINOIS HUMAN RIGHTS ACT. THE PARTIES AGREE TO COMPLY WITH ALL APPLICABLE FEDERAL, STATE AND LOCAL FAIR HOUSING LAWS.

Seller hereby acknowledges receipt of a signed copy of this agreement and all attachments. The attachments include the following: [HERE LIST ALL ATTACHMENTS]._____
_____.

(If seller is married both signatures are required)

SELLER:_____ _____, Broker

SELLER:_____ BY: _____ DATE: _____

ADDRESS:_____ _____ DATE: _____
_____ Seller's Designated Agent

DATE:_____ PHONE:_____ OFFICE:_____

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Exclusive Agency Agreement

An **exclusive agency** listing agreement is *an agency agreement between a seller and broker that also gives the broker the exclusive right to* ***represent the seller*** *in the sale of the seller's property*. However, with an exclusive agency agreement, sometimes called an **exclusive seller representation agreement**, the broker will be compensated if the broker or any other person or entity produces a purchaser in accordance with the terms specified in the listing agreement or if the property is sold or leased during the term of the listing agreement, *unless the property is sold or leased solely through the efforts of the seller or to a specifically exempted person or entity.* In other words, the listing broker will be compensated if **any other real estate agent or agency** procures the seller, but the seller retains the right to sell the property himself (to anyone) during the period of the exclusive agency listing agreement without being obligated to pay the listing broker. An exclusive agency listing agreement **must be in writing**

Open Listing Agreement

An **open listing** *is a non-exclusive listing given by a seller to as many brokers as he chooses*. It is an example of a **unilateral** contract, in that *only one party makes a binding promise.* If the property is sold, a broker is entitled to a commission only if he is the **procuring cause** of the sale, meaning, *the agent is primarily responsible for bringing about a sale.* The price, terms, and the broker's compensation are spelled out in the agreement. But, only the broker who produces a buyer at those terms (or other terms the seller agrees to accept) is considered the procuring agent and earns a fee.

Open listings are not that common, but as an example, consider a mortgage lender who works with many brokers in an area is selling his property. Since he has a business relationship with multiple brokers, he does not want to choose just one to represent him. He might offer an open listing to all the brokers he works with to show no favoritism.



There may be local zoning ordinances that limit the number of signs from different brokers that may be placed on a property.

Net Listings

A so-called **net listing** is not really a listing. Instead, it describes a method of compensation. With a net listing, the *seller sets a net amount he is willing to accept for the property, and the broker is entitled to keep any amount in excess of that as commission*. Net listings are discouraged—if not outright illegal—in most states since they could lead to charges of fraud by a seller who may not have understood the listing terms or believes that the broker did not advise him of the property's true value.

Provisions in a Listing Agreement

Most of the **terms** in a listing agreement are negotiable. The first thing that is normally defined in the listing agreement is the **type** of listing agreement (exclusive right to sell, exclusive agency). A typical listing agreement generally contains the following elements somewhere in the contract.

Parties to the Contract

The contract should clearly state the **parties** to the contract:

- **Anyone having a share of ownership** in the property to be sold should be listed in the contract and be required to sign it. If the owner is married, their spouse should also give written consent. If a tenant occupies the residence, this information should also be provided in the contract, and instructions on how the property is to be shown.
- The **brokerage** company name, the employing broker, and the salesperson listing the property should all be named in the listing agreement, as well as the names of the specific licensees within the agency who are authorized to work with the seller.
- It would also be important to indicate whether or not the seller already has a contract with **another broker**.

ILLINOIS ASSOCIATION OF REALTORS®
EXCLUSIVE SELLER REPRESENTATION CONTRACT
(WITHOUT DUAL AGENCY DISCLOSURE AND CONSENT)

EQUAL HOUSING OPPORTUNITY

1. In consideration of the services to be performed by _____, (Brokerage Company, hereinafter referred to as "Broker") and the commissions to be paid by _____, ("Seller"), the parties agree that Broker shall have the exclusive right to act as Seller's agent for the marketing and sale of Seller's property upon the following terms and conditions:
   Property Address:_____
   City: _____, Illinois Zip:_____
   Marketing Price: $_____
   Marketing Period: From_____2_____ through 11:59 p.m. on _____, 2_____.

   Seller understands that this exclusive right to represent Seller (Exclusive Representation) means that if the Seller sells the property identified above through the efforts of Broker and his agents or through another real estate office or agent, Seller will be obligated to compensate Broker pursuant to paragraph 3 of this Contract.
2. Broker agrees to provide those brokerage services set forth in Section 15-75 of the Illinois Real Estate License Act of 2000.
3. If during the term of this Contract Broker obtains an offer to purchase the property from a ready, willing, and able buyer at the marketing price, or if Seller enters into a contract or receives an offer from anyone to whom the property was presented during the term of this Contract, that results in a contract for the sale or exchange of the property at any price and upon any terms to which Seller consents, Seller shall be obligated to pay Broker a commission of _____ percent (___%) of the total purchase price of the sale or exchange. The full commission is to be paid at closing, which in the case of a sale on contract for deed shall be at the time buyer and Seller execute the initial contract or agreement for deed.
4. Seller agrees that such a commission shall be paid if the property is sold or exchanged by Seller within a protection period of_____ (__) days following the term of this Contract or any extensions thereof to anyone to whom the property was presented during the term of this Contract. However, this provision shall not apply if Seller has entered into a valid, written listing agreement with another licensed real estate broker during the protection period.
5. In the event a purchase contract is entered into and buyer defaults without fault on the Seller's part, Broker will waive the commission, and this agreement shall be continued from the date of default through the date provided in paragraph 1. Should Seller default on any contract for the purchase or exchange of the property, any commission owed under this agreement shall become payable immediately.

   [5. ALTERNATE TO BE SUBSTITUTED IN LIEU OF THE ABOVE ¶5.] In the event a purchase contract is entered into and buyer defaults with or without fault on the Seller's part, any commission owed under this contract shall become payable immediately. Should Seller default on any contract for the purchase or exchange of the property, any commission owed under this agreement shall become payable immediately.
6. When a contract to purchase is entered into for the purchase of Seller's property, the buyer may deposit earnest money with Broker. Broker will hold any such earnest money in a special, non-interest bearing escrow account on behalf of the buyer and Seller. Once the purchase goes to closing, the earnest money will be disbursed according to the terms of the contract to purchase.

   (a) If the transaction fails to close due to fault of the Seller, the earnest money shall be returned to the buyer.
   [AS TO ¶S (b) THROUGH (d) BELOW, THE PARTIES SHOULD CHECK THE ONE PARAGRAPH WHICH APPLIES].

   ☐ (b) IF THE TRANSACTION FAILS TO CLOSE DUE TO FAULT OF THE BUYER, THE EARNEST MONEY SHALL FIRST GO TOWARD PAYING THE COMMISSION BROKER WOULD HAVE EARNED IN THE SALE, AND THE BALANCE, IF ANY, SHALL GO TO SELLER.

   ☐ (c) IF THE TRANSACTION FAILS TO CLOSE DUE TO FAULT OF THE BUYER, THE EARNEST MONEY SHALL BE DISTRIBUTED TO THE SELLER, LESS ANY COSTS OF ADVERTISING OR REASONABLE EXPENSES INCURRED BY BROKER.

   ☐ (d) If the transaction fails to close due to fault of the buyer, the earnest money shall be distributed to the Seller.
7. Seller agrees that for the purpose of marketing Seller's property, Broker shall place Seller's property in the Multiple Listing Service(s) in which Broker is a member.
8. Seller makes the following elections with regard to having Sellers's property displayed on any Internet site: (circle YES or NO to all that apply)
   - Display listing on any Internet site: YES NO
   - Display Seller's property address on Internet: YES NO

   Seller understands and acknowledges that if seller circles "NO" for the above two options, consumers who conduct searches for listings on the Internet will not see the corresponding information about Sellers' property in response to their searches.

   _____ _____ _____
   Seller's Initials Seller's Initials Date

   - Allow for automatic valuation tools to be used for Seller's listing: YES NO
   - Allow for blogging or comments to be used or made regarding Seller's listing: YES NO

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9. Seller(s) acknowledge(s) that they have been informed of the responsibilities imposed upon sellers under the Residential Real Property Disclosure Act. Seller agrees to comply with the requirements of this Act to the best of Seller's ability and to not knowingly give any false or inaccurate information regarding the disclosures required by that Act.
10. Broker designates _____ , ("Seller's Designated Agent"), a sales associate(s) affiliated with Broker as the only legal agent(s) of the Seller. Broker reserves the right to name additional designated agents when in Broker's discretion it is necessary. If additional designated agents are named, Seller shall be informed in writing within a reasonable time. (ADD IF DESIRED: Seller acknowledges that Seller's Designated Agent may from time to time have another sales associate, who is not an agent of Seller, sit an open house of Seller's property or provide similar support in the marketing of Seller's property.) Seller understands and agrees that this agreement is a contract for Broker to market Seller's property and that Seller's Designated Agent(s) is (are) the only legal agent(s) of Seller. Seller's Designated Agent will be primarily responsible for the direct marketing and sale of Seller's property.
11. Seller has been informed that potential buyers may elect to employ the services of a licensed real estate broker or sales associate as their own agent (buyer's agent).
12. Broker is authorized to show the property to prospective buyers represented by buyer's agents, and Broker, in its sole discretion, may pay a part of the above commission to buyer's agent or other cooperating agents. Broker is authorized in its sole discretion to determine with which brokers it will cooperate, and the amount of compensation that it will offer cooperating brokers in the sale of Seller's property. Seller acknowledges that the compensation offered to such cooperating brokers may vary from broker to broker.
13. Seller understands that Broker and/or Designated Agent may have previously represented a buyer who is interested in your property. During that representation, Broker and/or Designated Agent may have learned material information about the buyer that is considered confidential. Under the law, neither Broker nor Designated Agent may disclose any such confidential information to you.
14. Seller understands and agrees that other sales associates affiliated with Broker, other than Seller's Designated Agent(s), may represent the actual or prospective buyer of Seller's property. Further, Seller understands and agrees that if the property is sold through the efforts of a sales associate affiliated with Broker who represents the Buyer, the other sales associate affiliated with Broker will be acting as a Buyer's Designated Agent.
15. Seller agrees to immediately refer to Seller's Designated Agent all prospective brokers or agents for buyers who contact Seller for any reason and to provide Seller's Designated Agent with their names and contact information.
16. Broker and Seller's Designated Agent are authorized in their sole discretion, to place a for sale sign on the property, if permitted by law, to remove all other brokerage signs, to place a lockbox on the property, to have access to the property at all reasonable times for the purpose of showing it to prospective buyers, to cooperate with other brokers and to use pictures of the property and to expose property information and/or images to the Internet for marketing purposes.
17. Seller agrees to provide a limited home warranty program from _____ at a charge of $_____ plus options, if any. Seller acknowledges that the home warranty program is a limited warranty with a deductible. Seller acknowledges receipt of the application for such home warranty program. [STRIKE THROUGH IF NOT OFFERED].
18. Items such as wall-to-wall carpeting, garage door openers, smoke detectors, built-in appliances, light fixtures, landscaping and many indoor and outdoor decorative items may legally be "fixtures" and if so they must remain with the house unless specifically excluded in the Purchase Agreement. (Discuss this matter with Seller's Designated Agent to avoid uncertainty for all parties regarding what you may take and what should remain with the house, and make specific provisions for these items in the Purchase Agreement.)
19. Seller understands that the information which Seller provides to Seller's Designated Agent as listing information will be used to advertise Seller's property to the public, and it is essential that this information be accurate. SELLER HAS EITHER REVIEWED THE MLS LISTING INPUT SHEET AND REPRESENTS THAT THE INFORMATION CONTAINED IN IT IS TRUE AND ACCURATE TO THE BEST OF SELLER'S KNOWLEDGE, OR SELLER UNDERSTANDS THAT THEY HAVE AN OBLIGATION TO PROVIDE ACCURATE, TRUTHFUL INFORMATION TO BE PUT IN THE MLS INPUT SHEET AND HEREBY PROMISES TO FULFILL THIS OBLIGATION. Although Seller is listing Seller's property in its present physical condition ("as is" condition), Seller understands that Seller may be held responsible by a buyer for any latent or hidden, undisclosed defects in the property which are known to Seller but which are not disclosed to the Buyer.
20. Seller agrees to save and hold Broker harmless from all claims, disputes, litigation, judgments, and costs (including reasonable attorney's fees) arising from Seller's breach of this agreement, from any incorrect information or misrepresentation supplied by Seller or from any material facts, including latent defects, that are known to Seller that Seller fails to disclose.
21. This contract shall be binding upon and inure to the benefit of the heirs, administrators, successors, and assigns of the parties hereto. This contract can only be amended by a writing signed by the parties.
22. THE PARTIES UNDERSTAND AND AGREE THAT IT IS ILLEGAL FOR EITHER OF THE PARTIES TO REFUSE TO DISPLAY OR SELL SELLER'S PROPERTY TO ANY PERSON ON THE BASIS OF RACE, COLOR, RELIGION, SEX, NATIONAL ORIGIN, ANCESTRY, AGE, ORDER OF PROTECTION STATUS, MARITAL STATUS, PHYSICAL OR MENTAL HANDICAP, MILITARY STATUS, SEXUAL ORIENTATION, UNFAVORABLE DISCHARGE FROM MILITARY SERVICE, FAMILIAL STATUS OR ANY OTHER CLASS PROTECTED BY ARTICLE 3 OF THE ILLINOIS HUMAN RIGHTS ACT. THE PARTIES AGREE TO COMPLY WITH ALL APPLICABLE FEDERAL, STATE AND LOCAL FAIR HOUSING LAWS.

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Seller hereby acknowledges receipt of a signed copy of this agreement and all attachments. The attachments include the following: [HERE LIST ALL ATTACHMENTS]._____

_____.

(If seller is married both signatures are required)

SELLER:_____ _____, Broker

SELLER:_____ BY: _____ DATE: _____

ADDRESS:_____ _____ DATE: _____

_____ Seller's Designated Agent

DATE:_____ PHONE:_____ OFFICE:_____

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Description of Property

The contract should include a description of the property. Normally, this includes the street address and sometimes the legal description, for example, if the seller is subdividing a property or any other situation in which the address does not sufficiently identify the property. Other information that may be noted includes the size of the lot, zoning, tax parcel number, municipality, school district, etc.

Asking Price

The proposed gross sales price of the property must also be stated in the contract. When putting a property up for sale, it is ultimately the **seller's responsibility** to determine the listing price. Additionally, the seller should understand that the amount they receive will be the gross of the actual sold price *minus* any real estate taxes, special assessments, outstanding mortgage and deed debts, broker commissions, and other obligations.

Term of Contract

A specific ending date must be included. The average expiration date is usually 90 to 120 days after the listing agreement is signed. And as the broker/salesperson, you want to have this listing period as long as possible, giving you ample time to generate interest, a sale, and ultimately, a commission. But keep in mind, your client may not want to commit to one agent for more than a few months and this is something that can be **negotiated** on the agreement. A listing agreement automatically expires at midnight on the specified end date.

Payment of Broker's Fee

The listing contract will specify the conditions under which the commission will be paid. Most clients will insist the listing agreement state the specific terms in which a commission is earned, typically when the seller and the buyer actually complete the sale, not when they sign the purchase agreement. The amount of the commission, either as a percentage of the sale or a flat fee, must be included. Remember that the commission rate or amount must be **negotiated** between seller and broker. **It's a violation of federal antitrust laws for brokers to set uniform commission rates.** Any discussion of rates among members of competing firms could give rise to a charge of price-fixing.

Other Recommended Elements

While some of the elements listed here may be required at some point in the transaction, their appearance in a listing agreement is optional but recommended.

- **Cooperation with Other Brokers.** Broker cooperation should have been discussed with the seller when presenting the agency disclosure at the first substantive meeting. The seller must indicate whether or not he is willing to accept designated agency or dual agency and if so, how much the broker should pay to another agent representing the seller. The buyer must also indicate whether or not he wants part of the commission/fee paid to a buyer's agent, and if so, how much. These fees should also appear in the Multiple Listing Service. **These are negotiable numbers.**
- **Permission to Advertise.** Illinois law requires the written consent of an owner for any advertising, whether it's a yard sign, a photo in a newspaper ad, or any other message indicating that the property is for sale. This requirement could be achieved with a clause or statement in the listing agreement.
- **Disclosure.** In most states, the seller is required by law to complete a standardized disclosure statement listing defects about the property. Disclosure laws protect potential buyers, giving them the right to make an informed decision on the property. Disclosures normally include structural, mechanical, or other conditions of the property. There is also a required disclosure related to lead paint. The property disclosures mandated in Illinois are covered elsewhere.
- **Personal Property or Lease Equipment.** Any personal property of the seller that will be included with the sale of the property may be specifically stated in a listing agreement. If the seller plans to remove anything from the property, that needs to be identified as well. Sometimes, the seller and prospective buyer will negotiate on these items. Any equipment such as appliances, security systems, cable boxes, etc., that the property owner is currently leasing should also be outlined. The sooner a seller can make clear that those items do not come with the property, or the items and the payments will be assumed by the buyer, the less opportunity for conflict when it's time to negotiate a purchase agreement.

Optional Clauses

These elements may be included in a listing agreement:

- Sometimes **proof of ownership** is required, most commonly, a warranty deed and title insurance policy.
- Both the seller and the broker may agree to include an **indemnification** clause, which basically states that they will not sue each other in the event that misinformation was shared between them.
- A statement may be included indicating that any **conflicts of interest** will be disclosed.
- A statement that the seller will **not** enter into a listing contract with another broker during the term of the agreement is often included.
- If a seller is willing to enter into any sort of **seller financing arrangement**, a statement to that effect may be included.
- A statement may be included indicating that the seller agrees that the person holding the earnest money deposit may keep an uncashed check until the seller accepts the offer.

Multiple Listing Service

Most brokers use a **Multiple Listing Service** (MLS). This is a marketing organization whose members are brokers that agree to share their listings by working together. The broker who lists the property generally agrees to share the commission with the broker who sells the property. An advantage for the broker is that they gain access to a lot more properties that they have the potential to sell. The seller benefits because their property is exposed to a much larger market without going the route of contracting with multiple brokers and open listings.

When a listing broker negotiates any listing agreement, one negotiable item is whether or not the property will go into the MLS. If so, the listing broker completes a worksheet with the required information for that property and submits to the MLS, generally within a day or two. Facts and photographs of the property are then published in the online MLS.

Although most items in the worksheet are self-explanatory, an agent should **always give clients copies of all documents they sign** immediately if possible and within 24 hours by law! Failure to do so could lead to disciplinary action, including loss of license.

Revoking a Listing Agreement

Sellers can revoke a listing contract at any time. However, canceling the listing before the agreed upon expiration date will typically constitute a **breach** of the contract terms and thus violate the broker's rights. In such a case, the listing broker may demand compensation for the damages sustained as a result of the early listing cancellation. Damages might include marketing and advertising expenses, the value of services rendered (assuming this is documented and can be proven), reimbursement for other expenses incurred in the process of listing the property, etc.

Some brokerages may include a provision to their listing agreements that specifically address early termination of a listing, such as an early termination fee. As long as the seller follows the contract provisions for termination, they can cancel the listing without fear of being charged for any damages.

It's also important to note, the seller can cancel the listing agreement without risk of damages if the termination is **for cause**. For example, if the brokerage is in breach of contract for not performing according to the terms of the listing agreement, the seller has the right to cancel the listing.

Buyer Agency Agreements

An agency relationship between a buyer and a broker in a real estate transaction can be created with a document such as a **buyer brokerage agreement**. A buyer brokerage agreement—which may also be called a buyer agency agreement, a buyer representation agreement, a buyer broker contract, or a buyer listing, among other things—is a *written agency contract between a buyer and a real estate broker stipulating the broker will be paid a commission when the buyer purchases real estate*. Agency relationships with buyers are commonly found in exclusive and non-exclusive (open) forms.

Requirements in Illinois

Rules: Section 1450.770

All written buyer brokerage agreements, whether exclusive or non-exclusive, must contain the following elements:

- The agreed basis or amount of **compensation** and time of payment
- The **duration** of the buyer brokerage agreement clearly set forth
- The **name** of the sponsoring broker and the buyer
- The **signatures** of the buyers and an authorized signator on behalf of the sponsoring broker
- The **duties** of the buyer's broker

The **designated agent** may be named in the agreement or in a separate document. Since disclosure of the potential for **dual agency** is required in Illinois, buyer brokerage agreements may also contain this disclosure, or it may be disclosed in a separate document.

Exclusive Buyer Agency Brokerage Agreement

An **exclusive buyer brokerage agreement** makes certain *the sponsoring broker is paid the negotiated fee even if the buyer purchases property through another brokerage.* While it is true the level of fiduciary duty owed to a buyer is the same in both exclusive and non-exclusive buyer arrangements, the level of service and diligence usually provided in such scenarios is amplified when a contractual buyer brokerage agreement is in place. For example, the buyer agent may extend his property search for the buyer client beyond listed properties. Properties offered for sale by owner (FSBO) are a good example. Additionally, the exclusive buyer agent might even canvass owners of properties not for sale but that match the buyer's specifications. Some buyer brokers may even market for their buyer clients. A listing broker in the course of representing a seller would advertise or frequently send direct mailings with information about a listed property to attract prospective buyers. An exclusive buyer agent might do the same thing, only advertising the kinds of property for which his buyer is searching.

Just as there are two types of exclusive listing agreement with sellers, an exclusive buyer brokerage agreement may provide for compensation to the buyer's broker if the buyer acquires a property through the efforts of:

- The buyer's broker or any other real estate brokerage (similar to an exclusive agency agreement).
- The buyer's broker, any other real estate brokerage, or any other third party (similar to an exclusive right to sell agreement).

An exclusive buyer brokerage agreement **must be in writing**.

Non-Exclusive / Open Buyer Agency

As with an open listing agreement, a **non-exclusive buyer agency agreement** or **open buyer agency agreement** is one in which *a sponsoring broker earns a commission only if he is the agent who introduces the buyer to the property he or she purchases.* The agent representing the buyer introduces the buyer to properties currently listed, typically properties listed by the buyer agent's firm as well as properties listed by other brokers who will allow the buyer agent to show and sell those properties. The extent to which the agent looks for properties on behalf of a non-exclusive buyer may seem casual in comparison with the diligence undertaken for an exclusive buyer. One of the greatest downfalls for an agent working for a non-exclusive buyer is lack of control. Agents often invest significant time and money working with potential buyers, but if the buyer purchases property though another agent, no commission is earned.

ILLINOIS ASSOCIATION OF REALTORS®
EXCLUSIVE BUYER REPRESENTATION/EXCLUSIVE RIGHT TO PURCHASE CONTRACT
(DUAL AGENCY DISCLOSURE AND CONSENT INCLUDED)

In consideration of _____'s (Brokerage Company hereinafter referred to as "Broker") agreement to designate a sales associate affiliated with Broker to act as an agent of the Buyer for the purpose of identifying and negotiating to acquire real estate for _____ ("Buyer"), the Buyer hereby grants to Broker the relationship as marked in Section 1 of the Contract.

SECTION 1: TYPE OF REPRESENTATION
(Instruction: check the box next to desired choice):

— **Exclusive Representation**. Buyer understands that this exclusive right to represent Buyer (Exclusive Representation) means that if the Buyer makes an acquisition of property, whether through the efforts of Broker and his agents or through the efforts of another real estate office or agent, Buyer will be obligated to compensate Broker pursuant to Section 8 of this Contract. This Exclusive Agency shall be effective for the following area: _____. The term "acquisition" shall include the purchase, lease, exchange or option of real estate.

— **Exclusive Right to Acquire**. Buyer understands that this "exclusive right to purchase" means that if Buyer acquires any property, whether through the efforts of the Buyer, Broker and his agents, another real estate agency besides Broker's, or other third party, Buyer will be obligated to compensate Broker pursuant to Section 8 of this Contract. This exclusive right to acquire shall be effective for the following area:_____"Acquisition" shall include the purchase, lease, exchange or option of real estate.

Broker designates and Buyer accepts_____
("Buyer's Designated Agent") as the legal agent(s) of Buyer for the purpose of representing Buyer in the acquisition of real estate by Buyer. Buyer understands and agrees that neither Broker nor any other sales associates affiliated with Broker (except as provided for herein) will be acting as legal agent of the Buyer. Broker shall have the discretion to appoint a substitute designated agent for Buyer as Broker determines necessary. Buyer shall be advised within a reasonable time of any such substitution.

SECTION 2: TERM
This Contract shall be effective until 11:59 p.m. on _____, 2____, when it shall then terminate. This Contract is irrevocable and can be terminated prior to the termination date only by written agreement of the parties. If within ____ days after the termination of this Contract (i.e. the protection period), Buyer purchases any property to which Buyer was introduced by Buyer's Designated Agent, then Buyer agrees to pay Broker the compensation provided for in Section 8. However, no compensation will be due to Broker if, during this protection period, Buyer enters into a separate buyer representation agreement with another broker.

SECTION 3: BUYER'S DESIGNATED AGENT'S DUTIES
(a) To use Buyer's Designated Agent's best efforts to identify properties listed in the multiple listing service that meet the Buyer's specifications relating to location, price, features and amenities, as identified on the attached Buyer's Information Checklist.
(b) To arrange for inspections of properties identified by the Buyer as potentially appropriate for acquisition.
(c) To advise Buyer as to the pricing of comparable properties.
(d) To assist Buyer in the negotiation of a contract acceptable to the Buyer for the acquisition of property.
(e) To provide reasonable safeguards for confidential information that the Buyer discloses to Buyer's Designated Agent.
(f) Other services: _____.

SECTION 4: BROKER'S DUTIES
(a) To provide through Buyer's Designated Agent, those brokerage services set forth in Section 15-75 of the Illinois Real Estate License Act of 2000.
(b) To provide Buyer's Designated Agent with assistance and advice as necessary in Buyer's Designated Agent's work on Buyer's behalf.
(c) To make the managing Broker, or his /her designated representative, available to consult with Buyer's Designated Agent as to Buyer's negotiations for the acquisition of real estate, who will maintain the confidence of Buyer's confidential information.
(d) To make other sales associates affiliated with Broker aware of Buyer's general specifications for real property.
(e) As needed, to designate one or more sales associates as Designated Agents of Buyer.

SECTION 5: BUYER'S DUTIES
(a) To complete the Buyer's checklist which will provide Buyer's specifications for the real estate Buyer is seeking.
(b) To work exclusively with Buyer's Designated Agent to identify and acquire real estate during the time that this Contract is in force.
(c) To supply relevant financial information that may be necessary to permit Buyer's Designated Agent to fulfill Agent's obligations under this Contract.
(d) To be available upon reasonable notice and at reasonable hours to inspect properties that seem to meet Buyer's specifications.
(e) To pay Broker according to the terms specified in Section 8 of this Contract.

SECTION 6: REPRESENTING OTHER BUYER
Buyer understands that Buyer's Designated Agent has no duty to represent only Buyer, and that Buyer's Designated Agent may represent other prospective buyers who may be interested in acquiring the same property or properties that Buyer is interested in acquiring.

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SECTION 7: DISCLOSURE AND CONSENT TO DUAL AGENCY

NOTE TO CONSUMER: THIS SECTION SERVES THREE PURPOSES. FIRST, IT DISCLOSES THAT A REAL ESTATE LICENSEE MAY POTENTIALLY ACT AS A DUAL AGENT, THAT IS, REPRESENT MORE THAN ONE PARTY TO THE TRANSACTION. SECOND, THIS SECTION EXPLAINS THE CONCEPT OF DUAL AGENCY. THIRD, THIS SECTION SEEKS YOUR CONSENT TO ALLOW THE REAL ESTATE LICENSEE TO ACT AS A DUAL AGENT. A LICENSEE MAY LEGALLY ACT AS A DUAL AGENT ONLY WITH YOUR CONSENT. BY CHOOSING TO SIGN THIS SECTION, YOUR CONSENT TO DUAL AGENCY REPRESENTATION IS PRESUMED.

The undersigned _____,("Licensee"/"Buyer's
(insert name(s) of licensee
Designated Agent") may undertake a dual representation (represent both the seller or landlord and the buyer or tenant) for the sale or lease of property. The undersigned acknowledge they were informed of the possibility of this type of representation. Before signing this document please read the following:

Representing more than one party to a transaction presents a conflict of interest since both clients may rely upon Licensee's advice and the client's respective interests may be adverse to each other. Licensee will undertake this representation only with the written consent of ALL clients in the transaction.

Any agreement between the clients as to a final contract price and other terms is a result of negotiations between the clients acting in their own best interests and on their own behalf. You acknowledge that Licensee has explained the implications of dual representation, including the risks involved, and understand that you have been advised to seek independent advice from your advisors or attorneys before signing any documents in this transaction.

WHAT A LICENSEE CAN DO FOR CLIENTS WHEN ACTING AS A DUAL AGENT

1. Treat all clients honestly.
2. Provide information about the property to the buyer or tenant.
3. Disclose all latent material defects in the property that are known to the Licensee.
4. Disclose financial qualification of the buyer or tenant to the seller or landlord.
5. Explain real estate terms.
6. Help the buyer or tenant to arrange for property inspections.
7. Explain closing costs and procedures.
8. Help the buyer compare financing alternatives.
9. Provide information about comparable properties that have sold so both clients may make educated decisions on what price to accept or offer.

WHAT LICENSEE CANNOT DISCLOSE TO CLIENTS WHEN ACTING AS A DUAL AGENT

1. Confidential information that Licensee may know about a client, without that client's permission.
2. The price or terms the seller or landlord will take other than the listing price without permission of the seller or landlord.
3. The price or terms the buyer or tenant is willing to pay without permission of the buyer or tenant.
4. A recommended or suggested price or terms the buyer or tenant should offer.
5. A recommended or suggested price or terms the seller or landlord should counter with or accept.

If either client is uncomfortable with this disclosure and dual representation, please let Licensee know. You are not required to sign this section unless you want to allow the Licensee to proceed as a Dual Agent in this transaction.

By initialing here and signing below, you acknowledge that you have read and understand this form and voluntarily consent to the Licensee acting as a Dual Agent (that is, to represent BOTH the seller or landlord and the buyer or tenant) should that become necessary.

_____	_____	_____
Buyer's initials	Buyer's initials	Date

SECTION 8: COMPENSATION

Broker and Buyer expect that Broker's commission will be paid by the seller or seller's broker for Broker's acting as a cooperating agent. However, if Broker is not compensated by seller or seller's broker, or if the amount of compensation paid by seller or seller's broker is not at least _____% of the purchase price, then Buyer agrees to pay Broker the difference between_____% of the purchase price and what seller or seller's broker actually paid. This Section applies if the Buyer enters into a contract to acquire real estate during the term of this Contract or the protection period, and such contract results in a closed transaction. Any modification to this Section, including the commission to be paid to Broker, shall be by a separate written agreement to this Contract.

SECTION 9: PREVIOUS REPRESENTATION

Buyer understands that Broker and/or Designated Agent may have previously represented the seller from whom you wish to purchase property. During that representation, Broker and/or Designated Agent may have learned material information about the seller that is considered confidential. Under the law, neither Broker nor Designated Agent may disclose any such confidential information to you.

SECTION 10: FAILURE TO CLOSE

If a seller or lessor in an agreement made on behalf of Buyer fails to close such agreement, with no fault on the part of Buyer, the Buyer shall have no obligation to pay the commission provided for in Section 8. If such transaction fails to close because of any fault on the part of Buyer, such commission will not be waived, but will be due and payable immediately. In no case shall Broker or Buyer's Designated Agent be obligated to advance funds for the benefit of Buyer in order to complete a closing.

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SECTION 11: DISCLAIMER
The Buyer acknowledges that Broker and Buyer's Designated Agent are being retained solely as real estate professionals, and not as attorneys, tax advisors, surveyors, structural engineers, home inspectors, environmental consultants, architects, contractors, or other professional service providers. The Buyer understands that such other professional service providers are available to render advice or services to the Buyer, if desired, at Buyer's expense.

SECTION 12: COSTS OF THIRD PARTY SERVICES OR PRODUCTS
Buyer agrees to reimburse Broker the cost of any products or services such as surveys, soil tests, title reports and engineering studies, furnished by outside sources immediately when payment is due.

SECTION 13: INDEMNIFICATION OF BROKER
Buyer agrees to indemnify Broker and Buyer's Designated Agent and to hold Broker and Buyer's Designated Agent harmless on account of any and all loss, damage, cost or expense, including attorneys' fees incurred by Broker or Buyer's Designated Agent, arising out of this Contract, or the collection of fees or commission due Broker pursuant to the terms and conditions of this Contract, provided the loss damage, cost, expense or attorneys' fees do not result because of Broker's or Buyer's Designated Agent's own negligence or willful and wanton misconduct.

SECTION 14: ASSIGNMENT BY BUYERS
No assignment of Buyer's interest under this Contract and no assignment of rights in real property obtained for Buyer pursuant to this Contract shall operate to defeat any of Broker's rights under this exclusive representation contract.

SECTION 15: NONDISCRIMINATION
THE PARTIES UNDERSTAND AND AGREE THAT IT IS ILLEGAL FOR EITHER OF THE PARTIES TO REFUSE TO DISPLAY OR SELL SELLER'S PROPERTY TO ANY PERSON ON THE BASIS OF RACE, COLOR, RELIGION, SEX, NATIONAL ORIGIN, ANCESTRY, AGE, ORDER OF PROTECTION STATUS, MARITAL STATUS, PHYSICAL OR MENTAL HANDICAP, MILITARY STATUS, SEXUAL ORIENTATION, UNFAVORABLE DISCHARGE FROM MILITARY SERVICE, FAMILIAL STATUS OR ANY OTHER CLASS PROTECTED BY ARTICLE 3 OF THE ILLINOIS HUMAN RIGHTS ACT. THE PARTIES AGREE TO COMPLY WITH ALL APPLICABLE FEDERAL, STATE AND LOCAL FAIR HOUSING LAWS.

SECTION 16: MODIFICATION OF THIS CONTRACT
No modification of any of the terms of this Contract shall be valid and binding upon the parties or entitled to enforcement unless such modification has first been reduced to writing and signed by the parties.

SECTION 17: ENTIRE AGREEMENT
This Contract constitutes the entire agreement between the parties relating to the subject thereof, and any prior agreements pertaining hereto, whether oral or written have been merged and integrated into this Contract.

This Contract may be executed in multiple copies and my signature as Buyer hereon acknowledges that I have received a signed copy.

_____
Buyer

_____
Buyer

Buyer's Address:
_____
_____

Date:_____

Accepted by:

_____, Broker

BY:_____ DATE: _____

_____ DATE: _____
Buyer's Designated Agent

PHONE:_____OFFICE:_____

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ILLINOIS ASSOCIATION OF REALTORS®
NON-EXCLUSIVE BUYER REPRESENTATION CONTRACT
(DUAL AGENCY DISCLOSURE AND CONSENT INCLUDED)

In consideration of_____ 's ("Brokerage Company hereinafter referred to as "Broker") agreement to designate a sales associate affiliated with Broker to act as an agent of the Buyer for the purpose of identifying and negotiating to acquire real estate for _____ ("Buyer"), the Buyer hereby grants to Broker a non-exclusive right to represent Buyer in such acquisition. The term "acquisition" shall include the purchase, lease, exchange or option of real estate by Buyer or anyone acting on Buyer's behalf.

SECTION 1: REPRESENTATION
Broker designates and Buyer accepts _____ _____ ("Buyer's Designated Agent") as the legal agent(s) of Buyer for the purpose of representing Buyer in the acquisition of real estate by Buyer. Buyer understands and agrees that neither Broker nor any other sales associates affiliated with Broker (except as provided for herein) will be acting as legal agent of the Buyer. Broker shall have the discretion to appoint a substitute designated agent for Buyer as Broker determines necessary. Buyer shall be advised within a reasonable time of any such substitution.

Buyer agrees to work with the Broker and Buyer's Designated Agent in the acquisition of property with the understanding that this relationship is **non-exclusive**. Buyer understands that Buyer may **not** enter into an **exclusive** representation agreement with any other real estate agent or broker. Buyer represents that he/she has not entered into any exclusive buyer representation agreement that is currently in effect.

SECTION 2: TERM
This Contract shall be effective until 11:59 p.m. on _____, 2_____, when it shall then terminate. This Contract is irrevocable and can be terminated prior to the termination date only by written agreement of the parties.

SECTION 3: BUYER'S DESIGNATED AGENT'S DUTIES

(a) To use Buyer's Designated Agent's best efforts to identify properties listed in the multiple listing service that meet the Buyer's specifications relating to location, price, features and amenities, as identified on the attached Buyers Information Checklist.
(b) To arrange for inspections of properties identified by the Buyer as potentially appropriate for acquisition.
(c) To advise Buyer as to the pricing of comparable properties.
(d) To assist Buyer in the negotiation of a contract acceptable to the Buyer for the acquisition of property.
(e) To provide reasonable safeguards for confidential information that the Buyer discloses to Buyer's Designated Agent.
(f) Other services: _____

SECTION 4: BROKER'S DUTIES

(a) To provide Buyer's Designated Agent with assistance and advice as necessary in Buyer's Designated Agent's work on Buyer's behalf.
(b) To make the managing broker, or his/her designated representative, available to consult with Buyer's Designated Agent as to Buyer's negotiations for the acquisition of real estate, who will maintain the confidence of Buyer's confidential information.
(c) To make other sales associates affiliated with Broker aware of Buyer's general specifications for real property.
(d) As needed, to designate one or more sales associates as designated agents of Buyer.

SECTION 5: BUYER'S DUTIES

(a) To complete the buyer's checklist which will provide Buyer's specifications for the real estate Buyer is seeking.
(b) To work with Buyer's Designated Agent to identify and acquire real estate during the time that this Agreement is in force.
(c) To supply relevant financial information that may be necessary to permit Buyer's Designated Agent to fulfill Agent's obligations.
(d) To be available upon reasonable notice and at reasonable hours to inspect properties that seem to meet Buyer's specifications.
(e) To pay Broker according to the terms specified in Section 8 of this Agreement.

SECTION 6: REPRESENTING OTHER BUYERS
Buyer understands that Buyer's Designated Agent has **no** duty to represent only Buyer, and that Buyer's Designated Agent may represent other prospective buyers who may be interested in acquiring the same property or properties that Buyer is interested in acquiring.

SECTION 7: DISCLOSURE AND CONSENT TO DUAL AGENCY

NOTE TO CONSUMER: THIS SECTION SERVES THREE PURPOSES. FIRST, IT DISCLOSES THAT A REAL ESTATE LICENSEE MAY POTENTIALLY ACT AS A DUAL AGENT, THAT IS, REPRESENT MORE THAN ONE PARTY TO THE TRANSACTION. SECOND, THIS SECTION EXPLAINS THE CONCEPT OF DUAL AGENCY. THIRD, THIS SECTION SEEKS YOUR CONSENT TO ALLOW THE REAL ESTATE LICENSEE TO ACT AS A DUAL AGENT. A LICENSEE MAY LEGALLY ACT AS A DUAL AGENT ONLY WITH YOUR CONSENT. BY CHOOSING TO SIGN THIS SECTION, YOUR CONSENT TO DUAL AGENCY REPRESENTATION IS PRESUMED.

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The undersigned _____,
(insert name(s) of Licensee undertaking dual representation)
("Licensee"/"Buyer's Designated Agent"), may undertake a dual representation (represent both the seller or landlord and the buyer or tenant) for the sale or lease of property. The undersigned acknowledge they were informed of the possibility of this type of representation. Before signing this document please read the following:

Representing more than one party to a transaction presents a conflict of interest since both clients may rely upon Licensee's advice and the client's respective interests may be adverse to each other. Licensee will undertake this representation only with the written consent of ALL clients in the transaction.

Any agreement between the clients as to a final contract price and other terms is a result of negotiations between the clients acting in their own best interests and on their own behalf. You acknowledge that Licensee has explained the implications of dual representation, including the risks involved, and understand that you have been advised to seek independent advice from your advisors or attorneys before signing any documents in this transaction.

WHAT A LICENSEE CAN DO FOR CLIENTS WHEN ACTING AS A DUAL AGENT

1. Treat all clients honestly.
2. Provide information about the property to the buyer or tenant.
3. Disclose all latent material defects in the property that are known to the Licensee.
4. Disclose financial qualification of the buyer or tenant to the seller or landlord.
5. Explain real estate terms.
6. Help the buyer or tenant to arrange for property inspections.
7. Explain closing costs and procedures.
8. Help the buyer compare financing alternatives.
9. Provide information about comparable properties that have sold so both clients may make educated decisions on what price to accept or offer.

WHAT LICENSEE CANNOT DISCLOSE TO CLIENTS WHEN ACTING AS A DUAL AGENT

1. Confidential information that Licensee may know about a client, without that client's permission.
2. The price or terms the seller or landlord will take other than the listing price without permission of the seller or landlord.
3. The price or terms the buyer or tenant is willing to pay without permission of the buyer or tenant.
4. A recommended or suggested price or terms the buyer or tenant should offer.
5. A recommended or suggested price or terms the seller or landlord should counter with or accept.

If either client is uncomfortable with this disclosure and dual representation, please let Licensee know. You are not required to sign this section unless you want to allow the Licensee to proceed as a Dual Agent in this transaction.

By initialing here and signing below, you acknowledge that you have read and understand this form and voluntarily consent to the Licensee acting as a Dual Agent (that is, to represent BOTH the seller or landlord and the buyer or tenant) should that become necessary.

_____	_____	_____
Buyer's Initials	Buyer's Initials	Date

SECTION 8: COMPENSATION
Broker and Buyer expect that Broker's commission will be paid by the seller or the seller's broker for Broker's acting as a cooperating agent. However, if Broker is not compensated by seller or seller's broker, or if the amount of compensation paid by seller or seller's broker is not at least_____ % of the purchase price, then Buyer agrees to pay Broker the difference between_____% of the purchase price and what seller or seller's broker actually paid. This Section applies if the Buyer, as a result of Buyer's Designated Agent's efforts and during the term of the Broker's representation on Buyer's behalf, enters into a contract to acquire real estate and such contract results in a closed transaction. Any modification to this Section, including the commission to be paid to Broker, shall be by a separate written amendment to this Contract.

SECTION 9: PREVIOUS REPRESENTATION
Buyer understands that Broker and/or Designated Agent may have previously represented the seller from whom you wish to purchase the property. During the representation, Broker and/or Designated Agent may have learned material information about the seller that is considered confidential. Under the law, neither Broker nor Designated Agent may disclose any such confidential information to you.

SECTION 10: FAILURE TO CLOSE
If a seller or lessor in an agreement made on behalf of Buyer fails to close such agreement, with no fault on the part of the Buyer, the Buyer shall have no obligation to pay the commission provided for in Section 8. If such transaction fails to close because of any fault on the part of Buyer, such commission will not be waived, but will be due and payable immediately. In no case shall Broker or Buyer's Designated Agent be obligated to advance funds for the benefit of Buyer in order to complete a closing.

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SECTION 11: DISCLAIMER
The Buyer acknowledges that Broker and Buyer's Designated Agent are being retained solely as real estate professionals, and not as attorneys, tax advisors, surveyors, structural engineers, home inspectors, environmental consultants, architects, contractors, or other professional service providers. The Buyer understands that such other professional service providers are available to render advice or services to the Buyer, if desired, at Buyer's expense.

SECTION 12: COSTS OF THIRD PARTY SERVICES OR PRODUCTS
Buyer agrees to reimburse Broker for the cost of any products or services such as surveys, soil tests, title reports and engineering studies, furnished by outside sources immediately when payment is due.

SECTION 13: INDEMNIFICATION OF BROKER
Buyer agrees to indemnify Broker and Buyer's Designated Agent and to hold Broker and Buyer's Designated Agent harmless on account of any and all loss, damage, cost or expense, including attorneys' fees incurred by Broker or Buyer's Designated Agent, arising out of this Contract, or to the collection of fees or commission due Broker pursuant to the terms and conditions of this Contract, provided the loss damage, cost, expense or attorneys' fees do not result because of Broker's or Buyer's designated Agent's own negligence or willful and wanton misconduct.

SECTION 14: ASSIGNMENT BY BUYERS
No assignment of Buyer's interest under this Contract and no assignment of rights in real property obtained for Buyer pursuant to this Contract shall operate to defeat any of Broker's rights under this Contract.

SECTION 15: NONDISCRIMINATION
THE PARTIES UNDERSTAND AND AGREE THAT IT IS ILLEGAL FOR EITHER OF THE PARTIES TO REFUSE TO DISPLAY OR SELL SELLER'S PROPERTY TO ANY PERSON ON THE BASIS OF RACE, COLOR, RELIGION, SEX, NATIONAL ORIGIN, ANCESTRY, AGE, ORDER OF PROTECTION STATUS, MARITAL STATUS, PHYSICAL OR MENTAL HANDICAP, MILITARY STATUS, SEXUAL ORIENTATION, UNFAVORABLE DISCHARGE FROM MILITARY SERVICE, FAMILIAL STATUS OR ANY OTHER CLASS PROTECTED BY ARTICLE 3 OF THE ILLINOIS HUMAN RIGHTS ACT. THE PARTIES AGREE TO COMPLY WITH ALL APPLICABLE FEDERAL, STATE AND LOCAL FAIR HOUSING LAWS.

SECTION 16: MODIFICATION OF THIS AGREEMENT
No modification of any of the terms of this Contract shall be valid and binding upon the parties or entitled to enforcement unless such modification has first been reduced to writing and signed by the parties.

SECTION 17: ENTIRE AGREEMENT
This Contract constitutes the entire agreement between the parties relating to the subject thereof, and any prior agreements pertaining hereto, whether oral or written have been merged and integrated into this Contract.

This Contract may be executed in multiple copies and my signature as Buyer hereon acknowledges that I have received a signed copy.

SAMPLE

_____
Buyer

_____
Buyer

Buyer's Address:
_____
_____

Date:_____

Accepted by:

_____, Broker

BY:_____ DATE: _____

_____ DATE: _____
Buyer's Designated Agent

PHONE:_____OFFICE:_____

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Real Success

Listing agreements and buyer brokerage agreements create a relationship between the **seller** or **buyer** and **sponsoring broker**, not the designated broker, even if that is the person who worked with the seller to get a listing or buyer brokerage agreement. The designated broker simply executes the contract on behalf of the sponsoring broker from a legal standpoint.

For example, if you have active listings and decide to leave your firm, it's important to remember **your listings belong to the sponsoring broker** and they stay with the sponsoring broker. Similarly, if you are working with a buyer client and change brokerages, that buyer client is no longer ***your*** client. If the client decides to sign a new agreement with your new sponsoring broker, you should make certain you don't put your client in a position where he has an obligation to two different sponsoring brokers for a commission.

One exception to this may be if an agent has a sale pending. Some employee agreements with sponsoring brokers allow the sponsoring broker to pay earned commission to an agent for pending transactions that close after the agent leaves the brokerage.

Illinois Requirements

The State of Illinois has set forth requirements for listing agreements and buyer brokerage agreements in both the Illinois Real Estate License Act and in the Administrative Rules of the Illinois Department of Financial and Professional Regulation.

Exclusive Agreements

Recall that all **exclusive** brokerage agreements, including all exclusive listing agreements and exclusive buyer brokerage agreements, must be **in writing** and must indicate the **minimum services** that must be provided by the sponsoring broker (225 ILCS 454/15-75):

- Accept delivery of and present to the client offers and counteroffers to buy, sell, or lease the client's property or the property the client seeks to purchase or lease
- Assist the client in developing, communicating, negotiating, and presenting offers, counteroffers, and notices that relate to the offers and counteroffers until a lease or purchase agreement is signed and all contingencies are satisfied or waived
- Answer the client's questions relating to the offers, counteroffers, notices, and contingencies

Failure to include language in a brokerage agreement providing for minimum services as defined or language in the brokerage agreement **waiving** those minimum services will result in the brokerage being considered to be **non-exclusive**.

General Requirements

All brokerage agreements must contain a provision for **automatic expiration**, or they are otherwise void. Brokerage agreements may **not** contain a clause that automatically extends the period of the contract.

The following are among the other general requirements related to brokerage agreements in the State of Illinois:

Commission

Every written brokerage agreement must expressly provide that no amendment or alteration to the terms, with respect to the amount of commission or with respect to the time of payment of commission, is valid or binding unless made in writing and signed by the parties. Furthermore, a real estate contract, such as a purchase agreement, **cannot** be used to change previously agreed commission payment terms.

If a listing agreement provides that, in the event of a default by a buyer, the broker's full commission or fees will be paid out of an earnest money deposit, with the remainder of the earnest money to be paid to the seller, the provision shall appear in the listing agreement in letters larger than those generally used in the listing agreement.

Fair Housing

Each brokerage agreement must clearly state that it is illegal for either the owner or the broker to refuse to display or sell to any person because of one's membership in a protected class, e.g., race, color, religion, national origin, sex, ancestry, age, marital status, physical or mental handicap, familial status, sexual orientation, unfavorable discharge from the military service, order of protection status or any other class protected by Article 3 of the Illinois Human Rights Act.

Remember: With or without a broker, **discrimination is against the law**. When meeting with a client, it is important to review the fair housing language. When encountering clients who say they know the rules, but still do not intend to comply, walk away. Brokers are always liable for fair housing violations.

Future Brokerage Agreements

A broker may discuss a possible future brokerage agreement with a consumer whose property is exclusively listed with another broker or who is subject to a written exclusive buyer brokerage agreement only under the following conditions:

- The consumer initiates the contact; or
- The current broker, upon request, fails to provide, within 10 calendar days, the type and expiration date of the brokerage agreement between the consumer and the current broker. The request and response must be in writing and mailed return receipt requested. If this information is not received within 14 calendar days, the broker may then contact the consumer *only* if this information cannot be obtained from another source of shared broker information.

Broker Protection

Rules: Section 1450.770

Most exclusive brokerage agreements contain a broker protection clause that covers a certain period after the agreement expires. A **broker protection clause** *provides that the broker is still entitled to a commission if the property is sold during a specified time period, and the buyer is someone the broker negotiated with during the listing term*. In some cases, the language might indicate "to whom the broker has exposed the property." Brokers should always provide sellers with a list of prospects she introduced to the property. If the seller is not aware the buyer is someone the broker worked with, he may not have to pay the commission.

Note, however, that in Illinois, any brokerage agreement for a residential property of **four units or less** that provides for a protection period subsequent to its termination date must also provide that no commission or fee will be due under the terms of the brokerage agreement if, during the protection period, a valid, written brokerage agreement is entered into with **another licensed real estate broker**.

Permission to Contact

Though not required, a typical rider attached to agency agreements is an endorsement that states the specific terms under which the broker or representative of the broker may **contact** the client.

ILLINOIS ASSOCIATION OF REALTORS®

RIDER TO BROKERAGE AGREEMENTS

The undersigned buyer/seller agrees that _____, Brokerage Company hereinafter referred to as "Broker" and any authorized representative or agent of Broker are hereby given express consent to contact the undersigned by telephone, facsimile transmission or electronic mail at the following locations, addresses and/or telephone numbers.

_____ _____
Print Name Signature

_____ _____
Print Name Signature

_____ _____ _____ _____
Telephone Number(s) Facsimile Number(s)

_____ _____
e-mail Addresses

Form 351 10/29/03

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Rental Finding Service

Rules: Section 1450.785

In Illinois, a **rental finding service** is any business that finds, attempts to find, or offers to find—for any person who pays or is obligated to pay a fee or other valuable consideration:

- A unit of residential rental real estate, or
- A lessee to occupy a unit of residential rental real estate.

Any person, corporation, limited liability company, partnership, or limited partnership that operates a rental finding service must be licensed under the provisions of the Illinois Real Estate License Act, unless otherwise exempt.

Contract for Finding Rental Units

In the case of a rental finding service that finds, offers, or attempts to find a unit of rental real estate for an individual, a rental finding service must enter into a **written contract** with that person prior to accepting a fee or other valuable consideration for the services. As with other signed contracts, the consumer must receive an individual copy. The contract must include, at a minimum, the following provisions:

- The **term** of the contract
- The total **amount to be paid** for the services to be performed and a clear designation of the amount paid in advance of the performance of the services
- A statement regarding the **refund** or **nonrefund** of the fee paid in advance that shall include the precise conditions, if any, upon which a refund is based, the fact that the conditions must occur within 90 days from the date of the contract, and the fact that the refund must be paid no later than 10 days after demand, provided the check has been honored (this statement must be in larger type than that of the rest of the contract)
- The **type** of rental unit desired, the **geographical area** requested, and the **rent** the prospective tenant is willing to pay
- A detailed statement of rental finding **services** to be performed by the licensee, which, at a minimum is the delivery to the prospective tenant of all required rental information
- A statement that the contract is null and void if information concerning possible rental units or locations is **not current or accurate**
- A statement that information furnished by the licensee concerning possible rental units may be up to **two days old**
- A statement requiring the licensee to refund all fees paid in connection with the contract if the contract is null and void for any reason with **no conditions** for the refund and a statement of **when** the refund will be paid

Rental Unit Information Disclosure

The following written information for each rental unit is required to be provided to the person with whom the contract is entered:

- The **name, address,** and the **telephone number** of the owner of each rental unit or the owner's authorized agent
- A **description** of the rental unit
- The amount of **rent** requested
- The amount of **security deposit** required
- A statement describing **utilities** that are located in the rental unit and included in the rent
- The **occupancy date** and the **term** of lease
- A statement setting forth the **source** of the rental information (i.e., owner, agent)
- All other information that may reasonably be expected to be of concern to the prospective tenant

Handling Earnest Money

As you know, real estate licensees bear a great deal of fiduciary responsibility. Real estate is often the single most expensive purchase of someone's life, and consumers need to know that they can trust their broker with their money. It is a clear violation of law for a licensee to fail to account for or fail to remit money that comes into their possession from others. Brokers specifically are also in violation if they fail to maintain funds as indicated by law.

An **earnest money deposit** made with an offer to purchase is *not* consideration. In fact, earnest money is not required for an offer. Instead, earnest money is *an inducement to have the buyer's offer accepted and a means of showing the seller the buyer is serious and able to follow through with the financing necessary to buy the property.* The amount of deposit on any given transaction, if any, is determined between the buyer and seller in the terms of the sales agreement itself. However, most brokerages like to get the largest deposit that a buyer is willing to commit, because it usually holds the deal more tightly together. In some cases, the amount of the deposit could be a factor in whether or not an offer is accepted, especially if more than one offer is presented to the seller. For instance, if Brian has 10% to put down and Jane has 20%, that makes Jane more secure and, theoretically, makes her offer more attractive.

Earnest money may be presented to the buyer's broker to hold, or it may be the **listing broker** who actually escrows the deposit money if both the buyer and seller agree. In some cases, the earnest money deposit may even be made to a third party, such as an attorney or the title company, instead of the brokerage itself.

Earnest money constitutes escrow moneys whether in the form of personal checks, cashier's checks, money orders, cash, or any other forms of legal tender. Once earnest money has been presented, it **must** be placed into an escrow account until the **successful consummation of the transaction** or until the transaction is otherwise **terminated** and the funds are not in dispute.

Illinois Escrow Account Basics

Rules: Section 1450.750

Illinois has specific requirements for a sponsoring broker's required escrow account. For example, Illinois law requires that an escrow account be in a **Federally-insured** depository, **separate and apart** from other business or personal accounts. A sponsoring broker may maintain more than one escrow account. Branch offices may maintain records separately or transmit all escrow moneys to the main office (though never to another branch office).

Interest. Unless otherwise directed in writing by both parties to the contract, or the character of the deposit is such that payment of interest on the escrow account is otherwise required by law, it should be in a **non-interest bearing** account. If an interest bearing account is required, the recipient of the interest must be specifically indicated, in writing, by the principals of the transaction. Note that although not required, escrow accounts are generally maintained in a **demand account**, which means that the account holder has instant access to the funds in the account with no advance notice or no penalties for withdrawal.

Timing of Deposit. When an employed licensee receives earnest moneys from a client or customer, that deposit should be **promptly** given to his or her sponsoring broker. Once a broker accepts the deposit, he is responsible for it until its disbursement. If the earnest money is given in cash, the sponsoring broker must provide a receipt to the payor and retain a copy of that receipt. The sponsoring broker must deposit all escrow moneys into the escrow account no later than the **next business day that the depository is open** following the transaction. A transaction exists once an accepted real estate contract is signed or a lease agreed to.

Notification. A sponsoring broker serving as escrow agent must notify all principals in writing:

- If a principal fails to tender escrow moneys.
- When a principal's payment as escrow moneys is dishonored by the financial institution on which it was drawn.
- When there appears on the face of the governing contract to be a deficiency in the amount on deposit.

Maintenance and Disbursement. Sponsoring brokers must maintain escrow moneys on deposit until a transaction is consummated or terminated, then should only disburse moneys according to the terms of the contract and no later than the **next business day** after receiving notice of consummation or termination, assuming the funds have been honored by the payor's depository. Note that a sponsoring broker cannot withhold, for any period of time, an authorized disbursement of escrow moneys due to any claim for a commission or compensation to any licensee.

Commingling and Conversion

As indicated, an escrow account should contain *only* escrow monies received with any real estate transaction. If a broker had one penny of personal money over what might be necessary and documented to simply maintain that escrow account and avoid incurring service charges, it would be considered commingling of funds. **Commingling** is the *illegal mixing of money that is held in trust on behalf of a client with the brokerage firm's funds.*

Commingling is specifically prohibited in Illinois (Rules: Section 1450.750 (b) (6)). The issue with commingling of funds is that the trust account must be accessible at all times so that the client's money can be returned to them as needed. Trust account funds must **always** be separate and distinct from the firm's general business accounts.

Another illegal act that could arise from mismanagement of a trust account is **conversion.** This occurs if a broker were to use any of the client's money maintained in the trust account for personal or brokerage expenses. Another word for conversion might simply be "stealing."

Real Success

You might want to think of an escrow account as a safe in which to temporarily park money that belongs to someone else, but you're not yet sure who will actually get the money until sometime down the road. For example, a buyer hands over a deposit check that will go to the seller at settlement. It's the seller's money, right? What if the deal falls through? Is it the seller's money, or is it still the buyer's money?

And you're probably familiar with the security deposit that a renter pays to a landlord. Who does that money belong to? The landlord? The tenant? Well, you won't really know until the conclusion of the lease and the landlord determines if there are damages or unpaid rent or utility bills.

In both cases, the one thing you can be sure of is that the money does ***not*** belong to the real estate broker or the property manager. That's why those funds must go into an escrow account: It protects the interests of all parties to the transaction.

Disputes over Earnest Money

Rules: Section 1450.750-755

What happens if a deal falls through before closing? Should the buyer get all of his or her earnest money back? Or does he forfeit it? Is the seller entitled to some or all of the deposit to compensate them for the inconvenience of having the transaction fall through? Think about a seller who may have a contract on another house contingent on the sale of his house, for example. Isn't he entitled to be reimbursed for his pain and suffering? Sometimes it may be necessary to fight it out.

Of course, the purchase agreement should specify what happens to any earnest money in the event that one of the parties backs out of the deal. For example, if the buyer defaults, the earnest money deposit is forfeited to the seller. This is a type of **liquidated damages** provision. The seller keeps the deposit instead of suing for breach of contract.

In Illinois, when both a buyer and a seller assert claim to the earnest money deposit, the broker should maintain the funds in the escrow account until:

- Both parties agree, in writing, how to proceed, in which case, the escrow moneys must be disbursed according to those terms no later than the next business day after receiving the last required **written release**.
- A **civil action** is filed either by the sponsoring broker or one of the parties, in which case the payment may be made into court for disbursement in accordance with the court's final judgment. A sponsoring broker who files an **interpleader action** with the court to settle a dispute may be entitled to withdraw amounts from the escrow account to cover the costs of filing that action.
- The funds are turned over to the **State Treasurer** or other appropriate State agency or officer because of inactivity in the account, inability to locate the parties, or inability of the parties to reach a resolution.

Record Keeping

Sponsoring brokers in Illinois are required to maintain in his or her office or place of business, a bookkeeping system to document the escrow accounts. Among the minimum requirements are the following:

- A **journal** showing the **chronological sequence** of funds received and disbursed, including a running balance.
- A **ledger** separated to show the receipt and disbursement of all funds affecting a **single particular transaction**.
- A **monthly reconciliation statement** that must be updated within 10 days after receipt of the monthly bank statement. This must be maintained for at least **five years** from the last day of the month covered by the reconciliation.
- A **master escrow account log** that identifies all escrow bank account numbers, as well as the name and address of the bank.

A sponsoring broker may **delegate** these bookkeeping duties to another person, including a managing broker, a bookkeeper, certified public accountant, unlicensed or licensed assistant or sponsored licensee. However, compliance with the bookkeeping duties remains the responsibility of the sponsoring broker, who must also institute **office policies** to ensure that the sponsored licensees tender escrow moneys received in compliance with Illinois law. Sponsored licensees may **not** maintain their own escrow accounts.

Maintenance

All escrow records and related documents must be maintained for **five years**. Records for the most previous **two years** must be maintained at the office location and must be made available to the Department **within 24 hours** of a request by Department personnel. Records older than two years old may be stored at an offsite location, either in hard copy form or electronically. These must be made available for inspection during normal business hours as soon as available, but no later than within **30 days** after the request.

Electronic Records

All records may be kept either in hard copy or electronically. If the records are kept electronically, the sponsoring broker must ensure that a back up is made at reasonable intervals so as to protect the data but no less frequently than monthly. Backups can be kept either at the sponsoring broker's office or offsite. The escrow journal shall be reduced to hard copy at least monthly and kept at the office of the sponsoring broker for 60 days.

Summary

1. A listing agreement or buyer (or tenant) representation agreement is considered an **employment contract** and creates an agency relationship. These contracts can be exclusive or non-exclusive. Most exclusive listing agreements contain a broker protection clause that covers a certain period after the listing expires and provides that the broker is still entitled to a commission if the property is sold during that time period under certain circumstances. In Illinois, exclusive contracts **must be in writing** and must list the minimum services related to offers, counteroffers, notices, and contingencies.
2. An **exclusive right to sell listing agreement** provides for commission to the broker when a ready, willing, and able buyer is found, no matter who procures the buyer. An **exclusive agency agreement** provides for commission to the broker when a ready, willing, and able buyer is found, unless it is the seller who procures the buyer. **Open listing agreements** are non-exclusive; commission is earned only by the broker who is the procuring cause of the sale. **Net listing agreements** are not listings, but a method of compensation. They are **illegal** in most states.
3. All listing agreements in Illinois must contain: List **price**, amount and timing of **commission**, **duration** with definite **end date**, **name** of sponsoring broker and seller, **property** identification, **signatures**, **duties** of the listing broker.
4. When a buyer exclusively engages a broker, it is known as **buyer brokerage**. Buyer agency agreements—also called buyer representation agreements, among other names—compensate the broker for finding a property for the buyer. Buyer agency agreements can be exclusive or non-exclusive. All buyer brokerage agreements in Illinois must contain: Agreed amount and timing of **compensation**, **duration** of the agreement, **name** of sponsoring broker and buyer, **signatures**, **duties** of the buyer's broker.
5. Brokerage agreements in Illinois: Cannot contain an automatic extension clause; cannot alter agreed to commission without express written consent of all parties; must include information about housing discrimination against members of the protected classes.
6. A **rental finding service** is any business that finds, attempts to find, or offers to find, for any person who pays or is obligated to pay a fee or other valuable consideration, a unit of residential rental real estate, or finds a lessee to occupy a unit of residential rental real estate. Any person, corporation, limited liability company, partnership, or limited partnership operating a rental finding service must be a real estate licensee, unless exempt. A **written contract** is required when the service is finding rental space for a paying client prior to accepting a fee or other valuable consideration for the services.
7. An **earnest money deposit** is an inducement to have the buyer's offer accepted and a means of showing the seller the buyer is serious and able to follow through with the financing necessary to buy the property. Once earnest money has been presented, it **must** be placed into an escrow account until the **successful consummation of the transaction** or until the transaction is otherwise **terminated** and the funds are not in dispute.
8. Sponsoring brokers must maintain escrow accounts, which must be separate from the regular business account of the brokerage. They must be in a Federally-insured depository. Both parties can agree in writing to place the funds in an interest-bearing account.
9. Failure to uphold the fiduciary obligation of accounting for clients' earnest money can take many forms: Failing to deposit earnest money into the escrow account **by the next business day** after receipt; commingling, or failing to maintain an escrow account separate from broker funds; conversion, or stealing, by using client funds for personal use or putting deposit money into the broker's general account; failing to keep complete and accurate records of all escrow account transactions, failing to make records available for review by the Department as requested.

Quiz

1. ***When a property is listed, it is***
   a. an offer to sell.
   b. an option to purchase.
   c. a solicitation of offers to buy.
   d. a unilateral promise to sell.

2. ***In a typical listing agreement, the agent's consideration is***
   a. delivering a ready and willing buyer.
   b. due diligence in marketing the property for sale.
   c. placing the listing in the MLS.
   d. the promise to find a buyer.

3. ***The seller lists her house with New Age Realty. The next day, the seller goes to work and mentions listing her house. A co-worker expresses interest in the listing. What kind of listing would entitle the broker to a commission if the co-worker makes an offer acceptable to the seller?***
   a. exclusive agency
   b. exclusive right to sell
   c. open listing
   d. No agreement would entitle a broker to commission under these circumstances.

4. ***Goldberg lists his home with PDQ Realty, allowing them to put a sign in the yard, list it in MLS, and advertise it in the local newspaper. During the listing period, Goldberg sells the home to his brother and is not obligated to pay PDQ any commission. What type of listing did Goldberg have with PDQ?***
   a. exclusive agency
   b. net listing
   c. non-exclusive right to sell
   d. open listing

5. ***Broker Alex sees an ad in a local brochure that a seller is offering property for sale by owner with a 3% fee to any broker who brings in a buyer. Alex asks the seller if he can show the property to a buyer. What type of listing has the seller offered?***
   a. exclusive agency agreement
   b. exclusive right to sell listing
   c. net listing
   d. open listing

6. ***Which statement about brokerage agreements in Illinois is FALSE?***
   a. All brokerage agreements must indicate the duration of the agreement.
   b. All brokerage agreements must list the protected classes.
   c. All brokerage agreements must list the minimum services provided by the sponsoring broker.
   d. No brokerage agreement may contain an automatic extension clause.

7. ***Terry is looking to purchase his first house. He has a contract with a broker to help him find a house and represent his interests throughout the purchase process. What type of contract is this?***
   a. broker employment agreement
   b. buyer agency agreement
   c. option to buy agreement
   d. purchase agreement

8. ***Agent Amy of Rob Realty worked closely with seller Stu and finally got him to sign a listing agreement for one year. Six months later, Amy transfers her license to Paula Properties. What happens to Stu's listing?***
   a. Amy automatically takes the listing with her to Paula Properties.
   b. The listing remains with Rob Realty.
   c. Rob can sell the listing to Paula.
   d. Stu has the option to let Amy take the listing or leave it with Bob.

9. ***Broker Jack has deposited commission checks from several settlements totaling $46,900 into the agency's escrow account. This is an example of***
   a. commingling.
   b. compensation.
   c. consideration.
   d. conversion.

10. ***Which statement about escrow accounts in Illinois is FALSE?***
    a. Account records must be maintained for at least five years.
    b. The account must be in a Federally-insured depository.
    c. The account must provide interest on any funds held more than six months.
    d. The account must be separate from the brokerage business account.

11. ***Who is the beneficiary of the funds deposited in escrow account?***

    a. the listing broker
    b. the lender providing the mortgage
    c. the seller
    d. the title agency conducting the closing

12. ***Broker Dana receives an earnest money check from a buyer. When must that check be deposited into the sponsoring broker's escrow account?***

    a. that day
    b. the next business day
    c. within 2 business days
    d. when the transaction closes



16 Contracts for Selling Property

Purchase agreements *are contracts in which a seller promises to convey title to real property to a buyer in exchange for the purchase price*. In some areas, these are may be called purchase contracts, sale contracts, earnest money agreements, and other similar terms. Whatever the name, it is the agreement **between the buyer and seller** reduced to writing. Typically, a purchase agreement for real property is the final product of negotiations between attorneys or agents representing buyers and seller, not the parties to the transaction themselves. In this chapter, you will have the opportunity to examine a sample purchase agreement and understand its provisions. You will see how the back and forth process of offer and counteroffer can eventually result in a **meeting of the minds**, which is one of the essential elements of a valid contract.

You will learn:

- Provisions in a typical purchase agreement.
- The impact of addendums, conditions, and contingencies.
- Considerations for presenting and negotiating offers.
- The purpose and use of other types of sales-related contracts.

Key Terms

Acceptance
Contemporaneous Offer
Contingency
Counteroffer
Installment Sales Contract / Land Contract / Contract for Deed
Lease / Purchase
Meeting of the Minds
Offer
Proprietary Lease
Purchase Agreement

Purchase Agreements

A **purchase agreement** usually serves these purposes:

- It is the buyer's initial **offer** (and subsequent counteroffers).
- It is the **receipt** for any earnest money deposit.
- It is the **contract** between the buyer and seller.
- It establishes the **terms** and **conditions** of the sale.
- It communicates the details of the transaction to the mortgage lender, title company, and any other party to the transaction.

Essential Elements of a Purchase Agreement

By law, purchase agreements must be **in writing** and must be **signed** by all parties to the contract. At the very least, the purchase agreement should identify the parties, the property, and the interest to be sold. Ideally, it will state all terms of the sale as clearly as possible, including:

- **Parties** to the contract, the buyer(s) and seller(s).
- **Property** to be sold, which is usually just the address of the property but may include (or require) a detailed legal description.
- **Interest** in the property to be sold (for example, all of the bundle of rights, just subsurface rights, etc.).
- **Terms** of the sale as clearly as possible (what is and isn't included in the sale).
- Total purchase **price** and method of payment, for example, the mortgage-related information.
- Critical **dates** related to the contract, such as those for clearing contingencies or closing dates.

Standardized Purchase Agreements

While the State of Illinois does not dictate the use of a specific form for sales agreements, it's critical to note that the law prohibiting real estate licensees from dispensing legal advice applies to contracts. However, as a result of the 1966 decision by the Illinois Supreme Court in the case of ***Chicago Bar Association, et al. v. Quinlan and Tyson*** (usually referred to simply as "Quinlan and Tyson"), real estate licensees are allowed to use acceptable pre-printed "fill-in-the-blank" purchase agreements. Generally, an acceptable form is one that has been written and approved by local bar associations in conjunction with REALTOR® associations. The rationale behind these broker-completed contracts is that they speed up the process, moving the buyer and seller to closing more quickly. This ruling applies only to purchase agreements. Licensees are *not* permitted to prepare or complete any other legal documents relating to the sale (e.g., deeds, bills of sale, mortgages, promissory notes, etc.).

Rules on Written Agreements

Rules: Section 1450.775

Let's review the rules on **written agreements** in the State of Illinois, according to Part 1450 of the **Rules of the Department of Financial and Professional Regulation**:

- No licensee shall solicit, accept, or execute any contract or other document relating to a real estate transaction that contains any blanks with the intention of filling them in after signing or initialing the contract or other document.
- No licensee shall make any addition to, deletion from, or alteration of any signed contract or other document relating to a real estate transaction without the written, telefax, or telegraphic consent or direction from all signatories.
- No licensee shall process any contract or other document that has been altered after being signed, unless each addition, deletion or alteration is signed or initialed by all signatories at the time of the addition, deletion, or alteration.
- A **true copy** of the original or corrected contract or other document relating to a real estate transaction shall be delivered or mailed **within 24 hours** after the time of signing or initialing the original or correction to the person signing or initialing the contract or other document.
- All forms used by licensees intended to become binding real estate contracts shall clearly state that fact in the heading in large bold type. No licensee shall use a form designated Offer to Purchase when it is

intended that the form shall be a binding real estate contract.

CHICAGO ASSOCIATION OF REALTORS®
RESIDENTIAL REAL ESTATE PURCHASE AND SALE CONTRACT
(single family home/fee simple townhome)

Rev. 01/2008

1. Contract. This Residential Real Estate Purchase and Sale Contract ("***Contract***") is made by and between _____ ("***Buyer***") and _____ ("***Seller***") (collectively, "***Parties***"), with respect to the purchase and sale of the real estate and improvements located at _____ ("***Property***").
(address) (unit #) (city) (state) (zip)
Property P.I.N. #:_____. Lot size:_____. Approximate square feet of Property:_____.

2. Fixtures and Personal Property. At Closing (as defined in Paragraph 7 of this Contract), in addition to the Property, Seller shall transfer to Buyer by a Bill of Sale, all heating, cooling, electrical and plumbing systems, together with the following checked and enumerated items ("***Fixtures and Personal Property***"):

☐ Refrigerator___	☐ Sump Pump___	☐ Central air conditioner__	☐ Fireplace screen and equipment___	☐ Built-in or attached shelves or cabinets___
☐ Oven/Range___	☐ Smoke and carbon monoxide detectors__	☐ Window air conditioner__		
☐ Microwave___		☐ Electronic air filter___	☐ Fireplace gas log___	☐ Ceiling fan___
☐ Dishwasher___	☐ Intercom system___	☐ Central humidifier___	☐ Firewood___	☐ Radiator covers___
☐ Garbage disposal___	☐ Security system___ (rented or owned) (*strike one*)		☐ Attached gas grill__	☐ All planted vegetation__
☐ Trash compactor___	☐ Satellite Dish__	☐ Lighting fixtures___	☐ Existing storms and screens___	☐ Outdoor play set/swings__
☐ Washer__	☐ T.V. antenna___	☐ Electronic garage door(s) with ___ remote unit(s)__		☐ Outdoor shed__
☐ Dryer___	☐ LCD/plasma/multimedia equipment__		☐ Window treatments___	
☐ Water Softener__	☐ Stereo speakers/surround sound___	☐ Wall-to-wall carpeting__	☐ Home warranty (as attached)___	

Seller also transfers the following:_____. The following items are excluded:_____.

3. Purchase Price. The purchase price for the Property (including the Fixtures and Personal Property) is $_____ ("***Purchase Price***").

4. Earnest Money. Upon Buyer's execution of this Contract, Buyer shall deposit with _____ ("***Escrowee***"), initial earnest money in the amount of $_____, in the form of _____ ("***Initial Earnest Money***"). The Initial Earnest Money shall be returned and this Contract shall be of no force or effect if this Contract is not accepted by Seller on or before _____, 20____. The Initial Earnest Money shall be increased to ***(strike one)*** 10% of the Purchase Price **OR** $_____ ("***Final Earnest Money***") within _____ business days after the expiration of the Attorney Approval Period (as established in Paragraph 13 of this Contract) (the Initial and Final Earnest Money are together referred to as the "***Earnest Money***"). The Parties acknowledge and agree that (i) the Parties shall execute all necessary documents with respect to the Earnest Money in form and content mutually agreed upon between the parties and (ii) except as otherwise agreed, Buyer shall pay all expenses with respect to the Earnest Money.

5. Mortgage Contingency. This Contract is contingent upon Buyer securing by _____, 20_____ ("***First Commitment Date***") a firm written mortgage commitment for a fixed rate or an adjustable rate mortgage permitted to be made by a U.S. or Illinois savings and loan association, bank, or other authorized financial institution, in the amount of $_____, the interest rate (or initial interest rate if an adjustable rate mortgage) not to exceed _____% per year, amortized over _____ years, payable monthly, loan fee not to exceed _____%, plus appraisal and credit report fee, if any ("***Required Commitment***"). If the mortgage secured by the Required Commitment has a balloon payment, it shall be due no sooner than ____ years. Buyer shall pay for private mortgage insurance as required by the lending institution. If a FHA or VA mortgage is to be obtained, **Rider 8, Rider 9, or the HUD Rider** shall be attached to this Contract. (1) If Buyer is unable to obtain the Required Commitment by the First Commitment Date, Buyer shall so notify Seller in writing on or before that Date. Thereafter, Seller may, within 30 business days after the First Commitment Date ("***Second Commitment Date***"), secure the Required Commitment for Buyer upon the same terms, and may extend the Closing Date by 30 business days. The Required Commitment may be given by Seller or a third party. Buyer shall furnish all requested credit information, sign customary documents relating to the application and securing of the Required Commitment, and pay one application fee as directed by Seller. Should Seller choose not to secure the Required Commitment for Buyer, this Contract shall be null and void as of the First Commitment Date, and the Earnest Money shall be returned to Buyer. (2) If Buyer notifies Seller on or before the First Commitment Date that Buyer has been unable to obtain the Required Commitment, and neither Buyer nor Seller secures the Required Commitment on or before the Second Commitment Date, this Contract shall be null and void and the Earnest Money shall be returned to Buyer. (3) If Buyer does not provide any notice to Seller by the First Commitment Date, Buyer shall be deemed to have waived this contingency and this Contract shall remain in full force and effect.

6. Possession. Seller agrees to surrender possession of the Property on or before the Closing Date (as defined in Paragraph 7 below). If possession is not delivered on or prior to the Closing Date, then, Seller shall pay to Buyer at Closing $_____ per day ("***Use/Occupancy Payments***") for Seller's use and occupancy of the Property for each day after the Closing Date through and including the date Seller plans to deliver possession to Buyer ("***Possession Date***"). If Seller delivers possession of the Property to Buyer prior to the Possession Date, Buyer shall refund the portion of Use/Occupancy Payments which extend beyond the date possession is actually surrendered. Additionally, Seller shall deposit with Escrowee a sum equal to 2% of the Purchase Price ("***Possession Escrow***") to guarantee possession on or before the Possession Date, which sum shall be held from the net proceeds at Closing on Escrowee's form of receipt. If Seller does not surrender the Property on the Possession Date, Seller shall pay to Buyer, in addition to all Use/Occupancy Payments, the sum of 10% of the original amount of the Possession Escrow per day up to and including the day possession is surrendered to Buyer plus any unpaid Use/Occupancy Payments up to and including the date possession is surrendered, these amounts to be paid out of the Possession Escrow and the balance, if any, to be returned to Seller. Acceptance of payments by Buyer shall not limit Buyer's other legal remedies. Seller and Buyer hereby acknowledge that Escrowee shall not distribute the Possession Escrow without the joint written direction of Seller and Buyer. If either Party objects to disposition of the Possession Escrow, then Escrowee may deposit the Possession Escrow with the Clerk of the Circuit Court by the filing of an action in the nature of an Interpleader. Escrowee shall be reimbursed from the Possession Escrow for all costs, including reasonable attorneys' fees, related to the filing of the Interpleader, and the Parties shall indemnify and hold Escrowee harmless from any and all claims and demands, including the payment of reasonable attorneys' fees, costs, and expenses.

7. Closing. Buyer shall deliver the balance of the Purchase Price (less the amount of the Final Earnest money, plus or minus prorations and escrow fees, if any) to Seller and Seller shall execute and deliver the Deed (as defined below) to Buyer at "***Closing***". Closing shall occur on or prior to _____, 20_____ at a time and location mutually agreed upon by the Parties ("***Closing Date***"). Seller must provide Buyer with good and merchantable title prior to Closing.

Buyer Initials:_____ Buyer Initials:_____ Seller Initials:_____ Seller Initials:_____

SAMPLE

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8. Deed. At Closing, Seller shall execute and deliver to Buyer, or cause to be executed and delivered to Buyer, a recordable warranty deed ("***Deed***") with release of homestead rights (or other appropriate deed if title is in trust or in an estate), or Articles of Agreement, if applicable, subject only to the following, if any: covenants, conditions, and restrictions of record; public and utility easements; acts done by or suffered through Buyer; all special governmental taxes or assessments confirmed and unconfirmed; and general real estate taxes not yet due and payable at the time of Closing.

9. Real Estate Taxes. Seller represents that the 20_____ general real estate taxes were $_____. General real estate taxes for the Property are subject to the following exemptions ***(check box if applicable)***: ☐ Homeowner's. ☐ Senior Citizen's. ☐ Senior Freeze. General real estate taxes shall be prorated based on (i) _____% of the most recent ascertainable full year tax bill, or (ii) mutually agreed by the Parties in writing prior to the expiration of the Attorney Approval Period.

10. Property Subject to Homeowners Association. ***(If not applicable, strike this entire Paragraph)*** Seller represents that as of the Acceptance Date (as set forth following Paragraph 15 of this Contract), the regular monthly assessment pertaining to this unit is $_____; a special assessment (*strike one*) **has / has not** been levied. The original amount of the special assessment pertaining to this unit was $_____, and the remaining amount due at Closing will be $_____ and (*strike one*) **shall / shall not** be assumed by Buyer at Closing. Buyer acknowledges and agrees that (i) the representations in this Paragraph are provided as of the Acceptance Date; (ii) this information may change, and these fees may increase, prior to Closing; and (iii) Seller is under no obligation to notify Buyer of any changes to this information, and, should changes occur, this Contract shall remain in full force and effect. Notwithstanding anything to the contrary contained in this Paragraph 10, Seller shall disclose to Buyer any new assessment that is actually approved and levied prior to Closing no later than 5 days after Seller is notified of the new assessment (and in no event later than the Closing Date). Seller shall furnish Buyer a statement from the proper representative certifying that Seller is current in payment of assessments, and, if applicable, proof of waiver or termination of any right of first refusal or similar options contained in the bylaws of the Association for the transfer of ownership. Seller shall deliver to Buyer the items stipulated by the Illinois Condominium Property Act (765 ILCS 605/1 et seq.) ("***ICPA Documents***"), including but not limited to the declaration, bylaws, rules and regulations, and the prior and current years' operating budgets within _____ business days of the Acceptance Date. In the event the ICPA Documents disclose that the Property is in violation of existing rules, regulations, or other restrictions or that the terms and conditions contained within the documents would unreasonably restrict Buyer's use of the Property or would increase the financial considerations which Buyer would have to extend in connection with owning the Property, then Buyer may declare this Contract null and void by giving Seller written notice within 5 business days after the receipt of the ICPA Documents, listing those deficiencies which are unacceptable to Buyer, and thereupon all earnest money deposited shall be returned to Buyer. If written notice is not served within the time specified, Buyer shall be deemed to have waived this contingency, and this Contract shall remain in full force and effect. Seller agrees to pay any applicable processing/moveout/transferring fees as required by the Association, and Buyer agrees to pay the credit report and move-in fee if required by the Association. If the right of first refusal or similar option is exercised, this Contract shall be null and void and the Earnest Money shall be returned to Buyer, but Seller shall pay the commission pursuant to Paragraph V of the General Provisions of this Contract.

11. Disclosures. Buyer has received the following ***(check yes or no)***: (a) Residential Real Property Disclosure Report: ☐ Yes/☐ No; (b) Heat Disclosure: ☐ Yes/☐ No; (c) Lead Paint Disclosure and Pamphlet: ☐ Yes/☐ No; (d) Radon Disclosure and Pamphlet: ☐ Yes/☐ No; and (e) Zoning Certification ☐ Yes/☐ No.

12. Dual Agency. The Parties confirm that they have previously consented to _____ ("***Licensee***") to act as Dual Agent in providing brokerage services on behalf of the Parties and specifically consent to Licensee acting as Dual Agent on the transaction covered by this Contract.
Buyer Initials:_____ Buyer Initials:_____ Seller Initials:_____ Seller Initials:_____

13. Attorney Modification. Within _____ business days after the Acceptance Date ("***Attorney Approval Period***"), the Parties' respective attorneys may propose written modifications to this Contract ("***Proposed Modifications***") on matters other than the Purchase Price, broker's compensation and dates. Any Proposed Modifications that are set forth in writing and accepted by the other party shall become terms of this Contract as if originally set forth in this Contract. If, within the Attorney Approval Period, the Parties cannot reach agreement regarding the Proposed Modifications, then, at any time after the Attorney Approval Period, either Party may terminate this Contract by written notice to the other Party. In that event, this Contract shall be null and void and the Earnest Money shall be returned to Buyer. IN THE ABSENCE OF DELIVERY OF PROPOSED MODIFICATIONS PRIOR TO THE EXPIRATION OF THE ATTORNEY APPROVAL PERIOD, THIS PROVISION SHALL BE DEEMED WAIVED BY ALL PARTIES, AND THIS CONTRACT SHALL BE IN FULL FORCE AND EFFECT.

14. Inspection. Within ____ business days after the Acceptance Date ("***Inspection Period***"), Buyer may conduct, at Buyer's sole cost and expense (unless otherwise provided by law) home, radon, environmental, lead-based paint and/or lead-based paint hazards (unless separately waived), wood infestation, and/or mold inspections of the Property ("***Inspections***") by one or more properly licensed or certified inspection personnel (each, an "***Inspector***"). The Inspections shall include only major components of the Property, including, without limitation, central heating, central cooling, plumbing, well, and electric systems, roofs, walls, windows, ceilings, floors, appliances, and foundations. A major component shall be deemed to be in operating condition if it performs the function for which it is intended, regardless of age, and does not constitute a health or safety threat. Buyer shall indemnify Seller from and against any loss or damage to the Property or personal injury caused by the Inspections, Buyer, or Buyer's Inspector. Prior to expiration of the Inspection Period, Buyer shall notify Seller or Seller's attorney in writing ("***Buyer's Inspection Notice***") of any defects disclosed by the Inspections that are unacceptable to Buyer, together with a copy of the pertinent pages of the relevant Inspections report. Buyer agrees that minor repairs and maintenance costing less than $250 shall not constitute defects covered by this Paragraph. If the Parties have not reached written agreement resolving the inspection issues within the Inspection Period, then either Party may terminate this Contract by written notice to the other Party. In the event of such notice, this Contract shall be null and void and the Earnest Money shall be returned to Buyer. *IN THE ABSENCE OF WRITTEN NOTICE PRIOR TO EXPIRATION OF THE INSPECTION PERIOD, THIS PROVISION SHALL BE DEEMED WAIVED BY ALL PARTIES, AND THIS CONTRACT SHALL BE IN FULL FORCE AND EFFECT.*

15. General Provisions and Riders. **THIS CONTRACT WILL BECOME A LEGALLY BINDING CONTRACT WHEN SIGNED BY BUYER AND SELLER AND DELIVERED TO BUYER OR BUYER'S DESIGNATED AGENT.** THIS CONTRACT INCLUDES THE GENERAL PROVISIONS ON THE LAST PAGE OF THIS CONTRACT AND RIDERS _____ *(list Rider numbers here)* AND ADDENDUM _____ *(list Addendum numbers here)* ATTACHED TO AND MADE A PART OF THIS CONTRACT.

[SIGNATURE PAGE FOLLOWS]

SAMPLE

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OFFER DATE:_____ **20**_____ **ACCEPTANCE DATE:** _____**20**___ **("*Acceptance Date*")**

BUYER'S INFORMATION:

Buyer's Signature:_____

Buyer's Signature:_____

Buyer's Name(s) (print):_____

Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Home Phone:_____

Fax:_____ Cell Phone:_____

Email Address:_____

The names and addresses set forth below are for informational purposes only and subject to change.

BUYER'S BROKER'S INFORMATION:

Designated Agent (print):_____

Agent Identification Number:_____

Broker Name:_____ MLS #_____

Office Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Cell Phone:_____

Fax:_____

Email:_____

BUYER'S ATTORNEY'S INFORMATION:

Attorney Name:_____

Firm:_____

Office Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Cell Phone:_____

Fax:_____

Email:_____

BUYER'S LENDER'S INFORMATION:

Mortgage Broker's Name:_____

Lender:_____

Office Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Cell Phone:_____

Fax:_____

Email:_____

SELLER'S INFORMATION:

Seller's Signature:_____

Seller's Signature:_____

Seller's Name(s) (print):_____

Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Home Phone:_____

Fax:_____ Cell Phone:_____

Email Address:_____

The names and addresses set forth below are for informational purposes only and subject to change.

SELLER'S BROKER'S INFORMATION:

Designated Agent Name (print):_____

Agent Identification Number:_____

Broker Name:_____ MLS #_____

Office Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Cell Phone:_____

Fax:_____

Email: _____

SELLER'S ATTORNEY'S INFORMATION:

Attorney Name:_____

Firm:_____

Office Address:_____

City:_____ State:_____ Zip:_____

Office Phone:_____ Cell Phone:_____

Fax:_____

Email: _____

SAMPLE

Buyer Initials:_____ Buyer Initials:_____

Seller Initials:_____ Seller Initials:_____

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GENERAL PROVISIONS

A. Prorations. Rent, interest on existing mortgage, if any, water taxes and other items shall be prorated as of the Closing Date. Security deposits, if any, shall be paid to Buyer at Closing. Notwithstanding anything to the contrary contained in Paragraph 9 of this Contract, if the Property is improved as of the Closing Date, but the last available tax bill is on vacant land, Seller shall place in escrow an amount equal to **2%** of the Purchase Price and the Parties shall reprorate taxes within 30 days after the bill on the improved property becomes available.

B. Uniform Vendor and Purchaser Risk Act. The provisions of the Uniform Vendor and Purchaser Risk Act of the State of Illinois shall be applicable to this Contract.

C. Title. At least 5 days prior to the Closing Date, Seller shall deliver to Buyer or his agent evidence of merchantable title in the intended grantor by delivering a Commitment for Title Insurance of a title insurance company bearing a date on or subsequent to the Acceptance Date, in the amount of the Purchase Price, subject to no other exceptions than those previously listed within this Contract and to general exceptions contained in the commitment. Delay in delivery by Seller of a Commitment for Title Insurance due to delay by Buyer's mortgagee in recording mortgage and bringing down title shall not be a default of this Contract. Every Commitment for Title Insurance furnished by Seller shall be conclusive evidence of title as shown. If evidence of title discloses other exceptions, Seller shall have 30 days after Seller's receipt of evidence of title to cure the exceptions and notify Buyer accordingly. As to those exceptions that may be removed at Closing by payment of money, Seller may have those exceptions removed at Closing by using the proceeds of the sale.

D. Notice. All notices required by this Contract shall be in writing and shall be served upon the Parties or their attorneys at the addresses provided in this Contract. The mailing of notice by registered or certified mail, return receipt requested, shall be sufficient service when the notice is mailed. Notices may also be served by personal delivery or commercial delivery service, by mail-o-gram, telegram, or by the use of a facsimile machine with proof of transmission and a copy of the notice with proof of transmission being sent by regular mail on the date of transmission. In addition, facsimile signatures shall be sufficient for purposes of executing, negotiating, and finalizing this Contract. E-mail notices shall be deemed valid and received by the addressee when delivered by e-mail and opened by the recipient, provided that a copy of the e-mail notice is also sent by regular mail to the recipient on the date of transmission.

E. Disposition of Earnest Money. In the event of default by Buyer, the Earnest Money, less expenses and commission of the listing broker, shall be paid to Seller. If Seller defaults, the Earnest Money, at the option of Buyer, shall be refunded to Buyer, but such refunding shall not release Seller from the obligations of this Contract. In the event of any default, Escrowee shall give written notice to Seller and Buyer indicating Escrowee's intended disposition of the Earnest Money and request Seller's and Buyer's written consent to the Escrowee's intended disposition of the Earnest Money within 30 days after the notice. However, Seller and Buyer acknowledge and agree that if Escrowee is a licensed real estate broker, Escrowee may not distribute the Earnest Money without the joint written direction of Seller and Buyer or their authorized agents. If Escrowee is not a licensed real estate broker, Seller and Buyer agree that if neither Party objects, in writing, to the proposed disposition of the Earnest Money within 30 days after the date of the notice, then Escrowee shall proceed to dispense the Earnest Money as previously noticed by Escrowee. If either Seller or Buyer objects to the intended disposition within the 30 day period, or if Escrowee is a licensed real estate broker and does not receive the joint written direction of Seller and Buyer authorizing distribution of the Earnest Money, then the Escrowee may deposit the Earnest Money with the Clerk of the Circuit Court by the filing of an action in the nature of an Interpleader. Escrowee may be reimbursed from the Earnest Money for all costs, including reasonable attorney's fees, related to the filing of the Interpleader and the Parties indemnify and hold Escrowee harmless from any and all claims and demands, including the payment of reasonable attorneys' fees, costs, and expenses arising out of those claims and demands.

F. Operational Systems. Seller represents that the heating, plumbing, electrical, central cooling, ventilating systems, appliances, and fixtures on the Property are in working order and will be so at the time of Closing and that the roof is free of leaks and will be so at the time of Closing. Buyer shall have the right to enter the Property during the 48-hour period immediately prior to Closing solely for the purpose of verifying that the operational systems and appliances serving the Property are in working order and that the Property is in substantially the same condition, normal wear and tear excepted, as of the Acceptance Date.

G. Insulation Disclosure Requirements. If the Property is new construction, Buyer and Seller shall comply with all insulation disclosure requirements as provided by the Federal Trade Commission, and Rider 13 is attached.

H. Code Violations. Seller warrants that no notice from any city, village, or other governmental authority of a dwelling code violation that currently exists on the Property has been issued and received by Seller or Seller's agent ("***Code Violation Notice***"). If a Code Violation Notice is received after the Acceptance Date and before Closing, Seller shall promptly notify Buyer of the Notice.

I. Escrow Closing. At the written request of Seller or Buyer received prior to the delivery of the deed under this Contract, this sale shall be closed through an escrow with a title insurance company, in accordance with the general provisions of the usual form of deed and money escrow agreement then furnished and in use by the title insurance company, with such special provisions inserted in the escrow agreement as may be required to conform with this Contract. Upon the creation of an escrow, payment of Purchase Price and delivery of deed shall be made through the escrow, this Contract and the Earnest Money shall be deposited in the escrow, and the Broker shall be made a party to the escrow with regard to commission due. The cost of the escrow shall be divided equally between Buyer and Seller.

J. Survey. At least 5 days prior to Closing, Seller shall provide Buyer with a survey by a licensed land surveyor dated not more than six months prior to the date of Closing, showing the present location of all improvements. If Buyer or Buyer's mortgagee desires a more recent or extensive survey, the survey shall be obtained at Buyer's expense.

K. Affidavit of Title; ALTA. Seller agrees to furnish to Buyer an affidavit of title subject only to those items set forth in this Contract, and an ALTA form if required by Buyer's mortgagee, or the title insurance company, for extended coverage.

L. Legal Description. The Parties may amend this Contract to attach a complete and correct legal description of the Property.

M. RESPA. Buyer and Seller shall make all disclosures and do all things necessary to comply with the applicable provisions of the Real Estate Settlement Procedures Act of 1974, as amended.

N. Transfer Taxes. Seller shall pay the amount of any stamp tax imposed by the state and county on the transfer of title, and shall furnish a completed declaration signed by Seller or Seller's agent in the form required by the state and county, and shall furnish any declaration signed by Seller or Seller's agent or meet other requirements as established by any local ordinance with regard to a transfer or transaction tax. Any real estate transfer tax required by local ordinance shall be paid by the person designated in that ordinance.

O. Removal of Personal Property. Seller shall remove from the Property by the Possession Date all debris and Seller's personal property not conveyed by Bill of Sale to Buyer.

P. Surrender. Seller agrees to surrender possession of the Property in the same condition as it is on the Acceptance Date, ordinary wear and tear excepted, subject to Paragraph B of the General Provisions of this Contract. To the extent that Seller fails to comply with this Provision, Seller shall not be responsible for that portion of the total cost related to this violation that is below $250.00.

Q. Time. Time is of the essence for purposes of this Contract.

R. Number. Wherever appropriate within this Contract, the singular includes the plural.

S. Flood Plain Insurance. In the event the Property is in a flood plain and flood insurance is required by Buyer's lender, Buyer shall pay for that insurance.

T. Business Days and Time. Any reference in this Contract to "day" or "days" shall mean business days, not calendar days, including Monday, Tuesday, Wednesday, Thursday, and Friday, and excluding all official federal and state holidays.

U. Patriot Act. Seller and Buyer represent and warrant that they are not acting, directly or indirectly, for or on behalf of any person, group, entity, or nation named by Executive Order or the United States Treasury Department as a Specially Designated National and Blocked Person, or other banned or blocked person, entity, nation or transaction pursuant to any law, order, rule or regulation which is enforced or administered by the Office of Foreign Assets Control ("OFAC"), and that they are not engaged in this transaction directly or indirectly on behalf of, or facilitating this transaction directly or indirectly on behalf of, any such person, group, entity, or nation. Each Party shall defend, indemnify, and hold harmless the other Party from and against any and all claims, damages, losses, risks, liabilities, and expenses (including reasonable attorneys' fees and costs) arising from or related to any breach of the foregoing representation and warranty.

V. Brokers. The real estate brokers named in this Contract shall be compensated in accordance with their agreements with their clients and/or any offer of compensation made by the listing broker in a multiple listing service in which the listing and cooperating broker both participate.

W. Original Executed Contract. The listing broker shall hold the original fully executed copy of this Contract.

Buyer Initials:_____ Buyer Initials:_____ Seller Initials:_____ Seller Initials:_____

SAMPLE

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Typical Elements in a Pre-Printed Agreement

The sample shown here is simply one example, but the elements contained here are common. Note the places where the agent has blank space to complete a portion of the sales agreement.

Identification. Identifies the parties to the contract including the buyers' and sellers' names. Also identifies by address the property to be sold as well as the approximate lot size, which may simply say "*as per deed*" to prevent reliance on estimated dimensions. To accurately verify the property description contained within a sales contract, information such as the legal description (metes and bounds, which you'll learn about later) or tax map designations and street addresses may also be used. Typically, the street address, and perhaps the plat, lot, or block reference, is what most buyers and sellers are interested in.

Property Transferred. Lists several items commonly included with the sale of property like window coverings, carpeting, and alarm systems. There is also room to incorporate any other items included in the sale. This may also list the items *excluded* in the sale. Special lighting fixtures, storage sheds, or play sets are common items excluded.

Price and Deposit. Indicates the purchase price. The earnest money deposit amount, as well as any other deposits, is also detailed. This sample also includes directions for holding and disbursing the earnest money.

Mortgage Contingency. Here is where it is noted that the agreement is contingent on the buyer obtaining approval for a mortgage loan. The loan type desired is noted as well as who should be contacted when financing is approved. The seller's contribution is also noted, along with how it should be applied. Unless it is an "all cash" transaction, most contracts contain a financing contingency, which means the contract will not be accepted until financing is approved. The type of financing is also indicated in the contract, including if it is a conventional, FHA, or VA loan, or a purchase money or assumable mortgage.

Deed. Indicates the type of deed that will be conveyed, as well as any other documents related to liens or easements associated with the property, such as existing leases, special assessments, etc.

Real Estate Taxes. It's common to include an estimate of the real estate taxes on the property being sold and how those taxes will be prorated between the buyer and the seller. This would include regular property tax as well as any special assessments. It may also include provisions for revisiting the proration of real estate taxes the following year once taxes are assessed, particularly for newly constructed dwellings.

Closing. For some buyers, the closing date could be a critical element of the offer, for example, if they're closing on the sale of their house and want to move into the new house by a certain date. Also, related to closing are details about the proration of taxes, rent, and insurance between the buyer and the seller.

Possession. The date on which the seller is intended to relinquish possession of the property is included. This should also include a discussion of how other costs of ownership would be prorated between the buyer and seller, as well as provisions for disbursement of escrow funds and penalties should the seller not vacate on the stated day.

Disclosures. Buyers who write a contract on almost any residential property built prior to 1978 must be given a booklet discussing **lead-based paint** hazards. Additionally, Illinois law requires sellers to provide buyers with a **Residential Real Property Disclosure Report** that requires a seller to respond to 23 specific questions related to material facts about the property, including known defects and occupancy, among others. Purchase agreements typically provide a way for buyers to acknowledge receipt of these required disclosures.

Other Provisions in a Purchase Agreement

Besides the essential terms and conditions stated in contracts, other provisions are often included.

Contingencies

A **contingency** is a way for either party of a contract to get out of the contract due to some circumstance or condition. A contingency makes the residential purchase agreement "conditional" upon some issue. If the condition is not met, the promisor can withdraw **without liability for breach of contract.** Contingencies are important in residential purchase agreements because they limit a buyer's or seller's responsibility to fulfill the agreement and close the deal.

For example, some buyers make an offer to buy a home before they even list their own home for sale. However, they need to sell their present home in order to come up with the down payment to make the purchase. So, they make their offer "conditional" on the successful sale of their own home. Typically, the seller's house remains on the market while the buyer tries to sell his home. If another purchase offer is received for the seller's property, the first buyer has a set time (often only 24 to 48 hours) to agree to remove the sale contingency and proceed with the transaction.

Another buyer may want to make his offer contingent on the home appraising at (or above) the purchase price. Since the appraiser is hired by the lender and is independent of the actual transaction, this is another contingency that is considered reasonable. Other typical contingencies that must occur before a contract is formed revolve around inspections, such as a home inspection of a property's structural integrity (such as roof, foundation, etc.) and major systems (heating, plumbing, electrical, septic, etc.), inspections for pests, etc.

Note that the party who **benefits** from or is being protected by a condition or contingency in a contract can **waive** it, but if a condition is included for the benefit of both parties, neither can waive it without the other's consent. Contingencies may also be known as **escape clauses** or **kick-out clauses**.

Financing

There are many common contingencies related to financing, for example:

- **Financing Clause.** A contingency that the buyer is able to obtain financing upon agreeable terms, including the mortgage amount, the type of mortgage, the maximum interest rate, the minimum term, etc.
- **FHA or VA Loan Clause.** A contingency that the buyer is able to obtain an FHA-insured or VA-guaranteed loan commitment.
- **Loan Assumption Clause.** A contingency that the buyer is able to assume the seller's loan.
- **Seller Financing Clause.** A contingency that the buyer is able to obtain financing from the seller.
- **Land Contract Clause.** A contingency that the seller grants a land contract to the buyer.
- **Sell Other Home Clause.** A contingency that the buyer is able to sell another home before he is bound to purchase another.

It's important to note that if the buyer can't get the financing and their agreement is **not** contingent upon the financing, then they're still obligated to buy the property, whether they're able to or not. The seller could take legal action against a buyer who breaches the contract.

Failure to Meet Contingencies

When a contingency written into the sales agreement cannot be met, the typical course of action is to provide some sort of **notice of inability to satisfy contingency**. Although there is no mandated form, such a notice would likely:

- Provide the reason(s) for not clearing the contingency.
- Declare the sales agreement to be null and void.
- Reiterate the provisions in the sales agreement related to disbursal of any deposit or earnest money funds held in escrow.

Other General Provisions

The following are among some other general provisions that may appear in the purchase agreement (this list is *not* inclusive):

- **Operational Systems.** Seller warranties that the property's operational systems—such as heating, plumbing, electricity—are in working order at the time of closing.
- **Code Violations.** Seller warranties that the property is not in violation of any property code violations.
- **Expiration Date.** Many offers include a "time is of an essence" clause and/or state they will expire at a certain time. Such a clause could void a contract as soon as an indicated deadline by which the terms of the contract must be performed passes.

NOTICE OF INABILITY TO SATISFY CONTINGENCY AND/OR MUTUAL CANCELLATION AGREEMENT

With reference to the Real Estate Contract dated _____, 20_____ for the sale of the Real Estate commonly known as _____ entered into by _____, Seller(s) and _____, Buyer(s).

By reason of: ***[check one]***

- ❑ Inability to satisfy contingency provided for in Paragraph #_____.
- ❑ Inability to secure an extension of the time/date provided for in Paragraph #_____.
- ❑ Other _____.

It is hereby agreed by and between the Parties that **the Contract is null and void. Escrowee is hereby authorized and directed to disburse the earnest money as follows: $_____to Buyer, $_____ to Seller**

_____ 20_____ _____ 20_____
Buyer Signature Date Seller Signature Date

_____ 20_____ _____ 20_____
Buyer Signature Date Seller Signature Date

NOTE: Disbursement of the earnest money is subject to the written direction of the Seller and Buyer only or as otherwise provided by law and not upon the oral or written direction of the Seller's Broker or Buyer's Broker.

Approved by the following organizations as of July 20, 2009

Illinois Real Estate Lawyers Association, Aurora Tri County Association of REALTORS®, Chicago Association of REALTORS®, DuPage County Bar Association, Mainstreet Organization of REALTORS®, McHenry County Association of REALTORS®, North Shore - Barrington Association of REALTORS®, Northwest Suburban Bar Association, Oak Park Area Association of REALTORS®, REALTOR® Association of the Fox Valley, REALTOR® Association of Northwest Chicagoland, Three Rivers Association of REALTORS®, West Towns Board of REALTORS®, Will County Bar Association.

SAMPLE

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- **Title Findings.** Directions for delivering acceptable evidence of title are generally included in a purchase contract, as well as obligations for title insurance.
- **Prorations.** In addition to prorating real property taxes, other expenses may be prorated between buyer and seller at closing, for example, utilities, association fees, etc.
- **Communication Requirements.** The acceptable method of communicating the terms of the contract are typically included, for example, whether the contract can be delivered electronically or by mail.
- **Transfer Taxes.** Indicates that the seller will pay any required state and county transfer taxes.
- **Flood Insurance.** When a property is located in a federally designated special flood hazard area (SFHA), a lender for federal loans will require a flood insurance policy for the life of the loan in addition to homeowner's hazard insurance. Purchase agreements may include a statement that flood insurance is the responsibility of the buyer.

Riders and Addendums

Riders are simply amendments or addenda to contracts to cover provisions that are not in the standard contract. For example, there may be a rider that outlines specific warranties that accompany the transaction, or an attorney rider that verifies the legality of the contract. The following examples are not inclusive.

"As-Is" Clauses

An **as-is clause** is a *provision in a purchase agreement stating the buyer accepts the property in its present condition.* The implication is the buyer has inspected the property and agrees to accept it as is without requiring the seller to fix any problems or renegotiating after the discovery of a problem. An as-is clause does not protect the seller from liability for non-disclosure of latent defects. Also, an as-is clause cannot protect sellers or agents if they deliberately conceal a defect from the buyer. An as-is clause is not a defense to fraud, because the "as-is" must be specifically described.

For example, broker Sue has a foreclosed house listed. For two months, the home has been vacant and the utilities disconnected. Recently, the basement flooded because the sump pump was not connected. The furnace, electrical services, and other mechanical components are located in the basement and may have suffered water damage.

Sue cannot protect herself and the seller from potential liability simply by stating to potential buyers the property is sold "as is," without apprising them of the water in the basement. She must make prospective purchasers aware of the condition, as she is aware of it.

FHA/VA Purchase Agreement Addendum

When a buyer intends to apply for an FHA-insured loan or VA-guaranteed loan, it is necessary to include an FHA/VA Purchase Agreement Addendum to the purchase agreement. This addendum includes an amendatory clause that allows the buyer to back out of the contract without penalty if the FHA or VA does not provide a written statement setting that value of the property at or above the sales prices stated in the purchase agreement. The buyer and seller could agree to adjust the sales price in response to an appraised value that is less than the sales price.

In addition, the following Real Estate Certification statement must be signed by the buyer and seller, as well as the listing and selling agents (as appropriate) **at the same time that the sales contract is signed** and presented to the lender along with the purchase agreement:

> *Seller, Buyer and Broker(s) hereby certify that the terms of the Contract to which this Addendum is attached are true to the best of their knowledge and belief. Any other agreement(s) entered into between the parties with respect to the purchase and sale of the Property has been fully disclosed and is attached to the Contract.*

This certification is typically included in the purchase agreement addendum.

RIDER 19
"AS IS" ADDENDUM
Rev. 01/2008

This "As Is" Addendum Rider ("***Rider***") is made a part of and incorporated into the certain real estate contract between _____ ("***Buyer***") and _____ ("***Seller***") on _____, 20____ ("***Contract***") for the purchase and sale of the real estate commonly known as: _____ ("***Property***").
(address) (unit #) (city) (state) (zip)

I. Except as modified by this Rider, all of the terms and conditions contained in the Contract remain in full force and effect. In the event of any conflict between the terms and conditions of this Rider and the terms and conditions of the Contract, the terms and conditions of this Rider shall prevail. Capitalized terms used but not defined in this Rider shall have the meanings given to them in the Contract.

II. Seller and Buyer acknowledge and agree that the Property is being sold to Buyer in its existing, "as is" condition ("As Is"), and Seller shall not be responsible for the repair, replacement or modification of any deficiencies, malfunctions or mechanical defects on the Property or to any improvements thereon, including but not limited to the material, workmanship or mechanical components of the structures, foundations, roof, heating, plumbing, electrical or sewage system, drainage or moisture conditions, air conditioning, hot water heater, appliances, or damage by the presence of pests, mold or other organisms. Seller makes no representation or warranty to Buyer, either express or implied, as to the (1) condition of the Property, (2) the zoning of the Property, or (3) the suitability of the Property for Buyer's intended use or purpose or for any other use or purpose. However, Seller represents and warrants that Seller shall maintain and repair the Property so that the Property, including all personal property located thereon that is included in the sale pursuant to the Contract, will be in substantially the same condition on the Closing Date as on the Effective Date of the Contract. Furthermore, Seller (*strike one*) **does / does not** agree to remove all debris and personal property not included in the sale from the Property prior to the Closing Date.

III. Buyer is advised to conduct independent inspections and investigations of the Property within the Inspection Period specified in the Contract. If Buyer's inspections uncover any defects in the Property, (i) Buyer shall be entitled to terminate the Contract prior to the expiration of the Inspection Period as provided in the Contract, and (ii) Seller shall have no obligation whatsoever to correct such defects or repair the Property as a result of such inspections.

IV. Seller acknowledges and agrees that selling the Property "As Is" does not relieve Seller from applicable legal obligations to disclose any and all known material latent defects in the Property and the improvements thereon, if any, to Buyer.

V. Buyer acknowledges and agrees that: (a) Buyer has been advised to seek appropriate counsel regarding the risks of buying Property in its "As Is" condition; (b) neither Buyer's nor Seller's respective brokers are qualified, or licensed, to conduct due diligence or inspections with respect to the Property or the surrounding area; and (c) Buyer expressly releases and hold harmless brokers from and against any liability for any defects or conditions in the Property and the improvements thereon, if any, that could have been discovered by an investigation or inspection.

_____		_____	
Buyer's Signature	Date	Seller's Signature	Date
_____		_____	
Buyer's Signature	Date	Seller's Signature	Date

SAMPLE

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RIDER 8
FHA FINANCING CLAUSE

Rev. 01/2008

This FHA Financing Clause Rider ("***Rider***") is made a part of and incorporated into that certain real estate contract between _____ ("***Buyer***") and _____ _____ ("***Seller***") on _____, 20___ ("***Contract***") for the purchase and sale of:_____ ("***Property***").
(address) (unit #) (city) (state) (zip)

I. Except as modified by this Rider, all of the terms and conditions contained in the Contract remain in full force and effect. In the event of any conflict between the terms and conditions of this Rider and the terms and conditions of the Contract, the terms and conditions of this Rider shall prevail. Capitalized terms used and not defined in this Rider shall have the meaning given to such terms in the Contract.

II. Seller agrees to deliver to Buyer a written statement issued by the Federal Housing Commissioner or a Direct Endorsement Lender setting forth the appraised value of the Property (excluding closing costs) (the "***Appraised Valuation***") on or prior to _____, 20___ ("***Valuation Contingency Deadline***"). If Seller does not deliver the Appraised Valuation prior to the Valuation Contingency Deadline or if the Appraised Valuation is less than the Purchase Price, then Buyer may elect to terminate the Contract by delivering written notice to Seller within _____ days after the Valuation Contingency Deadline, in which event the CONTRACT SHALL BECOME NULL AND VOID AND OF NO FURTHER FORCE AND EFFECT AND THE EARNEST MONEY, INCLUDING ALL INTEREST ACCRUED THEREON, IF ANY, SHALL BE RETURNED TO BUYER.

III. Any certifications required by the FHA or other governmental authority, including, but not limited to, heating, plumbing, electrical, roofing and termite, shall be paid as follows:_____
_____
_____
Seller agrees to make any repairs or replacements required by the FHA or other governmental authority prior to Closing, provided that the cost of such repairs or replacements do not exceed $_____ ("***Cost Cap***"). If the costs of completing the repairs or replacements exceeds the Cost Cap, then either party may elect to terminate the Contract by delivering written notice to the other party within _____ days of the Valuation Contingency Deadline, in which event the CONTRACT SHALL BECOME NULL AND VOID AND OF NO FURTHER FORCE AND EFFECT AND THE EARNEST MONEY, INCLUDING ALL INTEREST ACCRUED THEREON, IF ANY, SHALL BE RETURNED TO BUYER. If neither party delivers written notice in the time period specified in the foregoing sentence, then this provision shall be deemed waived, the Contract shall remain in full force and effect and Seller and/or Buyer shall have the option of paying for the costs of any repairs or replacements which exceed the Cost Cap.

IV. Seller and Buyer, certify, to the best of their knowledge and belief, that the terms of the Contract are true and that there are no other parties or undisclosed arrangements in connection with this transaction. Seller and Buyer acknowledge and agree that (i) the purpose of the Appraised Valuation is to determine the maximum mortgage amount that the Department of Housing and Urban Development ("***HUD***") will insure; (ii) HUD does not warrant the value or the condition of the Property; and (iii) Buyer should independently determine whether the Purchase Price and the condition of the Property are acceptable to Buyer.

_____		_____	
Buyer's Signature	Date	Seller's Signature	Date
_____		_____	
Buyer's Signature	Date	Seller's Signature	Date

SAMPLE

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SHORT SALE ADDENDUM TO MULTI-BOARD RESIDENTIAL REAL ESTATE CONTRACT 5.0

(Not to be attached to any Contract other than Multi-Board 5.0)

SELLER(S): _____

BUYER(S): _____

This Addendum is attached to and made part of a certain real estate contract (hereinafter "the Contract") between the above captioned Parties for the property commonly known as _____
(Address, City, Zip Code)
_____ and the Parties agree as follows:

1. **Conflict of Terms:** In the event of inconsistencies between the terms of the Addendum and the terms of the Contract, the terms of this Addendum shall control.

2. **Short Sale Payoffs:** The Contract is contingent upon the successful negotiation with Seller's lienholders and/or third parties for a payoff of less than the total amount owed. Seller agrees to promptly submit all documents necessary for lienholder approval. Buyer and Seller acknowledge that a "short sale" requires the written approval of all of such lienholders and/or third parties, and that there can be no assurance such approvals will be obtained. Buyer agrees to hold Seller harmless from any costs or damages Buyer may sustain as the result of Seller's inability to obtain approval of the Contract by all lienholders and/or third parties.

3. **Extension of Closing Date:** Buyer and Seller agree to extend the Closing date in the Contract until such times as the necessary approvals and payoffs are obtained.

4. **Termination Option:** Buyer and Seller acknowledge that, as a condition of acceptance by the lienholder(s) of a payoff of less than the full amount due, the lienholder(s) may require reduction in the compensation due third party service providers and other usual and customary expenses incurred as a result of the sale. In the event agreement is not reached by Buyer and Seller regarding allocation of expenses due third party service providers or if the contingency contained in Paragraph 2 above is not satisfied within _____ days (if blank then 90 days) after Date of Acceptance, then either Party may declare the Contract null and void.

5. **Right to Continue to Offer Property For Sale:** Buyer acknowledges and agrees that, prior to obtaining all necessary short sale payoffs and consents from third parties, Seller may continue to offer the Property for sale and, in the event Seller receives a bona fide offer to purchase the Property from another prospective purchaser with terms more favorable to Seller than those contained in the Contract, Seller shall first offer to Buyer the right to purchase the Property on the new terms and conditions. In the event Buyer does not agree to same within three (3) Business Days after the effective date of Seller's notice, Seller shall have the right to terminate the Contract, in which case all earnest money shall be refunded to Buyer.

6. **"As Is" Condition**: The Contract is for the sale and purchase of the Real Estate and personal property in its "As Is" condition as of the Date of Offer. **SELLER SHALL NOT BE REQUIRED TO UNDERTAKE ANY REPAIRS OR PROVIDE ANY CREDITS FOR REPAIRS.** Buyer acknowledges that no representations, warranties or guarantees with respect to the condition of the Real Estate and personal property have been made by Seller or Seller's Agent other than those known defects, if any, disclosed by Seller. Buyer may conduct an inspection at Buyer's expense. In that event, Seller shall make the property available to Buyer's inspector at reasonable times. Buyer shall indemnify Seller and hold Seller harmless from and against any loss or damage caused by the acts or negligence of Buyer or any person performing any inspection(s). **In the event the inspection reveals that the condition of the Real Estate is unacceptable to Buyer and Buyer so notifies Seller within five (5) Business Days after the Date of Acceptance, the Contract shall be null and void. Failure of Buyer to notify Seller or to conduct said inspection operates as a waiver of Buyer's right to terminate the Contract under this paragraph and the Contract shall remain in full force and effect.** Buyer acknowledges the provisions of Paragraph 10 and the warranty provisions of Paragraph 3 of the Multi-Board Residential Real Estate Contract 5.0 do not apply to the Contract.

The Parties have executed this Short Sale Addendum this _____ day of _____ 20_____.

_____	_____
Buyer	Seller
_____	_____
Buyer	Seller

Approved by the following organizations as of July 20, 2009

Illinois Real Estate Lawyers Association, Aurora Tri County Association of REALTORS®, Chicago Association of REALTORS®, DuPage County Bar Association, Mainstreet Organization of REALTORS®, McHenry County Association of REALTORS®, North Shore - Barrington Association of REALTORS®, Northwest Suburban Bar Association, Oak Park Area Association of REALTORS®, REALTOR® Association of the Fox Valley, REALTOR® Association of Northwest Chicagoland, Three Rivers Association of REALTORS®, West Towns Board of REALTORS®, Will County Bar Association.

SAMPLE

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Short Sale Addendum

A **short sale**, or short payoff, is when *a lender agrees to accept less than the loan balance when real property is sold.* Short sales may take additional time to close because every stakeholder—the lender(s), loan servicer, lien holders, mortgage insurers, securities investors, and possibly others—must decide whether or not to approve it. Often, offers will expire before the lender responds to the short sale agreement. Therefore, an addendum is usually included to address the unique conditions of a short sale.

Offer and Acceptance

For a contract to be a binding obligation, all parties must consent to its terms. This is achieved through *offer* and *acceptance*. An **offer** occurs when one party (the **offeror**) proposes a contract to another party (the **offeree**). A contract is formed only if the other party accepts the offer.

Offer

Once the information necessary to complete the purchase agreement has been gathered:

1. The buyer makes an offer by filling out a standardized purchase agreement form or, more commonly, by having a real estate broker fill in the blanks.
2. The buyer generally gives the broker an earnest money deposit, and the broker provides a receipt acknowledging the deposit.
3. The buyer usually provides the agreement to his or her attorney to review (unless the attorney wrote the contract, of course).
4. The buyer then signs the agreement and receives copies of all signed contracts and documents immediately.
5. The buyer's broker then promptly submits the offer to the seller or to the seller's broker. This can be done via mail, in person, or electronically, if that method is pre-approved.

Now, it's in the hands of the seller and his or her broker and attorney. If the seller decides to accept it, he signs the same form, creating a binding contract between buyer and seller.

Basic Requirements

When a buyer makes an offer to purchase, it must meet some basic requirements:

- **Intent to Contract.** The explicit words and actions of the offeror must reasonably indicate the intention of forming a contract. The intent requirement is concerned with **objective intent** (what the offeror says and does) rather than **subjective intent** (what the offeror is actually thinking). If a person says or does something that a reasonable person could interpret as a serious expression of the intention to make a contract, that may be a legally binding offer—even if the person was just kidding.
- **Definite Terms.** The offer must also have definite terms. An offer is not binding if it is too vague. The offer should state at least such basic items as the subject matter, the time for performance, and the price. In some cases, a court will fill in the blanks with a reasonable time or a reasonable price, but if too many terms are left unspecified, no contract is formed.

Presentation of Offers

An agent has a fiduciary duty to disclose to a seller client **all offers to purchase** even if an offer seems unacceptable or if its acceptance would mean a smaller commission. The seller, not the agent, decides if an offer is acceptable.

Similarly, a licensee must disclose **in writing** to a client the knowledge of all contemporaneous offers. The State of Illinois defines **contemporaneous offers** as *offers to purchase or lease on behalf of two or more clients represented by the same designated agent for the same unit or parcel that will be taken under consideration by the owners at the same time* (Administrative Rules: Section 1450.830). If there are **multiple** contemporaneous offers from two or more clients of a designated agent, written disclosure must be provided to all the clients of the designated agent and referrals made to other designated agents if requested by the client.

ILLINOIS ASSOCIATION OF REALTORS®
DISCLOSURE OF CONTEMPORANEOUS OFFERS

EQUAL HOUSING OPPORTUNITY

_____, an agent (hereinafter referred to as Designated Agent) with _____ (Brokerage company hereinafter referred to as Broker), is acting as Designated Agent for more than one prospective buyer or tenant who the Designated Agent has reason to believe are making or preparing to make contemporaneous offers to purchase or lease the property located at _____.
(street address or description of property).

At this time, buyers/tenants have the option of being referred to another designated agent who will serve as the agent for buyer/tenant.

Buyer elects: (choose one of the following)

- ☐ to remain with Designated Agent identified above notwithstanding that another client of Designated Agent may be making a contemporaneous offer to purchase or lease the real property identified above.
- ☐ to be referred to another designated agent who will act as agent for buyer/tenant in the making of an offer to purchase or lease the real property identified above.

Signed by: _____ dated _____
(Designated Agent)

Signed by: _____ dated _____
(Buyer or Tenant)

Signed by: _____ dated _____
(Buyer or Tenant)

SAMPLE

Form 427 12/18/09

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For example, broker Jane has two buyer clients, each interested in the same house. Buyer Jack wants to make an offer of $235,000 for the house. On the same day, buyer Jill wants to make an offer of $250,000 for the house. Even if Jane suspects that Jack's offer would not be accepted, she must present **both offers** to the seller's agent, assuming that Jane disclosed the situation to Jack and Jill and she obtained their written permission to do so.

Real Success

What happens if an offer comes in after a seller has accepted a previous offer? Does that fiduciary obligation to present all offers end once an offer is accepted? No, it does not. The existence of multiple offers can create a potential legal conflict, however. The concept of **tortious interference** means that you *cannot interfere with an existing contract*. That concept applies to a broker who tries to talk a seller out of a current listing agreement with another broker, for example, and it means that you can't induce a seller client to renounce a signed contract if a better offer comes along.

For example, you present your seller client with an offer that they accept. The next day, another offer comes in that is superior to the first offer, and your client asks you how they can back out of that first offer. That's when you tell them to contact their attorney. Not only might the first buyer sue them for breach of contract, but the broker for that first buyer earned a commission for bringing the seller a ready, willing, and able buyer. The seller may be obligated to paying full commission to two brokers.

Termination of an Offer

To create a binding contract, an offer must be accepted before it terminates. Many offers state they will expire at a certain time (e.g., "after five days" or "on March 31"). When an offer does not specify an expiration date, it expires after a reasonable time. Even when an offer has an expiration date, it may be terminated sooner by other means:

Death or Incapacity. The death or incapacity of one of the parties often makes it impossible to form a contract. This would also terminate an offer before a stated expiration date. For example, an offer made on March 1 states it will expire on March 31. If the offeror dies on March 23, before the offer has been accepted, the offer terminates on that date—it does not continue until March 31. The offeree cannot create a contract by accepting the contract on March 24.

Revocation. An offer is terminated if the offeror revokes or withdraws it before the offeree accepts it. At the point that the offer is revoked, the offeree has lost the chance to accept it. This is true even if the offer stated it was irrevocable, or that it would not expire until a particular date. For example, on March 1, Barb submits a written offer to buy Sam's house for $150,000. The offer states that it will remain open until March 9. While Sam is making up his mind, Barb finds a different house she wants instead of Sam's. She calls Sam on March 6 and revokes her offer. Now, even if Sam sends Barb an acceptance before March 9, it will not create a binding contract.

It is a different matter if an offeree pays the offeror a sum of money to keep the offer to purchase open: The offer **cannot be revoked** during the specified period. A preliminary contract has been formed in this situation. The offeree can still choose to accept or reject the original offer to purchase, but at least the offeror cannot withdraw the offer to purchase before the agreed time period has elapsed.

Rejection. An offer is also terminated when it is rejected by the offeree. For example, if George rejects the offer on Monday, he cannot change his mind and call Ruth, the offeror, back on Tuesday to accept it. If George is still interested in the deal, George and Ruth can start the process of offer and acceptance over again, but the original offer was terminated by George's rejection. If Ruth lost interest, George can no longer hold her to her offer.

Acceptance

To complete the formation of a sales contract, the offer must be accepted. **Acceptance**—also referred to as **a meeting of the minds**—occurs when *the parties agree on price, down payment, financing method, and other essential terms.* At this point, *the broker has earned a commission,* even if the sale never closes. There are four basic requirements for acceptance:

- Acceptance of an offer can be made only by the offeree.
- Acceptance must be communicated to the offeror.
- Acceptance must be made in the manner specified.
- Acceptance must not vary the terms of the offer.

Accepted Only by the Offeree

This may sound obvious, but there is an important distinction. It means that if Ann makes an offer to Bill, and Bill decides not to accept it, Carl cannot accept the offer and force Ann to deal with him. Of course, Ann may be willing to work with Carl but, in legal terms, any contract between Ann and Carl is based on a new offer, not on the offer Ann made to Bill.

Communicated to the Offeror

One party may have decided to accept an offer, but until that party communicates directly that the offer has been accepted, the offer can be revoked. For example, Nick offers to buy Tammy's house. She thinks it's a good offer and tells her broker that she will accept the offer. Before the broker communicates Tammy's acceptance directly to Nick, Nick changes his mind and can legally revoke his offer.

In the Specified Manner

Many offers specify a certain manner of acceptance (i.e., "in writing," "via fax," or "by delivering a cashier's check"). The offeree's acceptance is not effective unless the instructions in the offer are followed. If the offer states acceptance must be in writing, but the offeree calls and accepts over the phone, it does not create a binding contract; the offeror can still revoke the offer.

When an offer does not specify how it is to be accepted, any reasonable method of acceptance effectively binds the offeror and prevents revocation. This rule applies to all contracts—even those required by law to be in writing and signed, such as real estate purchase agreements. The *offeror* is bound by an oral acceptance even if the contract is required to be in writing, but only a written, signed acceptance is binding on the *offeree*.

Must Not Vary the Terms of the Offer

To create a contract, the offeree must accept *exactly* those terms offered. The offeree cannot modify them or add new terms. If an offeree makes changes, that response is not an acceptance, it is a **counteroffer**.

Counteroffer

In a perfect world, the seller will accept the offer and the transaction can move forward. It's more typical, as you can imagine, for the seller to **reject** the original offer and make a counteroffer. A **counteroffer** represents a change to some of the terms of the original offer, and is, therefore, a **rejection and a new offer**. The original offeror has become the **counterofferee**, and the original offeree is now the **counterofferor**. A binding contract is not created unless the counterofferee accepts the counteroffer.

If a counteroffer is rejected, it is too late to go back and accept the original offer. The counterofferor can start again with a new offer identical to the original one, but if the original offeror has had a change of heart, he can no longer be held to the original offer.

This process of negotiation will continue until both the buyer and the seller agree to the terms in the sales contract—known as a **meeting of the minds**—and all contingencies or clauses are satisfied. Sometimes, however, an offeree rewords the offer slightly, or adds a phrase to clarify or emphasize a particular provision. As long as these revisions or additions do not materially change the terms of the offer, the response is still an acceptance, not a counteroffer.

Remember: It is illegal to practice law without a license. Leave it to the attorneys to decide if the terms of a counteroffer are material and whether or not a response is an acceptance.

Signing the Contract

A signed sales contract for real property is the final product of negotiations between the buyer and seller or their representatives. A buyer typically signs the initial offer, and assuming it is acceptable, the seller then signs. A contract could go back and forth several times before all terms are agreed to and it is signed by all parties to the transaction.

Contracts are often delivered via courier, agents, mail, or even e-mail without the buyers or sellers ever meeting face to face.

One way that attorneys can avoid a contract going back and forth several times is to plan a **sit down contract signing**. With this strategy, all negotiating is conducted in one place at one time with all parties to the contract and their attorneys present. In the past, this was a common way to conduct business, but is less so today. A sit down contract negotiation benefits both parties because a binding contract is formed relatively quickly compared to traditional negotiations.

Of course, sit down contract signings do have a downside. For one, there's usually, a higher cost. Attorneys will probably charge more for a sit down contract because it requires them to work away from the office and essentially mediate negotiations between their clients.

Contracts generally require **original signatures**, in which case each party to the transaction signs **multiple copies** of the contract so that all can have their own original copy of the signed documents. When changes are made to the original contract, all parties must **initial at each change** or in the margin of the paper, next to the change.

Other Types of Sales-Related Contracts

While sales contracts for single-family residential property may be the most common type of sales agreement, it is helpful to be familiar with other ways in which property sales may be transacted.

Cooperative Apartment Purchase and Contract

Cooperatives are *buildings owned by corporations with the residents as shareholders who each receive a proprietary lease on an individual unit and the right to use common areas.* **Proprietary leases** have *longer terms than ordinary leases and offer more rights than an ordinary tenant lease does.* Title to the cooperative building is held by a corporation formed for that purpose. When a buyer makes an offer on a cooperative apartment, he actually wishes to purchase shares of stock in the cooperative corporation. It is for this reason the sales contract and financing are different from other types of real estate transactions.

Installment Sales Contract

An **installment sales contract,** also referred to as a **land contract** or a **contract for deed**, is an *agreement for which the buyer (vendee) makes payments to the seller (vendor) in exchange for the right to occupy and use the property, but no deed or title is transferred until all, or a specified portion of, payments have been made*. The seller holds title to the land as security, while the buyer/vendee has **equitable title.**

An installment sales contract is an express bilateral executory contract. The seller and the buyer each have certain obligations and responsibilities. The seller promises to give possession to the buyer during the contract, accept payments toward the purchase of the property, and convey title once all, or a specified portion of, payments have been made. The buyer promises to make the agreed upon payments, pay taxes, obtain insurance, and maintain the property.

There are unique advantages to an installment sales contract for buyers and sellers. For buyers who cannot qualify for a conventional mortgage loan, a land contract may be an option. And for sellers, tax advantages make land contracts attractive because they can still claim depreciation on the property as the owner, even though they do not actually reside on the property. Another benefit to sellers is they are not required to pay lump sum capital gains tax on a home sold under a land contract. They can simply pay a percentage each year as payments are received from the buyer.

Lease/Purchase

A **lease/purchase** is *when a seller leases property to someone for a specific term, with the tenant agreeing to buy the property at a set price during or following the lease term*. The lease/purchase plan is comprised of two elements: A lease and a purchase contract. Both contracts must conform to all laws governing real estate contracts. The lease/purchase is the equivalent of a sale, but there are additional considerations to take into account because the sale is delayed until a later date.

The purchase agreement locks in a predetermined price for the property and sets a date for the sale transaction to be completed on or by. Here, the buyer is committing to purchasing the property, but can't buy it until certain problems are resolved or other events take place, for example, time to acquire cash or await a change in circumstances that would allow the buyer to qualify for a loan. A lease/purchase might be used when a buyer and seller agree to credit part of the lease payment that is above the established market rent to the down payment, loan amount, or sale price, thus reducing the cost and making it easier to buy the property later.

Summary

1. **Sales contracts** are *contracts in which a seller promises to convey title to real property to a buyer in exchange for the purchase price*. Sales contracts must contain all of the essential elements to be valid. A sales contract usually includes: **Parties** to the contract, including the names and addresses of the buyer(s) and seller(s), **property** to be sold (address or legal description), **interest** in the property to be sold (for example, all of the bundle of rights, just subsurface rights, etc.), **terms** of the sale as clearly as possible (personal property, earnest money liquidation, closing, commission, etc.), total purchase **price** and **method of payment** (for example, mortgage-related information, down payment), and the **signatures** of all parties to the transaction.

2. Illinois does not dictate the use of a specific form for purchase agreements. Most brokers use **standardized** purchase agreement forms that have been approved by a recognized Bar Association in conjunction with a local Board of REALTORS®. These forms allow brokers to fill in the details as long as the contract indicates that it is legally binding and recommend attorney review.

3. Purchase agreements typically contain certain provisions and disclosures: An **as-is clause** is a *provision in a purchase agreement stating the buyer accepts the property in its present condition.* An as-is clause cannot protect sellers or agents if they deliberately conceal a defect from the buyer. **Contingencies** are *conditions that must occur in order for the contract to be formed,* for example, certain home inspections, mortgage contingency, contingency if the buyer cannot sell his house. **Riders** are *amendments to contracts* that should be written by an attorney; disclosures include **lead-based paint** hazards (for houses built prior to 1978) and the **Residential Real Property Disclosure Report** that Illinois law requires sellers to give to buyers.

4. Certain information is generally needed to complete a purchase agreement and carry out a closing, such as the *prior deed, survey, certificate of occupancy, tax bills, and buyer's and seller's personal information*. This information can be obtained from various sources, including the buyer, seller, and public records. Real estate licensees may help facilitate assembling all necessary information in order for the attorneys involved to complete their portion of the contract.

5. For a contract to be a binding obligation, all parties must consent to its terms. This is achieved through offer and acceptance. An **offer** occurs when one party (the **offeror**) proposes a contract to another party (the **offeree**). Brokers have a fiduciary obligation to present **all offers** to the seller client. A contract is formed only if the other party accepts the offer. Changes to the original offer constitute a **rejection** of the offer and become a **counteroffer**. When both parties agree to the terms, there is a **meeting of the minds** and a valid contract is formed. Brokers generally earn a commission when there is a meeting of the minds.

6. Other types of sales-related contracts include: **Cooperatives**, buildings owned by corporations with the residents as shareholders who each receive a proprietary lease on an individual unit and the right to use common areas, involve the sale of shares in the corporation. An **installment sales contract**, also called a **land contract** or a **contract for deed**. is a real estate agreement where the buyer (vendee) makes payments to seller (vendor) for right to occupy land and have equitable title, but the seller retains legal title and does not transfer it until all, or part of, payments are made. A **lease/purchase** combines a lease with a purchase contract, delaying the purchase until the termination of the lease.

Quiz

1. ***Which is NOT considered a purpose of the purchase contract?***
   a. buyer's offer
   b. contract between the buyer and the seller
   c. contract between the seller and the broker
   d. receipt for the earnest money deposit

2. ***A condition in a purchase contract states the agreement depends on the property passing a home inspection and radon gas test. This is called a***
   a. contingency clause.
   b. counteroffer.
   c. tender offer.
   d. time is of the essence clause.

3. ***Broker Stan, who represents a seller under an exclusive listing agreement, receives two offers for the seller's property at the same time: One from an agent in his office, and one from the salesperson of a cooperating broker. What should Stan do?***
   a. submit the higher offer first; if it is not acceptable, look at the other one
   b. submit the offer from his agent first, and let the seller decide on it before looking at the other offer
   c. submit the offer from the cooperating agent first, and let the seller decide on it before looking at the other offer
   d. submit both offers at the same time, allowing the seller to make a decision after looking at all the facts

4. ***Jim's broker, Bruce, submits to Tom an offer to purchase signed by Jim, stipulating a price of $250,000, a commission of 6%, and closing within 90 days. Tom accepts the price and closing, changes the commission to 5%, initials the changes, then signs and returns the contract to Bruce, who gives it to Jim. Is the contract valid?***
   a. no, because the broker's commission is non-negotiable
   b. no, because there was no meeting of the minds
   c. yes, because it is in writing and signed by both parties
   d. yes, because Tom initialed his changes

5. ***Buddy makes an offer to buy Wally's home. The offer contained a provision limiting the time for acceptance to 48 hours. Wally immediately rejected the offer as inadequate. After thinking about it overnight, Wally called his agent and said, "I've changed my mind. I'll take the offer." What is the status of Buddy's offer?***
   a. It is a binding contract now that Wally has accepted it
   b. It is still open because Buddy hasn't formally withdrawn it.
   c. It is still open because it still had 24 hours to run.
   d. It was terminated when Wally first rejected it.

6. ***Angie, the seller, signs the agreement of sale from the prospective buyer and hands it back to her agent. What element is missing in order to make this a valid contract?***
   a. communication back to the offeree
   b. communication back to the offeror
   c. earnest money deposit
   d. meeting of the minds

7. ***Ellen's offer to buy Eric's house does not indicate how acceptance must be communicated. Eric calls his agent, Jon, and tells him to communicate his acceptance. It's late in the day and Jon decides to call Ellen the next day. That night, Ellen leaves a message on Jon's phone revoking her offer. What now?***
   a. Ellen's revocation was not in writing, so she's still bound by the contract.
   b. It's too late. Eric accepted Ellen's offer, so she's bound by the contract.
   c. Jon did not communicate the acceptance, so Ellen can still revoke her offer.
   d. Since Eric's acceptance was verbal, Ellen would not be bound by it regardless.

8. ***A listing agent shows a buyer a home. The buyer completes an offer, which the listing agent takes to the sellers. The sellers like the offer and sign their acceptance. They then hand the accepted offer to their agent with instructions to deliver the accepted contract back to the buyer. Has a contract been created?***
   a. yes, because the listing agent now has possession of the accepted offer
   b. yes, because the offer has been delivered to the buyer
   c. yes, because the offer was accepted
   d. no, because the sellers have not relinquished control of the acceptance

9. ***Sam's house is on the market for $160,000. Taylor offers to buy it for $150,000. Sam is eager to sell, but wants to get at least $155,000, so he notes that in the agreement of sale and returns it to Taylor. This is an example of a(n)***

   a. acceptance.
   b. consideration.
   c. counteroffer.
   d. revocation.

10. ***Taylor offers to buy Sam's house for $150,000. Sam counteroffers. Sam is the***

   a. counterofferee.
   b. counterofferor.
   c. offeree.
   d. offeror.

11. ***If, upon receipt of an offer to purchase under certain terms, the seller makes a counteroffer, the prospective buyer is***

   a. bound by his original offer.
   b. bound by the agent's decision.
   c. bound to accept the counteroffer.
   d. released from his original offer.

12. ***Agent Eric has presented an offer to his seller client, Meg. While Meg is considering the offer, another offer comes in that is not quite as attractive. What should Eric do?***

   a. allow Meg to consider the first offer without the distraction of a second offer, then present the second offer if necessary
   b. encourage Meg to accept the first offer by telling her that it's the best she's likely to get
   c. present the second offer to Meg immediately so that she can compare the two
   d. tell the second buyer's broker that Meg has already accepted another offer



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Real Estate Closings

Already, willing, and able buyer is found; the sales contract is drawn up; and both parties have fulfilled their obligations under the agreement. Finally, closing can occur. At the closing, the buyer receives the deed for the purchase and the seller receives payment for the property. This chapter looks at the steps necessary to hold a closing and provides some background on related concepts and documents. Much of the discussion about title and deeds involves the practice of law and, thus, is not an area about which you can advise clients or customers, unless you are also licensed to practice law. Still, it's necessary for your professional development and overall knowledge to understand these concepts, since a real estate transaction culminates in delivery and acceptance of a properly drafted deed. However, it's important to remember that this chapter is intended to be an overview. It should NOT be used as the basis for personal action and is NOT intended as a substitute for competent professional legal advice.

You will learn:

- Methods of conveying property.
- The purpose of the public records system.
- The significance of a marketable title.
- The purpose and use of different types of deeds.
- The documents necessary for closing.
- Which closing costs are paid by a buyer and by a seller.
- How to calculate transfer tax and prorations.

Key Terms

Abstract of Title
Bargain and Sale Deed
Chain of Title
Closing Disclosure
Cloud on the Title
Constructive / Actual Notice
Credits / Debits
Deed
Descent
Devise
Escrow
General Warranty Deed
Grantor / Grantee
Habendum Clause
Intestate / Testate
Involuntary / Voluntary Alienation
Limited Warranty Deed
Marketable Title
Proration
Quitclaim Deed
Real Estate Settlement Procedures Act (RESPA)
Reconciliation
Sheriff's Deed
Survey
Title
Title Insurance
Title Search
Words of Conveyance

Transfer of Ownership

The process of transferring ownership interests in property is called **alienation**. **Voluntary alienation** is the most common way to transfer ownership of land. Voluntary alienation is an action which the property owner undertakes of his or her free will and may be accomplished through various methods, for example:

- **Sale** of property, in which the owner agrees to hand over title in exchange for consideration; usually completed with a **deed**
- **Gift** of a deed
- **Dedication** of private property for public use, for example, a developer who dedicates land for streets within a new subdivision or someone who dedicates land for a park to a municipality

Involuntary alienation, on the other hand, is the transfer of title in an interest in real property **against the will** of the owner, or **without action by the owner**. Some examples of involuntary alienation include foreclosure, adverse possession, or eminent domain. Property can also be transferred as a result of an **operation of law**, such as when a married couple divorces.

Devise and Descent

The transfer of property upon the death of the owner can happen through devise or descent.

Devise

A **will** (also called a **testament**) is *a person's legally binding instructions regarding how his estate should be disposed of after death. A male person making the will* is called a **testator**; a female is referred to as a **testatrix**.

A person who dies with a valid will in place is said to have died **testate**. A valid will appoints an **executor** (male) or **executrix** (female) *who is charged with carrying out the deceased's wishes.* The will sets forth the following items (and to whom they will go):

- **Bequest** (personal property)
- **Legacy** (money)
- **Devise** (real property)

A document cannot be a valid will unless the person who executed it had **testamentary intent.** That means *he intended that the document would take effect only after death*. No specific words are required, but the testamentary intent must be apparent from the document itself.

Descent

When a person dies ***without a will*** *(intestate),* the decedent's property automatically descends to the heirs or next of kin as provided for by state law. An administrator appointed by the court will handle the affairs of the estate. This process is also called **intestate succession.** Every state has some sort of **law of descent** that determines how to handle intestate succession. In Illinois, when someone dies without a will, the **Illinois Intestacy Statute** (755 ILCS 5/) provides property be distributed as follows:

Surviving spouse/legal partner AND children/descendents

- 1/2 of entire estate goes to spouse/legal partner
- 1/2 of entire estate goes to children/descendents

Children/descendents BUT NO surviving spouse/legal partner

- Entire estate to the children/descendents

Surviving spouse/legal partner BUT NO children/descendents

- Entire estate to the spouse/legal partner

NO surviving spouse/legal partner NOR children/descendents

- Equal parts of entire estate to parents, brothers, sisters (or descendents of brothers and sisters) OR
- If just one surviving parent, 2 parts to parent and remaining parts to brothers, sisters (or descendents of brothers and sisters)

NO surviving spouse/legal partner NOR children/descendents NOR parent NOR brothers, sisters (nor descendents of brothers and sisters)

- Surviving grandparents or their descendents
- Surviving great-grandparents or their descendents

NO surviving spouse/legal partner NOR any parent, brother, sister, grandparent, great-grandparent NOR any of their descendents

- Entire estate in equal parts to nearest kin

NO surviving spouse/legal partner NOR any other family

- Escheats to the county in which the decedent lived

Right of Survivorship

The way in which title to property is held also affects how property ownership can change upon death. For example, if legal spouses or partners in a civil union hold title to property as **tenants by the entirety**, ownership passes to the survivor immediately without having to go through probate court. The same is true when two or more people hold title to property as **joint tenants.**

Ownership Concepts

A **deed** is *an instrument that conveys a grantor's interest, if any, in real property.* The deed is the document used by the owner of real property to transfer all or part of his interests in the property to another. The deed serves as evidence of title. **Title**, on the other hand, is *the actual lawful ownership of real property.* Title refers to holding the bundle of rights conveyed. Unlike a deed, title is not a document, but rather a concept or theory of ownership. The deed is written proof of the rights conveyed to the owner, but having title to the land is what must be held to actually "own" it. **Equitable title** is an *interest in property created on the execution of a valid sales contract, whereby actual title will be transferred by deed at a future date*, such as at the closing. Equitable title creates a **less than freehold** estate, also referred to as a **non-freehold** estate. Having equitable title is *not* the same as having actual title, but the person who holds equitable title still enjoys certain rights and privileges.

When conveying real property, the seller is generally expected to deliver **merchantable title**, also known as **marketable title**. This is *a title that is free and clear from undisclosed encumbrances or other defects that would expose a purchaser to litigation or impede a purchaser's ability to enjoy the property or to later sell the property easily.* A **title search** of the public records, also known as a title examination, is necessary to *determine ownership and the quality of the title prior to conveyance*. If a merchantable title cannot be produced, a closing may have to be postponed.

Public Records

Recording is *the act of filing a document in the county where the property is located so that it will be placed in the public record.* The public records system is a way to provide **notice** so that the public is able to determine who holds an interest in any piece of property. Recording a document is a simple process and requires a fee to the county recorder's office. In most counties, the document is placed in the public record by being electronically copied to a database, but is sometimes photographed onto microfilm. Anyone can view these documents and request a copy. The documents are recorded in the order they are filed. This is very important, since deed priority or lien priority often depends on when the documents were filed. Each document is numbered so it can be located easily.

Recording documents allows property owners to defend their estate, right, or interest against third parties claiming a subsequent interest. Although there is no legal requirement to record a real estate document, such as a deed or title, an unrecorded document is likely to be unenforceable against a third party claiming a subsequent right or interest in the property. In most states, a recorded deed takes precedence over any prior unrecorded deed, and so it is in all parties' best interests to record deeds.

Notice

The concept of *constructive notice* provides this protection. A person is considered to have **constructive notice** of something when *it should be known*, even if it is not. Since the public records are available for anyone's inspection, *everyone is considered to have constructive notice of the contents of recorded documents*. The burden of discovery rests with the general public. Furthermore, the law expects a buyer or lender to search the public record for his or her own protection. This results in **actual notice**, which exists *when individuals have actual knowledge of a fact*. Actual notice includes what someone personally saw, heard, read, or observed.

In addition to actual notice and constructive notice, there's **inquiry notice**. A person has inquiry notice when there's *an indication of a claim or other situation that would alert a reasonable person to a possible problem, causing further inquiry about the title.* If you don't find a claim because you fail to look further, you may still be held to have inquiry notice of a claim. Also, when someone is in possession of land, a buyer is held to have inquiry notice of the possessor's claim, even if the buyer never visited the land, which is why land should not be purchased sight unseen.

Case in Point

Property owner Mary grants an easement across her land to Bill, so Bill records the easement document. Mary then sells her land to Joe. Joe claims he doesn't have to honor the easement since he couldn't tell it existed by looking at the land, and Mary never told him about it. The easement, however, is still valid because Joe is deemed to have constructive notice of it. Although he didn't have actual notice, he could have found out about the easement granted to Bill by checking the public records.

Abstract of Title

To perform a title search, a **title abstractor** will examine the public records for deeds, taxes, special assessments, liens, judgments, mortgages, and other encumbrances that have ever affected the property, even if the encumbrance has been removed or satisfied. The resulting **abstract of title** is *a chronological history of title to a property, listing all recorded documents that affect the title, as well as all public records searched, or not searched.*

An abstract of title does *not* ensure the validity of the title, and there is no guarantee associated with this type of title evidence, so the homeowner or lender does not have any recourse if title defects are discovered later.

Chain of Title

The **chain of title** is a *clear and unbroken chronological record of the ownership of a specific piece of property*. Tracing the chain of title simply means tracing the successive conveyances of title, starting with the current deed and going back a suitable number of years. Each owner is linked to the *previous* owner and the *subsequent* owner through deeds, forming a chain of title as disclosed in the public records.

A *gap or flaw in the chain of title* creates uncertainty, which is referred to as a **cloud on the title**. A cloud on the title could be something simple. For example, Sue Jones buys a house; she gets married and is now Sue Smith. When she sells the house, the grantor name on the deed is Sue Smith. This creates an ambiguity in the title. Another common example is when a married couple purchases a home together; when one spouse passes away, a death certificate might be needed to clear any clouds on the title.

A **suit to quiet title**, also called a quiet title action, may be required to close any missing links and remove the cloud on the title. This is a *lawsuit filed to determine and resolve problems of instruments conveying a particular piece of land.* The purpose of this suit is to clear a particular known claim, title defect, or perceived defect. To close the gap and clear the cloud on the title, the court may issue a quitclaim deed or a judicial deed.

Marketable Title Act

735 ILCS 5/13-118

Most states have some equivalent of a **marketable title act**, a law which is *intended to improve the marketability of title and simplify the title search process by extinguishing certain old claims against a title.* The **Illinois Marketable Title Act** is designed to assure a title searcher who has found a chain of title starting with a document at least **40 years old** that he need search no further back in the record to establish **marketable record title**. The **root of title** is the deed or other title transaction in the chain of title which was the *most recent to be recorded as of a date 40 years before the time marketability is being determined*.

For example, a title researcher in 2011 finds six recorded deeds on a particular parcel of land:

July 12, 1889:	Grantor, U.S. Land Office	>	Grantee, Robert Brown
March 5. 1934:	Grantor, Robert Brown	>	Grantee, Lyle Baxter
June 21, 1966:	Grantor, Lyle Baxter	>	Grantee, Peter Jones
April 4, 1989:	Grantor, Peter Jones	>	Grantee, Margaret Headley
June 14, 2005:	Grantor, Margaret Headley	>	Grantee, Denise Russell

Going back 40 years from 2011, the root of title would be the deed from 1966. Denise Russell, therefore, is considered to have marketable record title. When an owner establishes a marketable record title, claims that arose before the root of title are extinguished. That said, however, certain exceptions—such as mineral reservations, government interests, or railroad and utility easements—may survive from as far back as the original grant or patent on the land. Therefore, a thorough title search should extend beyond the root of title.

Title Insurance

Title insurance *protects lenders (and sometimes property owners) against loss due to disputes over ownership of a property and defects in the title not found in the search of the public record.* Further, title insurance protects lenders and property owners from claimants not listed in the insurance policy, including defects in the public record such as forged documents, improper deeds, undisclosed heirs, errors in a property's legal description, and other mistakes. Title insurance does not generally cure defects, although a title company could potentially purchase the property and fix the problem. More commonly, it simply insures against losses (up to the coverage amount specified in the policy) due to title defects *other than those specifically excluded.* It may require the title company to go to court if necessary and defend its policyholder against any claim against the ownership of the land. A title insurance policy, generally paid for with a one-time premium, may have different insureds:

- **Mortgagee's Policies.** The mortgagee (lender) may have a policy to protect its interests in the property. The mortgagee's policy is for the loan amount outstanding at the time a claim is paid. The owner's policies and the mortgagee's policies typically coincide, so the title insurance issuer is not paying twice on the same claim.
- **Owner's Policies.** Owner's fee title insurance policies are issued in the name of the property owner. Coverage runs from the time of purchase for as long as the policyholder owns the property. When the property is sold, the new buyer must purchase a new policy and be named beneficiary to collect on a claim from a title defect.
- **Leasehold Policies.** A less common type of title insurance is the leasehold policy. Lessees typically obtain this type of insurance when a substantial amount of money is invested in a property, such as for a building owned on leased land.
- **Easement Policies.** Another less common type of title insurance is the easement policy, which *protects an easement owner's interests across another's property*.

American Land Title Association

Professionals who deal with title insurance are likely to be members of the **American Land Title Association** (ALTA), a national association of title companies, abstractors, and attorneys. Members agree to promote uniformity, quality, and professional standards in title insurance policies. ALTA members advocate safe and efficient transfer of real estate and insist on high standards when searching land title records and preparing insurance documents. The stated goal of ALTA is to eliminate risk *before* insuring in order to provide the owner and lender with the best chance of avoiding land title problems.

Deeds

For a deed to be valid in most states, it must be *in writing* and contain necessary information on its face. In most states, basic requirements for a valid deed are as follows:

1. A **competent grantor** is *a person wishing to grant or convey land, who is of sound mind for the purposes of entering a contract, and who has reached the age of majority*. A competent grantor's signature (and the grantor's spouse, if married) is vital for a valid deed to transfer title.
2. An **identifiable grantee** is *the person to whom the interest in real property is to be conveyed; identified in such a way so as to reasonably separate this person from all others in the world*. This would include getting proper and complete full names for the grantee(s), as well as any generational designations (e.g., Jr., Sr.). Furthermore, a deed must name an identifiable grantee in existence at the time of conveyance.
3. **Words of conveyance** is *a clause in the deed that states the grantor intends to convey title to the land*. Also called the **granting clause**, these words identify the document as one that involves the transfer of interest from one person to another. The wording of the deed must be such that it communicates a definite and clear intent by the grantor to part with the subject land. The words "give," "grant," "bargain," "sell," and "convey" leave no doubt as to the intent of the grantor. The **habendum clause**, included after the granting clause in many deeds, begins "to have and to hold" and describes the type of estate granted.
4. A **legal description** of the property being conveyed, adequate enough to distinguish it from all other parcels of land, is required.
5. **Consideration** is *anything of value* (e.g., money, goods, services, promises) *given to induce another person to enter into a contract*. Consideration recited on the deed is necessary to prove that a sale of land took place and that the transfer was not a gift, since a gift may be attacked by creditors as a fraudulent transfer of assets. The actual price paid need not be recited, but the full consideration must be stated in cases involving public sale (e.g., at foreclosure). If the property is truly being given as a gift, then the consideration may just state "For the love and affection given to me by my daughter, I herby deed to her the following real property." This would be called "**good consideration**."
6. **Acknowledgment** is *when a party signs a document before an authorized official, generally a notary public, stating it was signed voluntarily*. In the case of a deed, the grantor acknowledges before the notary public that the act of selling the land is an act of free will. After a formal declaration before the authorized official (the notary), the official then certifies the signature is voluntary and genuine.

Once the deed is valid, **delivery and acceptance** of the deed, during the grantor's life, will transfer the title from the grantor to the grantee. Deeds are not required to be recorded to be valid; an unrecorded deed may in fact be valid, but it does not protect the grantee against challenges. Similarly, recording an invalid deed does not make it valid.

Donative intent is *intent by the grantor to transfer title immediately and unconditionally*. This is also vital for a valid deed. Even when a deed is given to the grantee while the grantor is alive, it is not effective unless the grantor intends to surrender control over the property and transfer title immediately. If the grantor retains any power to recall the deed, or intends for it to take effect only under certain conditions or at some other time in the future, the deed does not transfer title to the grantee.

Warranty Deeds

A **warranty** deed *carries certain guarantees related to title and the grantor's right to convey title.* Warranties may be very broad or very limited. When a warranty is breached, the grantee has the right to sue the grantor for compensation. The guarantees that go with a deed differ depending on whether a **general warranty deed** or a **limited warranty deed** is used.

General Warranty Deeds

General warranty deeds are *deeds in which a grantor warrants title against defects that may have arisen before or during the grantor's ownership* (also called standard warranty deeds or, sometimes, simply warranty deeds). A general warranty deed gives the grantee the greatest possible protection. General warranty deeds are the most common for property transfers. Grantor guarantees typically include the following covenants:

- **Covenant of Seizin.** The grantor owns the estate and has the right to convey it.
- **Covenant Against Encumbrances.** The property is free of encumbrances not recited as exceptions in the deed.
- **Covenant of Quiet Enjoyment.** The grantee can possess the land without claims of title from others.
- **Covenant of Warranty Forever.** The grantor will defend the grantee's interest against all lawful claims of title.

Limited Warranty Deeds

Limited warranty deeds are *deeds in which the grantor warrants the title only against defects arising during the time that he owned the property, and not against defects arising before that time.* They are also called **special warranty deeds.** This type of deed is not so broad. With this type of deed, the grantor guarantees only the following covenants:

- Grantor guarantees there are not any encumbrances he created.
- Grantor promises to defend title against anyone claiming under him.

Deeds without Warranties

Deeds without warranties can also transfer title to real property, but with them the grantor makes no warranties regarding title, nor does the grantor guarantee that he even has the right to convey title.

Quitclaim Deeds

Quitclaim deeds *convey any interest in real property the grantor has at the time the deed is executed*. A quitclaim deed makes no warranties whatsoever regarding the title, if any, held by the grantor. It conveys whatever right, title, or interest the grantor holds in the property without representation that there is any interest at all. Often, quitclaims are used to clear up **clouds on the title**. For example, a spouse may use a quitclaim deed to release any dower interest he may have in conveyed property. It may also be used in the case of a life estate to deed the remainder interest to the life tenant, thus creating marketable title by **merger**.

Bargain and Sale Deeds

Bargain and sale deeds *imply the grantor owns the property and has a right to convey it, but there are* ***no warranties*** *that go with it*.

Fiduciary Deeds

Fiduciary deeds are *executed by a trustee, executor, or other fiduciary, conveying property that the fiduciary does not own but is authorized to manage*. A fiduciary is one who is in an appointed position of trust and is acting on another's behalf. Since such deeds often result from some sort of **court order**, in which case they may be referred to as **judicial deeds**.

The fiduciary cannot give general warranty provisions, since the fiduciary is merely acting on behalf of someone else. The only warranties fiduciaries can give, by law, involve their role as fiduciaries, not the state of the title to land. Fiduciaries warrant that they have been duly appointed by a court of competent jurisdiction as fiduciaries and that the act of selling the subject land falls within the duties, as outlined, in their fiduciary relationships.

The name of the deed being used reflects the role of the person executing the deed:

- **Executor's Deed.** Used to convey property of the deceased
- **Administrator's Deed.** The person appointed by the court to convey property of the deceased
- **Guardian's Deed.** Used to convey property by a court-appointed representative
- **Sheriff's Deed.** Used in sheriff's sale at foreclosure
- **Referee's Deed.** Used in bankruptcy or foreclosure proceedings

Recording Deeds

Usually, a final step after delivery and acceptance is filing the document in the county clerk's office where the property is located. Deeds are *not* required to be recorded to be valid; an unrecorded deed may in fact be valid, but it does not protect the grantee against challenges. Recording a deed makes its existence clear to third parties as part of the public record and also insures against lost documents. (Note that recording an invalid document does *not* make it valid.) In addition to the elements required to create a valid deed, these elements must be present in order to record the deed:

- A public official, such as a notary public, must serve as a legal witness to the grantor's **acknowledging signature**.
- A **certificate of the address of grantee** ensures that tax authorities are informed as to where to send tax bills.
- There should be evidence of **real estate transfer tax**, which is often in the form of a stamp.

Illinois Uniform Vendor and Purchaser Risk Act

The **Uniform Vendor and Purchaser Risk Act** (765 ILCS 64/1) indicates specific rights and duties inherent in any contract for the purchase and sale of real property in the State of Illinois when all or a portion of the property being sold is either destroyed or taken by eminent domain.

If, **before** legal title or possession of the property under contract has been transferred to the buyer, all or a material part of the property is either destroyed (through no fault of the seller) or taken by eminent domain, the seller **cannot enforce the contract**. The buyer would be entitled to recover any portion of the price already paid. For example, if the house is struck by lightning and burns to the ground a week before closing, the buyer would be released from his contractual obligations to purchase the property.

If the property (or a material part of it) has been destroyed or taken by eminent domain **after either** legal title or possession of the property under contract has been transferred, the buyer is **not relieved from the contractual obligation** to pay the price agreed to in the contract, nor is the buyer entitled to recover any funds already paid.

Note that if the sale is to be consummated by means of an escrow, title is not considered to have been transferred unless the conditions of the escrow related to passing the full legal and equitable title have been fulfilled, even if the deed has been delivered and recorded.

The Closing

A **closing** is *the final step in a real estate transaction when the transfer of real property ownership from seller to buyer occurs, according to the terms and conditions in a sales contract*. Before a real estate transaction closes, all conditions and contingencies to the sales contract must be met. In most real estate transactions, two events take place simultaneously:

- **The closing of the buyer's mortgage loan and disbursement of funds.** At the closing, sellers are paid the balance of the purchase price, and existing liens, such as a mortgage, are satisfied. Typically, buyers pay the balance of the purchase price with a combination of a mortgage loan and personal funds.
- **The closing of the sale and transfer of title.** Before a real estate transaction closes, all conditions and contingencies of the sales contract must be met. Once all parties are satisfied the conditions and contingencies have been met, the deed can be executed and delivered, thus transferring title to the new owner.

The **closing officer** or **settlement officer** is generally the person responsible for conducting the closing proceedings. He or she may prepare the **settlement statement**, also called a closing statement, which involves calculating the division of credits and debits between the buyer and the seller. The settlement officer is also the one who will collect and disburse all funds to the appropriate parties. The closing could also be handled by:

- An escrow agent.
- A broker.
- The buyer's or seller's attorney.
- A representative from the lender or title company.

The most common methods of conducting a closing are the **roundtable closing**—which you may also see referred to as **face-to-face closing** or a **settlement meeting**—or an **escrow closing**. The purchase agreement typically identifies when, where, and how the closing takes place.

Roundtable Closing

A closing may be conducted as a face-to-face meeting of all interested parties. Closings are generally held at the title company's office, the broker's office, the lending institution, or at one of the participating attorney's offices. The closing may be conducted by an attorney, a broker, or a title company representative, sometimes called a *closing agent.* Each participant in the closing has a distinct role:

- **Buyers** attend to pay for and receive title to the property.
- **Sellers** attend to grant their property to the buyers and receive payment.
- The **buyer's and seller's attorneys** are present to review all closing documents to ensure they are in their clients' best interests.
- **Real estate agents** are there to fulfill their fiduciary obligation to their clients to account for all monies transacted.
- A **mortgage company representative** examines all loan documents and makes sure the property for which a mortgage is being issued has a clear title, prepares the settlement statement, and disburses funds to the seller.
- **Title company representatives** review the documents and, once satisfied, deliver evidence that the title is insured.

Escrow Closing

Settlement may also be conducted in an **escrow closing**. This is conducted by a disinterested third party referred to as an **escrow agent**, and is usually **not** attended by the buyer and seller. An escrow agent may be an attorney, a representative of a title agency, or the escrow department of the mortgage lender. The escrow agent is responsible for performing closing procedures as detailed in the purchase agreement, or in a separate set of escrow instructions, signed by both the buyer and seller. The same agent usually performs duties for both buyer and seller since there's no conflict of interest when procedures are followed as prescribed.

The steps in a typical escrow closing are similar to a roundtable closing:

1. The seller gives a new executed deed for the property to the escrow agent, along with any inspections or other required documentation.
2. If there's an outstanding mortgage loan balance on the property that is to be paid off by the sale, the escrow agent usually has to contact the lender to get the exact pay-off amount as well as a mortgage release document.
3. The buyer gives the escrow agent all funds needed for closing. If there's financing involved, the buyer's lender gives a loan commitment prior to closing and pays the loan amount at closing.
4. The escrow agent completes the closing after all conditions of the closing have been met, as spelled out in the purchase agreement or other instructions, and disburses the funds to the seller and previous lender, commission to the broker, deed to the buyer, and other documents, such as insurance policies or tax records, as necessary.

Real Success

Closing procedures may be different from state to state—or even from one part of a state to another. For example, in some states, an attorney is required to close the loan. Other states allow a title agent to perform the loan closing. Closings may be conducted in escrow, which means they are handled by a disinterested third party, or roundtable, where all parties are present. A borrower who cannot attend a closing may be able to use a power of attorney if one exists specific to the property being transferred.

In some areas, it is customary for brokers to step out of the picture once they have brought about a meeting of the minds and turn things over to attorneys for the seller and buyer. In other areas, brokers remain involved all the way through closing, advising the client and remaining in contact with all parties involved to ensure everything needed to close the transaction is in place. Brokers attend a final walk-through with buyers on the day of closing or immediately prior to it. Even though brokers are not typically responsible for actually conducting the closing, a broker is fulfilling the fiduciary obligations of care and accountability by ensuring the closing transaction follows the terms as outlined in the written sales contract.

Regardless of the extent of the broker's participation, the broker's commission is paid at the closing. Prior to the closing, the broker submits a commission statement to the participating attorneys or closing agent and a check is cut to the broker(s) for commission earned. The broker(s) is then responsible for distributing the commission to his agents and to any cooperating agents according to their agreement.

Typical Closing Documents

One of the most important documents necessary to prepare for a real estate closing is the **purchase agreement**. The terms of the purchase agreement dictate the requirements of the closing, including the necessary documents. For example, if the transaction involves the *transfer of personal property* from the seller to the buyer, a **bill of sale** may be required. While not every document is applicable for every closing, several documents or forms are typically presented and reviewed as part of the closing process.

Deed. A **deed** is *an instrument that conveys a grantor's interest, if any, in real property.* At closing, the seller (the grantor) provides a new signed deed to the buyer (the grantee). To be properly executed, the grantor must *deliver* the deed with the intention of transferring title. Once the grantee *accepts* the deed, she holds title to the land.

Survey. In some transactions, either the buyer or the buyer's lender will require a survey to ensure the property description is accurate. A **survey** is the *process of determining the physical size and boundaries of a property.* If the mortgage company requires a survey, the seller usually bears the cost of it, although this is certainly open to negotiation. Some lenders will accept a less expensive alternative called a **location note endorsement** to the title insurance policy.

Mortgage Documentation. Since buyers generally do not have ready cash on hand to purchase property, most real estate transactions require some sort of financing, which involves multiple documents:

- The financing instrument, typically a **promissory note**, is a written promise to repay the money owed and is signed by the borrower.
- The security instrument, usually a **mortgage** or **deed of trust**, provides security for the debt by creating a voluntary lien against the property. The buyer is required to sign this and give it to the lender as security for repayment of the note. The mortgage must be recorded at the county recorder's office in the county where the property is located to ensure constructive notice to the public and establish lien priority.
- If the seller still has a mortgage on the property, the buyer's lender typically brings a check in the payoff amount made out to the seller's mortgagee or to the title company or closing agent, who in turn writes checks to all of the parties to the transaction as appropriate. Once the seller's lender is paid, that lender issues a **satisfaction of mortgage**, also called a **discharge of mortgage**, which should be recorded as evidence that the lien has been released.

Homeowners Insurance. Lenders require homeowners insurance policies be sufficient to replace the home or reimburse the mortgage amount *in the event of a fire or other disaster.* Depending on the location of the property, **flood insurance** may also be required.

Property Inspection Reports and Certificates of Occupancy. Lenders require a pest inspection, while buyers may also require a home inspection. Other inspections that may be required by a buyer or lender include structural integrity, septic systems/soil/waterflow (referred to as percolation or perc tests), and radon gas, among others. Some municipalities may require a certificate of occupancy as evidence that the property is inhabitable as well as property inspections.

IRS Form 1099. The Internal Revenue Service requires that every real estate transaction be reported. The closing agent is responsible for filing a **Form 1099** with the IRS. If the closing agent fails to notify the IRS, the responsibility is then passed to the mortgage lender. However, any of the parties involved in the transaction could be held liable if the transaction goes unreported.

Settlement Statement. The **settlement statement**, also called a **closing statement**, *itemizes all expenses and costs paid by the buyer and seller to close the real estate transaction.* It is generally prepared by the buyer's and seller's attorneys or title or bank representatives prior to closing. Ultimately, it is the lender who is responsible for the accuracy and timely delivery of the Closing Disclosure. While real estate licensees do not typically prepare settlement statements, it is advisable to be familiar with them so that clients' questions may be addressed. The **Real Estate Settlement Procedures Act** requires the use of the standardized **Closing Disclosure** settlement statement for all federal-related residential loans. Lenders must provide this to borrowers within **three business days** prior to closing.

Closing Costs

When considering expenses associated with a real estate transaction, people often think about commission, sale price, interest, homeowners insurance, and property taxes. *Any* cost to a buyer or seller can be listed on a settlement statement.

Some items not required by the lender, such as a fee for a professional home inspection or for repairs necessary to close the transaction, may not appear on the settlement statement. However, the escrow deposits that lenders require a buyer to pay to cover future property taxes or homeowners insurance *are* required to appear on the settlement statement, even if they are considered an out of pocket expense.

A more thorough discussion of reconciling closing costs and the Closing Disclosure, including a sample, is available in Chapter 22: The Mortgage Lending Process.

Typical Seller Closing Costs

The costs sellers can expect to pay include the following:

- **Attorney fees**, which vary depending on the type of representation provided and the amount of work involved.
- **Broker's commission**, which is typically a percentage of the property's sale price. When a buyer's broker is involved in the transaction, the buyer's broker may be paid a percentage of the selling broker's commission through a cooperative arrangement as detailed in the purchase agreement.
- **Title charges** to ensure a good, marketable title.
- **Existing lien payments**, if there are any on the property, are generally satisfied prior to close, although it is not a legal requirement. For example, in a cash transaction, the buyer has the right to purchase the property subject to outstanding liens.
- **Recording fees** are incurred by sellers when they have to file a discharge of mortgage and/or other satisfaction of judgments through attorneys.

Illinois Real Estate Transfer Tax

Sellers are also required to pay a **real estate transfer tax**, which is simply a *tax on the value of real property when it is sold.* The **Illinois Real Estate Transfer Tax Law** (35 ILCS 200/31-10) imposes a transfer tax at the rate of **50 cents for each $500 in value or portion of $500**. The county in which the property is located imposes its own real estate transfer tax at the rate of **25 cents**, for a consolidated total of **75 cents per $500 of** value, or portion thereof. "Value," in this instance, is defined as the amount of the full actual consideration for the real property, which means the full purchase price. An exception to this if the mortgage is being assumed by the buyer, in which case, only the owner's equity (not the amount of the mortgage outstanding) is included as the base for computing the tax.

For example, let's say that the purchase price of a home is **$420,300**. The buyer is assuming the seller's existing mortgage, which has a balance due of $100,000. The owner's equity, therefore, is $320,300. To determine the transfer tax, you need to first calculate how many "units" of $500 there are:

$320,300 / 500 = 640.6

That .6 tells you that there is an additional portion of $500, so you need to add 1 to get 641 "units." Now you simply multiply by 75 cents to determine the transfer tax:

641 x $0.75 = $480.75 transfer tax

What if the full actual consideration for another property transfer was $422,510? Again, find the number of $500 units, then multiply by 75 cents:

$422,510 / 500 = 845.02

846 units x $0.75 = $634.50 transfer tax

The tax is collected by the recorder or registrar of titles of the county in which the property is situated through the sale of **revenue stamps**. The revenue stamps must be affixed to the deed or other document conveying title before the deed can be recorded. A declaration must accompany the deed, signed by at least one of the sellers and one of the buyers (or their attorneys or agents), that includes the value of the property being transferred on which the tax is based as well as property identification information.

You may see this 75 cents per $500 amount referred to simply as the "state transfer tax" or "Illinois transfer tax" even though part of it does go to the county in which the property is located. Municipalities may impose their own transfer taxes separately.

Typical Buyer Closing Costs

The costs buyers can expect to pay include the following:

- **Appraisal, credit report, and survey fees**, typically charged to buyers by lenders as part of the mortgage application process.
- **Attorney's fees** for their own attorney's representation; if the lender has an attorney, the buyers are responsible for paying those fees as well.
- **Bank fees**, which can be a variety of charges payable to the lender upon closing:
  - **Origination fee** to compensate the lender for making the loan
  - **Points** charged by the lender for a variety of reasons, such as to lower the interest rate or to accommodate a higher risk borrower or a higher risk property. A point is equal to 1% of the loan amount.
  - **Escrow** collection for hazard insurance and property taxes
  - **Tax service fees** to offset the cost of monitoring the escrow account for property taxes
  - **Private mortgage insurance** (PMI) for the protection of lender in the event a buyer defaults on the home loan, if applicable

- **Home inspection fees**, which are the buyer's responsibility. Although encouraged, home inspections are not a lender requirement. Lenders do, however, generally require a **termite inspection**, which the buyer must pay for.
- **Recording fees** paid to the county clerk for filing the deed, mortgage, etc.
- **Title insurance**, which is required by lenders.
- **Flood certification fee**, which is required to analyze whether property is in a flood zone and therefore requires flood insurance.

Transaction File Maintenance

A sponsoring broker in Illinois is required to retain records relating to residential property transactions either in hard copy or electronically (Rules: 1450.755). These records may include copies of the following:

- Signed contracts, including offers and counteroffers
- Written release of escrow funds
- Dual Agency Authorization
- Notices of designated agency or non-agency
- Written direction for deposit into interest bearing special account
- Power of attorney
- Disclosures (e.g., lead paint, radon, seller disclosure)
- Closing statements

This transaction file must be maintained for at least **five** years.

Summary

1. A person who dies leaving a will is said to have died **testate**. A person who dies without leaving a will is said to have died **intestate**. A **will** is a person's legally binding instructions regarding how his estate should be disposed of after death. **Intestate succession** is when property passes to a person's legal heirs because he died without a valid will according to the **statute of descent**. In Illinois, if a person dies intestate without leaving a valid will and with no living heirs, title to that person's property **escheats** to the county in which the decedent lived.
2. The **deed** is the document used by the owner of real property to transfer all or part interest in the property to another. The deed is mere evidence of title; it does not necessarily prove ownership of property. **Title** is the actual lawful ownership of real property and refers to holding the bundle of rights conveyed. Title is not a document, but rather a theory pertaining to ownership.
3. **Marketable title** is title that is free and clear from undisclosed encumbrances or other defects that would affect the purchaser. A title search to determine ownership and the quality of the title prior to conveyance is usually performed by an abstractor or a title company. It starts with the **chain of title** and results in the creation of an **abstract of title**, a complete historical summary of title to a piece of property. If there is a cloud on the title, a **suit to quiet title** may be necessary.
4. There are several forms of deeds. A **general warranty deed** *contains the strongest and broadest form of guarantee of title of any type of deed and provides the greatest protection of any deed to the grantee.* In this type of deed, the grantor makes various legal promises, or covenants, including the: **Covenant of seizin** (assures the grantee that the grantor holds the title to convey); **covenant of right to convey** (states the grantor owns the land and has the right to convey); **covenant against encumbrances** (assures the grantee the property is free of encumbrances not recited as exceptions in the deed); **covenant of quiet enjoyment** (ensures the grantee can possess the land without claims of title from others and will not be disturbed in the use of the land); **covenant for further assurances** (requires the grantor to remedy any defects in the title being conveyed and any errors or deficiencies in the deed itself); and **covenant of warranty forever** (provides the grantor will defend grantee's interest against unlawful claims of title).
5. Other deeds may or may not include warranties but are still a valid way to transfer title to real property: **Bargain and sale deed with covenants** (implies the grantor holds title to the property and has not encumbered the property); **quitclaim deed** (conveys any interest in a parcel of land the grantor has at the time the deed is executed); **judicial deed** (someone empowered by the court to exercise judicial power to convey the land in question, such as an executor, guardian, administrator, sheriff, or referee).
6. A **closing** is the final stage in a real estate transaction; transfer of real property ownership from seller to buyer occurs according to the terms and conditions in a sales contract. In most real estate transactions, two events simultaneously take place: The closing of the buyer's mortgage loan and disbursement of funds, and the closing of the sale. Participants in a closing usually include the buyers and sellers, their attorneys, the real estate agent, and representatives from the mortgage and title companies.
7. The purchase agreement dictates how closing is handled. It may be held as a roundtable closing with all participants gathered or an escrow closing where an escrow officer handles everything. Documents typically required for closing include: Evidence of title (usually title insurance), mortgage documents, the deed from the grantor, homeowner's insurance, and a settlement statement.
8. A **settlement statement** is a document prepared by a lender or closing agent that itemizes all expenses and costs paid by the buyer and seller to close the real estate transaction. Any cost to a buyer or seller can be listed on the settlement statement. Items can vary from closing to closing because the payment of any item is always negotiable between buyer and seller. Items not listed on a settlement statement are those paid for personally by the buyer or seller prior to closing. **Sellers** can expect to pay: Attorney's and broker's fees, any existing liens on the property, recording fees, and **Illinois state/county transfer taxes of $0.75 / $500 or portion** of the consideration paid. **Buyers** can expect to pay: Fees for appraisals, credit reports, and surveys; attorney's fee; bank fees; recording fees; and title, mortgage, and homeowners insurance premiums. Borrowers may request a preliminary copy of the Closing Disclosure settlement statement three business days prior to closing.

Quiz

1. ***Equitable title is***
   a. actual lawful ownership of real property.
   b. an instrument that conveys ownership of real property.
   c. an interest in real property created by the execution of a valid sales contract.
   d. when two people share an equal interest in the title to land.

2. ***Brett bought a farm, and two tractors were included in the sale. What is required at the settlement to transfer title of those tractors?***
   a. abstract
   b. bill of sale
   c. deed
   d. original receipts

3. ***Why are real estate instruments recorded in the county in which the property is located?***
   a. because the law requires that such instruments be recorded
   b. because the broker cannot get his commission until these documents are recorded
   c. to comply with the terms of the statute of frauds
   d. to give constructive notice of an interest in a particular parcel of real estate

4. ***Margaret, a single woman, dies intestate. She has no living parents, brothers, or sisters. According to the Illinois Intestacy Statute, who would be next in line to inherit her estate?***
   a. the county in which she lived
   b. her maternal grandfather
   c. her nephew, who is her sister's son
   d. whomever is named in her will

5. ***Which deed guarantees title against all encumbrances occurring during any previous ownership?***
   a. general warranty deed
   b. judicial deed
   c. quitclaim deed
   d. sheriff's deed

6. ***How is the closing date generally determined?***
   a. It is based on the lender's availability.
   b. It is indicated in the purchase agreement.
   c. It is set by the settling officer.
   d. It must be concluded within 30 days of signing a purchase agreement.

7. ***Of these types of deeds, which would most likely be used to clear a cloud on a title?***
   a. bargain and sale deed
   b. general warranty deed
   c. quitclaim deed
   d. special warranty deed

8. ***At closing, who signs the new deed?***
   a. the buyer only
   b. the seller only
   c. both the buyer and the seller
   d. the buyer, the seller, and a witness, usually the settlement officer

9. ***Kim and Bill sold their Illinois house for $185,900. What is the state/county transfer tax on this transaction?***
   a. $95
   b. $279
   c. $379
   d. $744

10. ***Patricia, a first-time home buyer, requests to see the Closing Disclosure settlement statement prior to the closing. The lender must provide this at least _____ prior to closing.***
    a. 1 business day
    b. 2 business days
    c. 3 business days
    d. 5 business days

11. ***Which document is one of the most critical to the closing, and basically lays the foundation for the closing?***
    a. abstract of title
    b. bill of sale
    c. mortgage
    d. purchase agreement

12. ***Who is responsible for bringing a promissory note to the closing table?***
    a. buyer
    b. lender
    c. seller
    d. settlement officer



18

Leases

A **leasehold estate** is an interest that gives the holder a **temporary** right to possession of the estate without having a title. In this chapter, you will look at the contract that creates a leasehold estate. You'll learn about types of leases and contract provisions that are specific to leases. You'll also spend time seeing how security deposits must be handled according to Illinois law. Finally, you will discuss concepts related to transferring a lease and see the circumstances under which a lease may be terminated. You will learn:

- How to distinguish among the different types of leasehold estates.
- The use of different types of leases.
- Typical provisions in a residential lease.
- Requirements for handling security deposits.
- How leases may be terminated.

Key Terms

Assignment
Covenant of Quiet Enjoyments
Estate at Will
Estate for Years
Graduated Lease
Gross Lease
Ground Lease
Holdover Tenant
Index Lease
Lease
Leasehold Estate
Lessee / Lessor
Net Lease
Percentage Lease
Periodic Estate
Security Deposit
Sublease
Tenancy at Sufferance

Leasehold Estates

The *holder of a leasehold estate* is known as a **tenant** or **lessee**. The *property owner* is known as the **landlord** or **lessor**. Leasehold estates are created by lease agreements that provide contractual rights and obligations to all parties involved. A leasehold interest is reversionary, meaning that once the lease ends, *possession of the property reverts to the landlord.* There are several types of leasehold estates.

Estate for Years

An **estate for years** is a leasehold estate *set to last for a specific period, after which it automatically terminates.* It is also known as a **term tenancy** or a **tenancy for years**. Duration of an estate for years can be any amount of time, even just for one day. An estate for years terminates automatically at the end of the specified rental period and does not require either party to give notice. Unless someone breaches the terms of the lease, neither the landlord nor the tenant can terminate a term tenancy sooner than what is stated in the contract, unless both parties agree. An estate for years is *not* terminated by the death of either party or by the sale of the property.

Periodic Estate

A **periodic estate** is a *leasehold estate that continues for successive equal periods of length until terminated by proper notice from either the lessor or the lessee.* The term of a periodic estate, also called a **periodic tenancy**, may be any length of time agreed to—such as week-to-week, month-to-month, or year-to-year—and the tenancy automatically renews itself at the end of each period until one party terminates it.

In Illinois, proper notice of intent to terminate a periodic estate must be provided, in writing, a prescribed number of days before the tenancy ends (735 ILCS 5/9)

Type of Periodic Tenancy	Proper Notice
Year-to-year	60 days *
Month-to-month	30 days
Week-to-week	7 days

* This notice may be given at any time within four months preceding the last 60 days of the term of the year-to-year tenancy.

A periodic estate is *not* terminated by the death of either party or by the sale of the property.

Estate at Will

An **estate at will** is a *leasehold estate that does not have a lease to specify the termination date and rental period.* Sometimes no rent is paid (e.g., resident apartment superintendent), or the rent owed has no reference to time periods (e.g., "35% of gross profits"). A common example of an estate at will is someone who rents to a family member who occasionally pays rent, but there is no lease agreement.

Either party can end an estate at will at any time with proper notice, which in Illinois is **30 days**.

Unlike the estate for years or the periodic estate, an estate at will *automatically terminates* when either the landlord or tenant dies.

Tenancy at Sufferance

Tenancy at sufferance, also known as an **estate at sufferance**, describes *possession of property by a tenant who came into possession of the property under a valid lease, but stays on after the lease expires without the landlord's permission.* A tenancy at sufferance is ***not a leasehold estate***.

A landlord is not required to give a tenant at sufferance--sometimes called a **holdover tenant**—notice of termination. Illinois real property law allows landlords to remove holdover tenants by initiating the legal eviction process. Landlords cannot use force to regain possession of the property; only a sheriff can physically remove a holdover tenant.

Under Illinois law, if a landlord accepts rent from a holdover tenant after the lease has expired, the landlord has essentially agreed to the terms and a **month-to-month** or **periodic tenancy** is automatically created. In this particular situation, a periodic tenancy may also be referred to as a **holdover tenancy**. Such a tenancy may be terminated upon 30 days notice.

If the landlord refuses to accept the offered rent and the tenant continues living on the property, the landlord may consider it to be a **willful withholding of the property**, which allows the landlord to charge the tenant **double** the rent due.

Leases

Leases are *contracts in which one party (*the **lessee**) *pays the property owner* (the **lessor**) *rent in exchange for possession of real estate. Thus, a lease is the conveyance of a leasehold estate from the fee owner to a tenant.* Lessees, or tenants, are entitled to **quiet enjoyment** of the property, which is the *right to the use and possession of real property without interference from the previous owner, the lessor, or anyone else claiming title*.

Owners are expected to receive money in the form of rent plus the reversionary interest in the property. *Reversionary interest* means the property will revert to the owner at the end of the lease term. Leases are generally categorized by the method of rent payment. A **gross lease** is one in which the *tenant pays a fixed rent, while the owner or landlord pays all ownership expenses,* such as property taxes, repairs, insurance, and sometimes utilities. Residential leases are usually gross leases.

Commercial Leases	Definition
Net lease	The tenant pays some or all of the expenses associated with the property—taxes, insurance, and maintenance—in addition to rent. If the lease requires the tenant to pay one of these expenses, it's called a single net lease. If the tenant is required to pay any two of these expenses, it's a net-net lease, or a double net lease. A triple net, or net-net-net lease, requires the tenant to pay all three of these expenses.
Percentage lease	The tenant pays a percentage of gross sales on the premises, often in addition to a fixed monthly rental payment. This type of lease is most commonly used for retail tenants and may include a clause that allows the owner to reclaim the premises if gross sales fall below a specified point.
Land lease / Ground lease	A tenant leases unimproved land on a long-term basis; this lease typically includes a provision that provides the tenant will construct a building on the property, which the tenant will own upon completion.
Index lease	The amount of the rent is tied to some common index indicator such as the Consumer Price Index or the Wholesale Price Index that neither the landlord nor the tenant controls. As the agreed upon index increases, the rent goes up by the same percent of change.
Graduated lease	Spells out step-by-step rent increases (or decreases), generally paid in installments. An example might be a long-term lease that spells out annual rent increases.

Standard Lease Provisions

In Illinois, there is no statutory form for a residential lease. Many local associations and Multiple Listing Services provide sample lease forms with generic language. Property owners can also find sample residential leases from online providers or even local office supply stores. Since the lease is a contract, however, the essential elements of a valid contract are also necessary for a valid lease. For example, the lease must be stated in plain language. Standard provisions in a lease include:

- **Legal capacity to contract**, in other words, both parties must be competent and over the age of 18.
- A **demising clause**, which grants possession of the property to the lessee.

- **Terms** of the lease must be clearly stated, including the duration of the tenancy and its expiration date.
- An adequate **description** of the property. For most leases, the street address is sufficient.
- **Consideration**, which usually is a sum of money paid as **rent** in exchange for possession of the property. It should indicate the amount of rent as well as how and when it is paid.
- **Lease renewal**. Illinois does not provide for statutory rights of renewal. However, included in many leases is an **option to renew,** which *sets forth the renewal methods and terms of the new lease.*
- A **use provision**. Residential leases typically assert the premises cannot be used for anything other than its intended purpose—a place to live. Commercial leases, unless otherwise noted, usually state the premises may be used "for any lawful purpose," if the purpose does not violate private deed restrictions.
- **The terms listed in writing** if it will last for more than **one year** to comply with the statute of frauds**.** In Illinois, an **oral** lease for *less than one year is generally enforceable*.
- **Signatures** of both parties.

Illinois Liability Exemptions. Section 1 of the Illinois Landlord and Tenant Act (765 ILCS 705/1) indicates that it is forbidden to include any covenant, agreement, or understanding in a residential lease that would exempt the lessor from liability from damages for injuries to people or property resulting from any negligence on the part of the lessor, his agents, servants, or employees.

Covenant of Quiet Enjoyment

Leases often contain **covenants**, which are *promises or guarantees.* A common guarantee in a lease is the **covenant of quiet enjoyment**, which means the property *cannot be interrupted or invaded by anyone, including the property owner, without the lessee's consent.* What this means is property owners do not have the automatic right to enter the premises unannounced. This also applies to contractors employed by the owner to make repairs and/or installations.

Property owners must provide reasonable notice to tenants before they, or contractors they have employed, enter the premises. Usually, 24 to 48 hours is sufficient. The owner *does* have the right to enter the premises in an emergency in order to protect the property.

Other Common Lease Provisions

Typical residential leases may also address:

- The landlord or property manager's right of entry/inspection
- Pet policies, including deposits, additional rent, or damage fees
- Smoking policies
- Conduct and house rules
- Responsibilities of landlord and tenant for property condition and maintenance
- The landlord's rights of lease termination in the event of breach
- Liability and indemnity/insurance
- Late fees
- Parking
- Noise issues
- Alternation of premises
- Prohibited personal property or furnishings (e.g., large aquarium or water bed)

Since landlords are required to provide tenants in buildings built prior to 1978 with the **Residential Lead Paint Disclosure**, most leases will also contain an acknowledgement from the tenant the that disclosure was received. Lessors should also provide lessees with a **Mold Disclosure Form.**

This lease form is intended for properties to which the Chicago Residential Landlord and Tenant Ordinance is applicable. However, the Chicago Association of Realtors© recommends that the Ordinance be carefully reviewed and that an attorney be consulted before using this or any other standard lease form for properties in the City of Chicago.

INSTRUCTIONS TO TENANT: Please sign and return both copies to Landlord. Your copy will be mailed back to you.

REV. 2008

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NOT FURNISHED CHICAGO APARTMENT LEASE

DATE OF LEASE	TERM OF LEASE		MONTHLY RENT	SECURITY DEPOSIT*
	BEGINNING	ENDING		

**IF NONE, WRITE "NONE" and Section 5 of Lease Agreements and Covenants shall then be INAPPLICABLE.*

ADDITIONAL CHARGES AND FEES*			
Late Charge $ _____	**Returned Check Charge $_____**	**Reletting Charge $ _____**	**Monthly Parking Fee $_____**
Monthly Condominium Association Fee $ _____	**Monthly Storage Fee $_____**	**Property Management Administrative Fee $ _____**	**Monthly Rent Due Upon Lease Execution $ _____**

**IF NONE, WRITE "NONE".*

TENANT:	**LANDLORD:**
NAME(S): ADDRESS: STREET: UNIT #: CITY: STATE: ZIP: TELEPHONE #:	NAME: ADDRESS: STREET: UNIT #: CITY: STATE: ZIP: TELEPHONE #:
NAMES OF PERSONS AUTHORIZED TO OCCUPY PREMISES:	PERSON AUTHORIZED TO ACT ON BEHALF OF LANDLORD FOR PURPOSE OF SERVICE OR PROCESS AND RECEIPT OF NOTICES: ☐ Check box if same address as above NAME: ADDRESS: STREET: UNIT #: CITY: STATE: ZIP: TELEPHONE #:
ADDRESS OF LEASED APARTMENT (the "Premises"): ADDRESS: STREET: UNIT #: CITY: STATE: ZIP:	

ADDITIONAL AGREEMENTS AND COVENANTS (INCLUDING DECORATING, REPAIRS AND CONDOMINIUM BYLAWS, IF ANY)

** IF NONE, WRITE "NONE".*

NOTICE OF CONDITIONS AFFECTING HABITABILITY

I hereby acknowledge that Landlord has disclosed any code violations, code enforcement litigation and/or compliance board proceedings during the previous 12 months for the Premises and the Building and any notice from utility providers of intent to terminate utility services, copies of which, if any, are attached to this Lease.

_____*(Tenant(s) Initials)*

FURTHER ACKNOWLEDGMENTS BY TENANT

Tenant hereby acknowledges that as of the Date of Lease, Tenant has received from Landlord the following documents:

☐ Security Deposit Receipt _____ *(Tenant(s) initials)*

☐ Heating Cost Disclosure Statement _____ *(Tenant(s) initials)*

☐ Rules of Building from Property Manager and/or Condominium Association _____ *(Tenant(s) initials)*

☐ Lead-Based Paint Brochure: *Protect Your Family From Lead in Your Home* _____ *(Tenant(s) initials)*

In consideration of the mutual agreements and covenants set forth in this Lease, and in further consideration of the statements made by Tenant in the application for Lease and all supporting documents thereto, including Tenant's financial statements (if any), the truth and accuracy thereof being attested to by Tenant and the information therein contained being incorporated into this Lease as if set forth herein in full, Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, for use as a private dwelling unit only, the Premises, together with the fixtures and appliances belonging thereto, for the Term. If there is more than one undersigned Tenant, the term "Tenant", as used herein, shall include all of such undersigned persons and each and every provision of this Lease shall be binding on each and every one of the undersigned persons and they shall be jointly and severally liable hereunder and Landlord shall have the right to join one or all of them in any proceeding or to proceed against them in any order.

TENANT:

_____
Name Date

_____
Name Date

LANDLORD:

_____
Name Date

_____
Name Date

SAMPLE

LEASE AGREEMENTS AND COVENANTS

1. RENT: Tenant shall pay to Landlord at the above address (or such other address as Landlord may designate in writing) the Monthly Rent set forth above on or before the first day of each month of the Term in advance. The Monthly Rent, Monthly Storage Fee and Monthly Parking Fee, and all other rental fees due and payable under this Lease, if any, shall hereinafter be referred to collectively as "Rent". The time of each and every payment of Rent is deemed to be of the essence of this Lease. To cover Landlord's added costs resulting from late payments, the Rent set forth above shall be increased by the amount set forth above as "Late Charge" if paid after the 5th day of the month. To cover Landlord's added costs for processing of checks that are dishonored or are returned due to insufficient funds in the account, Rent shall be increased by the amount set forth above as "Returned Check Charge." Rent mailed in shall be deemed paid on date of receipt by Landlord. If Tenant fails to pay Rent within 5 days after receipt of written notice from Landlord that such Rent is overdue, Landlord may terminate this Lease or pursue any other rights and remedies of Landlord at law or in equity.

2. POSSESSION: On or prior to the Beginning Date of this Lease, Landlord shall deliver possession of the Premises to Tenant. Possession shall be deemed to have been delivered to Tenant on the day that Landlord either (A) actually delivers to Tenant keys to the Premises or (B) makes available to Tenant at the office of the Building or at such other place as designated by Landlord keys to the Premises. If Landlord cannot deliver possession of the Premises to Tenant on or prior to the Beginning Date of the Term, this Lease shall remain in full force and effect with Rent abated until such time as the Premises is available for Tenant's occupancy, unless Tenant elects to maintain an action for possession of the Premises, or, upon written notice to Landlord, elects to terminate this Lease.

3. APPLICATION: The application for this Lease and all representations and promises contained therein are hereby made a part of this Lease. Tenant warrants that the information given by Tenant in the application is true. If such information is false, Landlord may at Landlord's option terminate this Lease by giving Tenant not less than 10 days prior written notice, which shall be Landlord's sole remedy. Tenant shall be responsible for any and all Rent which accrues under this Lease prior to the termination date.

4. PROMISES OF THE PARTIES: The terms and conditions contained herein shall be conclusively deemed the agreement between Tenant and Landlord and no modification, waiver or amendment of this Lease or any of its terms, conditions or covenants shall be binding upon the parties unless made in writing and signed by the party sought to be bound.

5. SECURITY DEPOSIT: Tenant has deposited with Landlord the Security Deposit in the amount set forth above for the performance of each and every covenant and agreement to be performed by Tenant under this Lease. Landlord shall have the right, but not the obligation, to apply the Security Deposit in whole or in part as payment of such amounts as are covenants or agreements contained herein. Landlord's right to possession of the Premiseet for non-payment of Rent by Tenant or any other reason shall not be affected by the fact that Landlord is holding the Security Deposit. Tenant's liability is not limited to the amount of the Security Deposit. Within 30 days after Landlord's application of the Security Deposit, or any part thereof, Landlord shall give Tenant written notice of such application. If the application is on account of maintenance, repairs or replacements necessitated by Tenant, Landlord's notice shall include the estimated or actual cost of the same, attaching estimates or paid receipts. Upon receipt of Landlord's notice, Tenant shall at once pay to Landlord an amount sufficient to restore the Security Deposit in full. Upon termination of this Lease, full payment of all amounts due and performance of all Tenant's covenants and agreements (including surrender of the Premises in accordance with Section 15), the Security Deposit or any portion thereof remaining unapplied shall be returned to Tenant in accordance with applicable law. The Security Deposit shall not be deemed, construed or allocated by Tenant as payment of Rent for any month of the Term.

6. LANDLORD'S MAINTENANCE OBLIGATIONS:

A. Tenant hereby declares that Tenant has inspected the Premises, the Building and all related areas and grounds and that Tenant is satisfied with the physical condition thereof. Tenant agrees that no representations, warranties (expressed or implied) or covenants with respect to the condition, maintenance or improvements of the Premises, the Building, or other areas have been made to Tenant except (1) those contained In this Lease or otherwise In writing signed by Landlord and (2) those provided under applicable law.

B. Landlord agrees that Landlord will perform work required to be performed by Landlord under this Lease within a reasonable time not to exceed 30 days from the Beginning Date hereof.

C. Landlord covenants that all times during the Term, Landlord shall maintain the Premises and the Building (if Landlord owns and/or has control over the owners of the Building) to the following minimum standards:

(1) Effective weather protection, including unbroken windows and doors;
(2) Plumbing facilities in good working order;
(3) A water supply which either under the control of Tenant is capable of producing hot and cold running water, or under the control of Landlord produces hot and cold running water, furnished to appropriate fixtures, and connected to a sewerage system;
(4) Heating (and, if furnished, air conditioning and ventilation) facilities in good working order which, if under the control of Tenant, are capable of producing, or, if under the control of Landlord, produce heat (and, if furnished, air conditioning and ventilation) in fixtures provided (and no others) within reasonable accepted tolerances and during reasonable hours. (In the case of heat, minimum tolerances shall be those established by the governing municipal code or ordinance);
(5) Gas and/or electrical appliances which are supplied by Landlord in good working order, and appropriate gas piping and electrical wiring system to the extent existing in the Building maintained in good working order and sale condition;
(6) Building, grounds and areas under the control of Landlord in clean, sanitary and safe condition free from ail accumulations of debris, filth, rubbish, garbage, rodents and vermin;
(7) Adequate and appropriate receptacle(s) for garbage and rubbish, and, if under the control of Landlord, in clean condition and good repair;
(8) Floors, stairways, and railings and common areas in good repair;
(9) Apartment floors, walls and ceilings in good repair and safe condition; and
(10) Elevators (it existing) in good repair and safe condition.

D. It is, however understood and agreed that the Building is a physical structure subject to aging, wear, tear, abuse, inherent defects, and numerous forces causing disrepair or breakdown beyond Landlord's reasonable control, and that components and skilled workmen are not always immediately available. Landlords costs of operation are fixed and unavoidable and to permit rent abatement or damages to Tenant would create an intolerable burden on Landlord, other tenants and the surrounding neighborhood. It is, therefore, understood and agreed that breakdowns of equipment or disrepair caused by (1) conditions caused by Tenant, members of Tenant's household, guests or other persons who enter or occupy the Premises with Tenant's consent; (2) Tenant's unreasonable refusal of or other interference with entry of Landlord or Landlord's workmen or contractors into the Premises or the Building for purposes of correcting defective conditions; (3) lack of reasonable opportunity for Landlord to correct defective conditions; or (4) conditions beyond Landlord's reasonable control, including strikes or lockouts. In any action against Landlord for breach of the Lease or the covenants contained herein with respect to Landlord's obligations to maintain the Building and/or the Premises, Landlord may assert, as a defense to such claim, that Landlord did not have actual knowledge of such defective conditions.

7. UTILITIES: Unless otherwise agreed in writing, if the Premises is separately metered for utilities, Tenant shall pay the utility company or authorized metering agency directly for all applicable charges for gas, electricity, water and other utilities serving the Premises, including, if applicable, telephone, internet, cable, and current used for electric heating, ventilation, air conditioning, hot water, etc., as such charges become due and payable. If Tenant fails to timely pay the utility companies for the use of such utilities, Landlord shall have the right, but not the obligation, to pay such utility companies directly, in which event Tenant shall reimburse Landlord for such costs, including any late fees, upon demand. Unless otherwise agreed in writing, if the Premises are not separately metered for utilities, Tenant shall reimburse Landlord, no more than once per month, for all utilities consumed by Tenant in the Premises during the Term within 10 days after Landlord delivers a statement to Tenant setting forth Tenant's share of the costs for such utilities, which statement shall include invoices, receipts or other documentation setting forth such costs in reasonable detail.

8. TENANT'S USE OF PREMISES: The Premises shall be occupied solely for residential purposes by Tenant, those other persons specifically listed on the first page of this Lease, if any, and any children which may be born to or legally adopted by Tenant during the Term. Neither Tenant nor any of those persons shall perform nor permit any practice that may damage the reputation of or otherwise be injurious to the Premises, the Building or the neighborhood, or be disturbing to other tenants, be illegal, or increase the rate of insurance on the Premises or the Building.

9. TENANT'S MAINTENANCE OBLIGATIONS: Tenant covenants and agrees to perform the following obligations during the Term: (A) maintain the Premises and appurtenances in a clean, sanitary and safe condition; (B) dispose of all rubbish, garbage and other waste in a clean, sanitary and timely manner from the Premises into the refuse receptacles provided; (C) properly use and operate all appliances, electrical, gas and plumbing fixtures within the Premises; (0) not place in the Premises or the Building any furniture, plants, animals, or any other things which harbor insects, rodents, or other pests; (E) keep out of the Premises and the Building materials which cause a fire hazard or safety hazard and comply with all reasonable requirements of Landlord's fire insurance carrier; (F) not destroy, deface, damage, impair nor remove any part of the Building, the Premises or facilities, equipment or appurtenances thereto; (G) maintain the smoke detector and carbon monoxide detector, if any, in the Premises in accordance with applicable law, and (H) prevent any person in the Premises or the Building with Tenant's permission from violating any of the foregoing obligations of Tenant. Tenant shall not suffer or commit any waste in or about the Premises or the Building and shall, at Tenant's expense, keep the Premises in good order and repair (except with respect to the maintenance obligations of Landlord under this Lease). On termination of this Lease, Tenant shall return the Premises to Landlord in the condition that the Premises was in as of the Beginning Date, reasonable wear excepted.

10. ALTERATIONS, ADDITIONS, FIXTURES, APPLIANCES, PERSONAL PROPERTY: Tenant shall make no alterations or additions nor install, attach, connect or construct in the Premises or any part of the Building, interior or exterior, major appliances or devices of any kind without, in each and every instance, first receiving the written consent of Landlord, and then, if such consent is granted, only upon the terms and conditions specified in such written consent. All alterations, additions and fixtures (including security devices) whether temporary or permanent in character, made by Landlord or Tenant, in or upon the Premises shall, unless otherwise agreed to in writing or unless Landlord requests their removal prior to the Ending Date, become Landlord's properly and shall remain in the Premises at the termination of the Lease without compensation to Tenant. The foregoing notwithstanding, neither Landlord's nor Tenant's insurance carriers shall be liable to Tenant for the replacement of such alterations, additions, or fixtures in the event of casualty loss unless Tenant notifies Landlord of the replacement value and pays, as additional rent, the resultant premium increase, if any. If Landlord shall permit or demand removal, Tenant shall put that part of the Premises into the same condition as existed prior to the installation of such alteration, addition, or fixture.

11. ACCESS: Landlord reserves the right in accordance herewith to enter the Premises in order to inspect same, make necessary or agreed repairs, decorations, alterations, or improvements, supply necessary or agreed services, or exhibit the Premises to prospective or actual purchasers, mortgagees, tenants, workmen, or contractors, or as is otherwise necessary in the operation and/or protection of the Premises, the Building, its components or persons therein. At Landlord's discretion, Landlord shall be provided with and may retain and use copies of any keys necessary for access to the Premises. In the event of apparent or actual emergency, Landlord may enter the Premises at any time without notice. At any time within 90 days prior to the end of the Term, after a single general written notice, Landlord may as often as necessary show the Premises for rent any day between the hours of 9 AM and 8 PM on not less than 15-minute verbal or written specific notice to Tenant or other occupant of the Premises. At other times, Landlord shall only enter the Premises at times mutually agreed upon between Landlord and Tenant; however, if entry at such times is impractical or refused, Landlord may enter the Premises after 24 hours' notice and only during the period of 7 AM to 7 PM Monday through Saturday. In the event of the willful or negligent breach of this Section 11, the non-breaching party shall at once be entitled to actual damages or liquidated damages in the amount of 2 months of the then-current Monthly Rent and an injunction, if necessary, to prevent continuation of such breach.

12. SUBLETTING AND RE-LETTING:

A. In no event shall Tenant assign this Lease or sublet the Premises without, in each instance, first receiving the prior written consent of Landlord. Tenant may only assign this Lease or sublet the Premises if all of the following conditions are met: (1) Tenant is not then in default under the terms of this Lease, (2) Landlord consents to the prospective new tenant in writing, and (3) Tenant upon demand pays, in advance, (a) the deficiency, if any, that exists between the aggregate rent being paid as a result of such assignment or subletting and the Rent that is due and owing Landlord under this Lease for the balance of the Term, and (b) ell permissible expenses of Landlord on account of such assignment or subletting, if any, including, but not limited to, decorating, repairs, replacements, commissions and/or administrative fees for performing the details attendant to such a transaction in the amount set forth above as the 'Reletting Charge.' Landlord, at Landlord's option, shall determine whether Tenant's transfer of interest in the Lease or the Premises shall be treated as a subletting, assignment or re-letting. In the event of a subletting or assignment, Tenant shall still be liable for all of the terms and conditions required of Tenant to be performed under this Lease. In the event of a re-letting, this Lease shall terminate as of the date of such re-letting and Tenant shall have no further obligations hereunder, except for those obligations that expressly survive termination of this Lease.

B. Landlord may at any time and for any reason reject any prospective new tenant offered by Tenant or by others; provided, however, that if Landlord shall do so without cause, Tenant shall be liable to Landlord only for the deficiency and/or actual or estimated expenses described in A(2) (a) and (b) of this Section 12 which would have been due from Tenant had the prospective new tenant been accepted. Cause shall be deemed to be the failure, based on information and data made available to Landlord (or lack thereof), of such prospective new tenant to meet the criteria customarily employed by Landlord to evaluate the acceptability of prospects as tenants for similar apartments in the Building. During the last 3 months of the Term, Landlord shall be obligated to accept an otherwise qualified prospective new tenant only If said prospective new tenant enters into a direct lease with Landlord for a term for which leases are customarily offered for similar apartments in the Building. Landlord may fill other vacancies in the Building first before re-letting or subletting or attempting to re-let or sublet the Premises.

C. Tenant shall neither sublet the Premises nor any part thereof nor assign this Lease nor permit by any act or default or any transfer of Tenant's interest in the Premises or this Lease by operation of law or otherwise, nor offer the Premises or any part thereof for lease or sublease except in accordance with the terms and conditions of this Section 12. Any attempted transfer by Tenant in violation of the terms of this Section 12 shall be voidable by Landlord.

13. ABANDONMENT: Tenant shall not abandon the Premises, nor permit the Premises to remain vacant or unoccupied for a period of time which could be construed as abandonment under state or local law or ordinance. Tenant shall not allow persons other than those authorized by this Lease to occupy the Premises as guests for periods in excess of 7 consecutive days during the Term for any reason.

14. FIRE AND CASUALTY:

A. If the Premises and/or the Building is damaged or destroyed by fire or casualty, and the Premises is only partially damaged and is inhabitable, and Landlord makes full repairs within 90 days, this Lease shall continue without abatement or apportionment of rent; or

B. If the Premises is damaged or destroyed by fire or casualty and (1) the Premises is rendered uninhabitable, (2) continued occupancy would be illegal, or (3) Landlord cannot or does not repair within 90 days, then Landlord may at Landlord's option, (1) terminate this Lease or (2) relocate Tenant to another comparable apartment in the Building until repair and restoration of the Premises is completed. If Landlord cannot or does not repair within 90 days, Tenant's sole remedy shall be to vacate the Premises (or substitute premises) and notify Landlord in writing within 5 days thereafter of Tenant's intent to terminate this Lease, in which event this Lease shell terminate as of the date Tenant vacates the Premises and all prepaid rent and unapplied Security Deposit shall be returned to Tenant.

C. In the event that a fire or casualty causes damage or destruction to the Premises, nothing in this Section 14 shall be construed to limit the rights and remedies available to Tenant under state and local laws and ordinances governing fire and casualty damage in buildings like the Building.

15. TERMINATION AND RETURN OF POSSESSION:

A. Upon the termination of this Lease, whether by lapse of time or otherwise, or upon termination of Tenant's right of possession without termination of this Lease, Tenant shall immediately vacate and surrender possession of the Premises to Landlord and deliver all keys to Landlord at the place where Rent is payable, or as otherwise directed by Landlord. The mere retention of possession of the Premises after termination of this Lease or termination of Tenant's right of possession of the Premises shall constitute a forcible detainer, and Landlord shall have the right and license with process of law (and if Tenant abandons the Premises, Tenant grants Landlord and Landlord shall have such right and license without process of law) to enter into the Premises, to have the Premises returned to Landlord as Landlord's former estate and to take possession of the Premises and to expel and remove Tenant, and any others who may be occupying or within the Premises and any personal property within the Premises from the Premises without relinquishing Landlord's right to Rent or any other right given to Landlord under this Lease or by operation of law. If Tenant abandons the Premises and Landlord exercises the right and license to enter without process of law, Landlord r may use such force as may be necessary without being deemed in any manner guilty of trespass, eviction, or forcible entry or detainer.

B. Tenant agrees that in the event Tenant fails to vacate and surrender the Premises upon termination of this Lease or Tenant's right of possession of the Premises that:

(1) Tenant shall pay as liquidated damages for the entire time that possession is withheld a sum equal to the greater of (i) three times the amount of rent herein reserved, pro rated per day of such withholding, or (ii) Landlord's actual damages if same are ascertainable; or

(2) Landlord, at its sole option, may, upon giving Tenant written notice, extend the Term of this Lease for a like period of time not to exceed one year at such rent as Landlord has stated prior to said termination date; or

(3) If Landlord fails to notify Tenant or Landlord's election under either (1) or (2) of this Section 15 within 45 days of the termination of this Lease or the termination of Tenant's right of possession, Tenant's continued occupancy shall be for a month-to-month term.

C. No action or non-action by Landlord except as expressly provided herein shall operate as a waiver of Landlord's right to terminate this Lease or Tenant's right of possession, nor operate to extend the Term.

16. **EMINENT DOMAIN (CONDEMNATION)**: If the whole or any substantial part of the Building is taken or condemned by any competent authority for any public use or purpose, or if any adjacent property or street shall be so condemned or improved in such a manner as to require the use of any part of the Building, the Term of this Lease shall, at the option of Landlord or the condemning authority, be terminated upon, and not before, the date when possession of the part so taken shall be required for such use or purpose, and Landlord shell be entitled to receive the entire award without apportionment with Tenant. Rent shall be apportioned as of the date when Tenant vacates the Premises and possession of the part of the Building so taken is transferred to the condemning authority.

17. **LANDLORD'S MORTGAGE:** This Lease is not to be recorded and is, and shall hereafter be deemed to be, subordinate to any present or future mortgages on the real estate (or any part of It) upon which the Building is situated and to all advances upon the security of such mortgages.

18. LEASE BINDING ON HEIRS, ETC: All the covenants and agreements of this Lease shall be binding upon and inure to the benefit of the heirs, executors, administrators, successors, and assigns of Landlord and Tenant, subject to the restrictions set forth in Section 12 hereof, except that where there are only one or two persons named or remaining as Tenant herein, then, in the event of the death of one or both Tenants, the surviving Tenant and/or the heirs or legal representatives of the deceased Tenant may terminate this Lease effective as of the last day any calendar month within 120 days of said occurrence by delivering to Landlord not less than 45 days prior written notice.

19. NOTICES: Except as herein provided, any demand to be made or notice to be served, including those provided by statute, shall be construed to mean notice in writing signed by or on behalf of the party giving same, and served upon the other party (A) in person, or (B) by certified or registered mail, return receipt requested, postage prepaid, al the address herein set forth or at such other address as either party may designate by written notice to the other. Notice by mail shall be deemed given, served and effective at the time deposited Into the United Slates Mail, regardless of when received. Notice served in person on Tenant may be served if left with some person residing in or in possession of the Premises above the age of 12 years, and in the event of an apparent abandonment, notice may be served by posting same on the door of the Premises in addition to service by mail in accordance herewith, Notices served in person on Landlord may be served on any office employee of Landlord, or, if Landlord receives Rent at Landlord's home, in the same manner as on Tenant.

20. RULES AND REGULATIONS: The rules and regulations at the end of this Lease shall be a part of this Lease. Tenant covenants and agrees to keep and observe these rules and regulations. Tenant also covenants and agrees to keep and observe such further reasonable rules and regulations as may later be promulgated by Landlord or Landlord's agent for the necessary, proper and orderly care of the Building (provided such later rules do not materially change the terms contained in the body of this Lease).

SAMPLE

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21. TENANT TO INSURE POSSESSIONS / LIMITATIONS OF LANDLORD LIABILITY: Landlord is not an insurer of Tenant's person or possessions. Tenant agrees that all of Tenant's person and property in the Premises or elsewhere in the Building shall be at the risk of Tenant only and that Tenant will carry such insurance as Tenant deems necessary therefor. Tenant further agrees that except for instances of negligence or willful misconduct of Landlord, Landlord's agents or employees (collectively, the "Landlord Parties"), the Landlord Parties shall not be liable for any damage to the person or property of Tenant or any other person occupying, visiting or entering the Premises or the Building, sustained due to the Premises or the Building or any part thereof or any appurtenances thereof becoming out of repair (as example and not by way of limitation), due to damage caused by water, snow, ice, frost, steam, fire, sewer gas or odors; heating, cooling, and ventilating equipment, bursting leaking pipes, faucets, and plumbing fixtures; mechanical breakdown or failure; electrical failure; the misuse or non operation of observation cameras or devices (if any), master or central television equipment and antennas (if any), cable television equipment (If any) or mailboxes; or due to the happening of any accident in or about the Building; or due to any act or neglect of any other tenant or occupant of the Building or any other person. Further, Landlord shall not be liable to Tenant for any damage to the person or property of Tenant sustained due to, arising out of, or caused by, the acts or omissions of any third party whether or not such third party Is a tenant of the Building.

22. REMEDIES CUMULATIVE, NON-WAIVER: All rights and remedies given to Tenant or to Landlord shall be distinct, separate and cumulative, and the use of one or more thereof shall not exclude or waive any other right or remedy allowed by law, unless specifically limited or waived in this Lease. No waiver of any breach or default of either party hereunder shall be implied from any omission by the other party to take any action on account of a similar or different breach or default. The payment or acceptance of money after it falls due after knowledge of any breach of this Lease by Landlord or Tenant, or after the termination in any way of the Term or of Tenant's right of possession hereunder, or after the service of any notice, or after the commencement of any suit, or after final judgment for possession of the Premises shall not reinstate, continue or extend the Term of this Lease nor affect any such notice, demand or suit or any right hereunder not expressly waived. No express waiver shall affect any breach other than the breach specified in the express waiver and then only for the time and to the extent therein stated. Tenant's obligation to pay Rent during the Term or any extension thereof or any holdover tenancy shall not be waived, released or terminated by the service of any 5-day notice, demand for possession, notice of termination of tenancy, institution of any action or forcible detainer, ejectment or for any judgment for possession, or any other act or acts resulting in termination of Tenant's right of possession.

23. TENANT'S REMEDIES: If Landlord defaults in (i) Landlord's duty to maintain the Premises or the Building or to perform repairs, remodeling, or decorating as set forth in Section 6 and such default is not cured by Landlord within 30 days after written notice from Tenant to Landlord (unless such default involves a hazardous condition or failure to furnish heat, hot water or essential services, which shall be cured forthwith); and provided Landlord's failure to cure is not excused on account of one or more of the defenses set forth in Section 6, in which case Landlord shall notify Tenant of specific facts constituting such excuse within said 30-day period (or in the case of a hazardous condition, or failure to furnish heat, hot water or essential services, within 5 days of Tenant's notice); or (ii) the performance of any other covenant or agreement of this Lease and such default is not cured by Landlord within 10 days after written notice from Tenant to Landlord, Tenant may (A) treat such event as a breach of this Lease and, in addition to all other rights and remedies provided at law or in equity (including without limitation those provided in the Illinois Revised Statutes relating to building code violations) may, by giving Landlord not less than 10 days prior written notice, terminate this Lease by setting forth the date of said termination In the 10 days' notice and vacating the Premises on or before said date, with Rent paid up to and including said termination date. Prepaid rent and the Security Deposit. if any, shall be promptly refunded to Tenant in accordance with the terms and conditions of this Lease.

24. TENANT'S WAIVER: Tenant's covenant to pay Rent is and shall be independent of each and every other covenant of this Lease. Tenant agrees that Tenant's damages for Landlord's breach of this Lease shall in no event be deducted from Rent nor set off for purposes of determining whether any Rent is due in a forcible detainer action brought on the basis of unpaid Rent.

25. LANDLORD'S REMEDIES: If Tenant defaults (i) in the payment of any single installment of Rent or In the payment of any other sum required to be paid under this Lease or under the terms of any other agreement between Tenant and Landlord and such default is not cured within 5 days of Tenant's receipt of written notice of such default from Landlord, or (ii) in the performance of any other covenant or agreement hereof, and such default is not cured by Tenant within 10 days after written notice to Tenant from Landlord (unless the default involves a hazardous condition which shall be cured forthwith), Landlord may treat such default as a breach of this Lease and Landlord shall have any one or more of the following described remedies in addition to all other rights and remedies provided at law or in equity:

A. Landlord may terminate this Lease, in which event Landlord may forthwith repossess the Premises in accordance with Section 15 hereof and Tenant agrees to pay to Landlord damages in an amount equal to the amount of Rent provided in this Lease to be paid by Tenant for the balance of the Term, less the fair rental value of the Premises for said period, and, in addition, any other sum of money and damages owed by Tenant to Landlord;

B. Landlord may terminate Tenant's right of possession and may repossess the Premises in accordance with Section 15 hereof without further demand or notice of any kind to Tenant and without such entry and possession terminating this Lease or releasing Tenant in whole or in part from Tenant's obligation to pay Rent hereunder for the full Term. Upon and after such entry into and possession of the Premises without termination of this Lease, Landlord may. but need not, re-let the Premises as Tenant's agent and may, but need not, make repairs, alterations and additions in or to the Premises and redecorate, as necessary, all under the same terms and conditions as set forth in Section 12 hereof. Tenant shall on demand pay to Landlord damages and all of Landlord's expenses of re-letting as set forth and described in Section 12 hereof. If the consideration collected by Landlord from any such re-letting for Tenant's account is not sufficient to pay the amount provided in the Lease to be paid monthly by Tenant together with all such expenses, Tenant shall pay to Landlord, as damages, the amount of each monthly deficiency for the remainder of the Term. Tenant agrees that Landlord may from time to time file suit to recover any such sums falling due under the terms of this Section and that no suit or recovery of any portion due Landlord hereunder shall be a defense to any subsequent action brought for any amount not theretofore reduced to judgment in favor of Landlord except that Landlord shall not be permitted more than one recovery In the aggregate amount so due.

C. Tenant shall pay Landlord all of Landlord's costs, expenses and attorney's fees incurred by Landlord in the enforcement of the covenants and agreements of this Lease.

26. OTHER AGREEMENTS:

A. The headings or captions of Sections in this Lease are for identification purposes only and do not limit or construe the contents of the Sections.

B. "Landlord" as used herein shall refer to the person, partnership, corporation or trust hereinabove set forth in that capacity, and if such person be designated an agent, Landlord shall also refer to and Include the principal. Obligations and duties to be performed by Landlord may be performed by any of the Landlord Parties, Landlord's agents, employees or Independent contractors. Only Landlord or Landlord's designated agent may amend or modify this Lease or Landlord's obligations hereunder.

C. All rights and remedies of Landlord under this Lease, or that may be provided by law, may be exercised by Landlord in Landlord's own name individually, or in Landlord's name by Landlord's agent, and all legal proceedings for the enforcement of any such rights or remedies, including distress for Rent, forcible detainer, and any other legal or equitable proceedings. may be commenced and prosecuted to final judgment and execution by Landlord in Landlord's own name individually, or by agent of any Landlord who is a principal.

D. Tenant agrees that Landlord may at any lime and as often as desired assign or re-assign all of its rights as Landlord under this Lease.

E. The words 'Landlord" and "Tenant" as used herein shall be construed to mean plural where necessary and the necessary grammatical changes required to make the provisions hereof apply to corporations or persons, women or men, shall in at cases be assumed as though in each case fully expressed.

F. The obligations of two or more persons designated Tenant in this Lease shall be joint end several. If there be more than one party named as Tenant, other than children in a family, all must execute this Lease and any modification or amendment hereto.

G. "Premises" used herein shall refer to the dwelling unit leased to Tenant.

H. Tenant's occupancy or use of any storeroom, storage area, laundry room or parking space in or about the Building shall be as licensee only and, unless specifically provided otherwise in this Lease, such license is granted without charge to Tenant and may be revoked by Landlord at any time. Tenant understands and agrees that due to the construction, location and use of such storeroom, storage area, laundry room or parking spaces, Landlord cannot and shall not be liable for any loss or damage of or to any property placed therein. Tenant should not store or leave valuable items in such areas. The termination of this Lease for any reason shall also serve to automatically terminate Tenant's right to use such storeroom, storage area, laundry room or parking spaces.

I. "Building" as used herein shall include the entire physical structure located at and about the address hereinabove slated, including machinery, equipment end appurtenances which are a part thereof, grounds, recreational areas and facilities, garages and out-buildings, and other apartment buildings which form a complex owned an operated as a single entity.

J. The invalidity or unenforceablility of any provision hereof shall not effect or impact any other provision.

RULES AND REGULATIONS

These rules are for the mutual benefit of all tenants. Please cooperate. Violations of the Rules and Regulations may cause termination of your Lease.

1. Tenant cannot have any pets or animals in the Premises without written consent of Landlord or Landlord's agent (which consent may be revoked upon 10 days prior written notice at any time). No animals without leash are allowed in any public area of the Building.

2. Passages, public halls, stairways, landings, elevators and elevator vestibules shall not be obstructed or be used for play or for any other purpose than for ingress to and egress from the Building or apartments, nor shall any person be permitted to congregate or play In or around the common interior areas of the Building. All personal possessions must be kept in the Premises or in other storage areas if provided.

3. All furniture, supplies, goods and packages of every kind shall be delivered through the rear or service entrance, stairway or elevator.

4. Carriages, velocipedes, bicycles, sleds and the like shall not be allowed in the lobbies, public halls, passageways, courts or elevators of the Building and are to be stored only in places designated for their storage by Landlord or Landlord's agent.

5. Laundry and drying apparatus shall be used in such a manner and at such times as Landlord may clearly post in such area. Clothes washers and dryers, and dishwashers, unless installed by Landlord cannot be kept or installed in the Premises or the Building.

6. The use of garbage receptacles **or** Incinerators shall be in accordance with posted signs and only garbage and refuse wrapped in small, tight parcels, may be placed in garbage receptacles or incinerator hoppers. Aerosol cans or inflammable materials shall be placed **in** garbage receptacles or dropped into the incinerator only as so posted. They are highly explosive.

7. No sign, signal, illumination, advertisement, notice or any other lettering, or equipment shall be exhibited, inscribed, painted, affixed or exposed on or at any window or on any part of the outside or inside of the Premises or the Building without the prior written consent of Landlord.

8. No awnings or other projections including air conditioners, television or radio antennas or wiring shall be attached to or extend from or beyond the outside walls of the Building.

9. Tenant shall not alter any lock or install a new lock or a knocker or other attachment on any door of the Premises without the written consent of Landlord.

10. No noise, music or other sounds shall be permitted et any time In such manner as to disturb or annoy other occupants of the Building.

11. No waste receptacles, supplies, footwear, umbrellas or other articles shall be placed In the halls, on the staircase landings, nor shall anything be hung or shaken from the windows or balconies or placed upon the outside window sills.

12. The water closets, basins and other plumbing fixtures shall not be used for any purpose other than for those for which they were designed; no sweepings, rubbish, rags or any other improper articles shall be thrown into them. Any damage resulting from misuse of such facilities shall be paid for by Tenant.

13. There shall be no cooking or baking done in or about the Premises except in the kitchen. Cooking on a barbeque or other similar equipment on a porch, terrace, or balcony is expressly forbidden.

14. If Landlord provides television master antenna hookup, at the option of Landlord, only Landlord's authorized agent shall install Tenant's television set to master antenna and Tenant agrees to pay installation cost and annual maintenance fee. Tenant shall permit access to disconnect hookup for nonpayment. Tenant agrees to pay $100.00 as liquidated damages to Landlord's authorized agent for each illegal hookup in the Premises.

15. No furniture filled with a liquid or semi-liquid shall be brought in or used in the Premises unless contained in proper frame and liner.

16. Except as otherwise required by applicable law, Landlord shall have no obligation to cause or allow cable television service or internet to be installed in the Building or the Premises. In the event that cable television service is provided in the Building or the Premises, Tenant understands end agrees that (a) Landlord cannot and shall not be liable to Tenant for any damage suffered by or to the person or property of Tenant due to improper or inadequate cable television or internet installation or reception, (b) Landlord shall have no obligation or responsibility to collect any fee on behalf of any provider of cable television service or internet, and (c) Tenant shall provide access to the Premises at all reasonable hours to allow the installation, repair or maintenance of the cable television or internet equipment in the Building or the Premises.

17. If the Premises is part of a condominium building or co-op, the rules and regulations of the condominium association and/or co-op board shall apply to the Premises as if fully set forth in this Lease.

GUARANTY

In consideration of One Dollar ($1.00) to the undersigned in hand paid, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the undersigned Guarantor hereby guarantees the payment of Rent and the performance by Tenant, Tenant's heirs, executors, administrators, successors and assigns of all covenants and agreements of this Lease. Any assignment of the Lease or subletting of the Premises shall not release the undersigned Guarantor from any obligations hereunder, unless Landlord expressly consents to such release of the undersigned Guarantor in writing at the time Landlord consents to such assignment or subletting. If more than one party executes this Guaranty, then each undersigned Guarantor shall be joint and severally liable for all obligations of Tenant hereunder.

_____ _____

Name Date

_____ _____

Name Date

SAMPLE

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Utility Payments

According to the **Illinois Tenant Utility Payment Disclosure Act** (765 ILCS 740/), a residential lease must explicitly define the utility metering in the unit. No landlord may demand payment for master metered public utility services to cover a proportionate share of the tenant's space without first providing a written copy—either in the lease or separately—of the formula used for allocating the payments among tenants.

Drug Free Housing Addendum

A common addendum to a residential lease is the **Lease Addendum for Drug Free Housing** as promulgated by HUD (or a substantially similar addendum). This addendum, sometimes called a Crime Free addendum or something similar, gives lessors in Illinois the right to **void** a lease if any lessee or occupant is charged during the term of the lease with having committed an offense on the premises constituting a **Class X felony** (765 ILCS 705/5).

Transferring Right of Occupancy

A tenant can transfer his or her right of occupancy to another person either by **assignment** or **sublease**. The requirements for a valid assignment or sublease are typically the same as those for a lease. The assignment or sublease must be in writing and signed by the assignor or sublessor if it will end more than a year after it's agreed to. But there's an important distinction between the two.

Assignment

Assignment occurs when the *lease contract is transferred from the present lessee to an assignee.* Assignment transfers a tenant's entire interest, but it does *not* transfer a tenant's entire liability under the lease. With an assignment, the assignee (the second tenant) and the assignor (the original tenant) *share legal responsibility* for paying rent to a landlord. The assignee has primary liability; the assignor has secondary liability. If the assignee doesn't pay, the landlord has a right to sue both the assignee and the assignor for the rent.

Subletting

A **sublease** is *when a tenant transfers only part of his right of possession or other interest in leased property to another person for part of the remaining lease term*. Typically, with a sublease, the sublessee pays rent to the lessee, who then pays the lessor.

A sublease doesn't alter the legal relationship between a landlord and the original tenant. The subtenant usually pays rent directly to the original tenant, who in turn pays the landlord. If the subtenant doesn't pay as agreed, it is still the **original tenant that has full legal responsibility** for paying the landlord. If the landlord doesn't get paid, he or she will sue only the original tenant.

Case in Point

Richard has a two-year lease on an apartment. Six months before the end of his lease, he has an opportunity to take a three-month trip to South America, so he rents the apartment to Georgette for the months of July, August, and September. Since Richard has not transferred his entire interest, this arrangement is a **sublease**. Richard is the sublessor, and Georgette is the sublessee or subtenant. When Richard returns from South America at the beginning of October, Georgette moves out and Richard resumes his tenancy for the rest of the lease term.

Now, suppose that Richard's trip will last six months instead of three, so he won't be back until after his lease expires in January. Richard transfers the apartment to Georgette for July through December. This is an **assignment** because Richard has transferred the entire remainder of his lease to Georgette; their arrangement is an assignment instead of a sublease. Richard is the assignor, and Georgette is the assignee.

LEASE ADDENDUM FOR CRIME-FREE/DRUG-FREE HOUSING

In consideration of the execution or renewal of a lease of the dwelling unit identified in the lease, Owner and Resident agree as follows:

1. Resident, any members of the resident's household or a guest or other person under the resident's control shall not engage in illegal activity, including drug-related illegal activity, on or near the said premises. "Drug-related illegal activity" means the illegal manufacture, sale, distribution, purchase, use or possession with intent to manufacture, sell, distribute, or use of a controlled substance (as defined in Section 102 or the Controlled Substance Act [21 U.S.C. 802]) or possession of drug paraphernalia.
2. Resident, any member of the resident's household or a guest or other person under the resident's control shall not engage in any act intended to facilitate illegal activity, including drug-related illegal activity, on or near the said premises.
3. Resident or members of the household will not permit the dwelling to be used for, or to facilitate illegal activity, including drug-related illegal activity, regardless or whether the individual engaging in such activity is a member of the household.
4. Resident or members of the household will not engage in the manufacture, sale, or distribution of illegal drugs at any locations, whether on or near the dwelling unit premises or otherwise.
5. Resident, any member of the resident's household, or a guest or other person under the resident's control shall not engage in acts of violence or threats of violence, including but not limited to the unlawful discharge of firearms, prostitution, criminal street gang activity, intimidation, or any other breach of the rental agreement that otherwise jeopardizes the health, safety or welfare of the landlord, his agents or tenants.
6. **VIOLATION OF THE ABOVE PROVISIONS SHALL BE A MATERIAL VIOLATION OF THE LEASE AND GOOD CAUSE FOR TERMINATION OF TENANCY.** *A single violation of any of the provisions of this added addendum shall be deemed a serious violation and material non-compliance with the lease.*

It is understood and agreed that a single violation shall be good cause for termination of the lease. Unless otherwise provided by law, proof of violation shall not require criminal conviction, but shall be by the preponderance of the evidence.

7. In case of conflict between the provisions of this addendum and any other provisions of the lease, the provisions of the addendum shall govern.
8. This LEASE ADDENDUM is incorporated into the lease executed or renewed this day between Owner and Resident.

Resident _____ Date _____

Property Owner/Manager _____ Date _____

Property Address _____

Resident(s) acknowledge receipt of this addendum by signature of this document.

SAMPLE

Landlord's Consent

The landlord's consent is generally not required for an assignment or sublease unless the original lease *expressly states* it is required or the original lease *expressly forbids* it. Many leases do contain a consent requirement, however. Sometimes a lease forbids assignment without consent, but doesn't require consent for subleasing (or vice versa). That's another reason why the technical distinction between an assignment and a sublease can be important.

If a lease requires landlord consent for assignment, but doesn't say anything about subleasing, a tenant can sublease without consent. And if the lease requires consent for subleasing but doesn't mention assignment, a tenant can assign without consent. In other words, courts won't interpret "assignment" to include "subleasing," or vice versa. This problem occurs because many people assume that assignment and subleasing are the same thing, and carelessly drafted leases often use the terms interchangeably.

Many leases that require the landlord's consent for an assignment or sublease provide that the lessor cannot unreasonably withhold consent. There must be some good reason for refusing to accept the assignee or sublessee as a tenant.

Novation

Recall that a **novation** is when one party to a contract withdraws and a new party is **substituted**. This must be done with the landlord's consent. By arranging a novation instead of an assignment or sublease, the original tenant is able to escape liability under the lease altogether. A novation **replaces the lease** between the landlord and the original tenant with a **completely new lease** between the landlord and the substitute tenant. In this way, the original tenant is released.

Of course, a novation is only possible with the landlord's consent, since it's a new contract between the landlord and the substitute tenant. Landlords are generally unwilling to consent to a novation unless the substitute tenant is just as desirable and financially sound as the original tenant.

Security Deposits

A **security deposit** is *money the tenant pays to the landlord that provides monetary security in case of damage to the residence or failure by the lessee to comply with the lease agreement*. Usually, lessees receive the deposit back at the end of the lease term, less any deductions for necessary repairs beyond normal wear and tear.

Security deposits must be held in an escrow account, separate from the owner's personal or operating accounts. It is illegal to commingle security deposit funds with other funds.

Illinois Security Deposit Interest Act

765 ILCS 715/

The **Illinois Security Deposit Interest Act** sets forth the provisions for paying interest on security deposits paid by tenants to lessors to secure payment of rent of compensation for damage to property. The Act applies only to lessors of residential real property containing **25 or more units** in either a single building or in a complex of buildings located on contiguous parcels of real property. It does not, however, apply to public housing.

The interest must be paid on any deposit held by the lessor for **more than six months**, as computed from the date of the deposit. The interest rate must be equal to the interest paid on minimum deposit passbook savings accounts as paid by the largest commercial bank (measured by total assets) having its main banking premises in Illinois as of December 31 of the calendar year *immediately preceding* the inception of the rental agreement.

Within **30 days** of the end of any 12-month rental period, the lessor must pay the interest to the tenant either by **cash** or **rent credit**, unless the tenant is in default under the terms of the lease.

A tenant can bring a civil suit against any lessor who willfully fails or refuses to pay the required interest. If the Circuit Court finds for the tenant, the lessor will be liable for an amount equal to the entire security deposit, as well as court costs and reasonable attorney's fees.

Rights of Possession

The rights of possession are usually very strong in most states. Think back to the leasehold estate known as estate or tenancy at sufferance. This occurs, you'll recall, when a tenant originally gained possession of the property legally, but is now occupying the property illegally, for example, a tenant who ceases to pay rent or who refuses to move when the lease expires. In most states, the procedures that must be followed to evict someone from illegally occupying property can be quite extensive, often involving lots of time, money, and headache. But even legal tenancy must be examined carefully by anyone who takes title to land that is leased to determine what tenants' rights are spelled out in the lease.

Death of the Property Owner

When one party to the lease dies or the property is sold, it does *not* terminate the lease. The heirs or new owner *must honor the existing lease contracts.* However, a tenancy at will leasehold estate *cannot* be transferred to someone else and so it generally *does end on the death* of the landlord or tenant.

Case in Point

Jim owns an apartment building. Kim signs a 12-month lease. She moves into the apartment. Two months after she moves in, she dies. What's the status of the lease? The lease is still valid and her heirs are responsible for making the next 10 months payments. Could a landlord choose to terminate the lease? Of course. Could Kim's heirs take possession of the property for the duration of the lease? Yes.

Now, let's turn it around. Kim signs a 12-month lease. Two months after Kim signs the lease, Jim the landlord dies. Can his heirs knock on the door and say, "Oh Kim, by the way, Jim died, and we want you out of here by 3:00"? No. Kim has a right to live up to that contract.

The contract's a two-way street. If a tenant expects to be able to stay in the apartment space if the landlord dies, then the landlord's entitled to rent if the tenant dies.

Selling Leased Property

A landlord/owner is free to sell the leased property at any time, but this does *not* automatically terminate the lease. The new owner takes the property subject to the leases, *unless* the leases provide otherwise. Leases tend to "run with the land," which means that changes in ownership generally do not affect the rights of the tenant. So, when a new owner takes title *subject to a lease*, the tenant remains with the property and all former owner's rights and duties under the lease are transferred to the new owner.

For example, if the tenant gave the former owner a security deposit or paid any rent in advance, the former owner should either refund that money, including statutory interest, to the tenant or turn it over to the new owner (who must agree to hold it as a deposit or apply it to the rent). In Illinois, the **original owner remains jointly and severally liable with the new owner** to the tenant for such security deposits or prepaid rent (765 ILCS 701/1.1).

What if the new "owner" of the property is the bank that holds the mortgage on foreclosed property? The lender cannot evict tenants because the lease will take priority over the deed or mortgage. The lender could continue to collect rent from the tenants until the term of the lease expires. The new owner must notify the tenants in writing that the building was sold and provide the tenants with contact information and directions about making rent payments.

Lease Termination

Leases can be terminated in a number of ways:

- The most common termination occurs when a lease term **expires**. Upon expiration if no renewal agreement is in place, lessees are obligated to vacate the premises voluntarily and fully. Possession then reverts to the owner.
- Another method of termination is when the *property owner and the tenant mutually agree to cancel a lease agreement prior to its expiration,* called **surrender**. Surrender cancels all parties' duties and responsibilities, and possession reverts to the owner.
- A lease can also be terminated due to **destruction** of the building. The lease's purpose is frustrated if the building is damaged or destroyed, so the tenancy ends with no more rent due.
- If a tenant breaches the lease contract, an owner can choose to terminate the contract by evicting the tenant. **Eviction** is *the forced removal, by legal means, of a tenant and the tenant's belongings from a leased premise*. The key word in this definition is **legal**. This process is known as **actual eviction**.

Abandonment

If a tenant abandons the premises and the owner re-enters to repossess it, a lease can be terminated. If a tenant does in fact abandon the property, the owner does not have to accept return of the premises and can pursue the lessee for rent, even though the tenant no longer resides there. If the owner chooses to accept return of the premises, he may still pursue the lessee for lost rent under the old lease through a **distress for rent** action.

Illinois Safe Homes Act

765 ILCS 750/

Under certain circumstances, tenants may be able to legally break a lease and abandon the property before the end of its term. The purpose of the **Illinois Safe Homes Act** is to reduce domestic violence, dating violence, sexual assault, and stalking by enabling victims of domestic or sexual violence and their families to flee existing dangerous housing in order to:

- Leave violent or abusive situations,
- Achieve safety,
- Minimize the physical and emotional injuries from domestic or sexual violence, and
- Reduce the devastating economic consequences of fleeing dangerous situations.

Alternatively, upon written notice from all tenants who have signed as lessees under a written lease, the tenants may request that a landlord **change the locks** of the dwelling unit in which they live if one or more of the tenants reasonably believes that one of the tenants or a member of tenant's household is under a credible imminent threat of domestic or sexual violence at the premises.

Summary

1. A **leasehold estate** gives the holder (tenant) a temporary right to possession, without title. Lease agreements create leasehold estates and provide contractual rights and obligations to all parties involved. There are several types of leasehold estates, including: **Estate for years** (or term tenancy), which is set to last for a specific period, after which it automatically terminates; **periodic estate**, which continues for successive equal periods of length, such as week-to-week or month-to-month; **estate at will**, when a tenant is in possession with the owner's permission, but there is no lease and no specific rent terms (terminates at the death of either party). A **tenancy at sufferance** (or estate at sufferance) is not a leasehold estate but is when a holdover tenant refuses to vacate the property when the lease ends. If a landlord accepts rent, a periodic or holdover tenancy is created. Landlords who do not accept rent may be able to charge a holdover tenant double the rent.
2. **Leases** are contracts in which one party (lessee) pays the property owner (lessor) rent in exchange for possession of real estate, so, a lease is the conveyance of a leasehold estate from the owner to a tenant. Lessees, or tenants, are entitled to **quiet enjoyment** of the property, which is the right to the use and possession of real property without interference from the previous owner, the lessor, or anyone else claiming title. Lessors have a **reversionary interest** in the property, which means the property reverts to them at the end of the lease term.
3. Leases must contain all essential elements of a contract to be valid. A **demising clause** grants possession of the property to the lessee. A lease should define terms for **duration** and **rent**, an adequate **description** of the property, and include **signatures** of both parties. Most leases also contain details related to security deposits, lease renewal, use provisions, and sublease and assignment. Residential leases of property built prior to 1978 include certain language to ensure that disclosure and notification about **lead paint** have taken place. Leases in Illinois should indicate the utility metering/payment responsibilities in the unit.
4. A **gross lease** is one in which the property owner pays all the expenses associated with the property. With a **net lease**, the tenant pays some or all the expenses associated with the property. Typical commercial leases include: A **percentage lease**, tenants pay a base rent plus an additional monthly rent derived from a percentage of gross sales; **land lease**, tenant leases unimproved land on a long-term basis; **index lease**, the rent a tenant pays is tied to an index; **graduated lease**, the rent changes throughout the lease term.
5. A **security deposit** is money the tenant pays to the landlord that provides monetary security in case of damage to the residence or failure by the lessee to comply with the lease agreement. Lessees receive the deposit back at the end of the lease term, less any deductions for necessary repairs beyond normal wear and tear, unpaid utilities or rent. Owners with **25 or more units** in either a single building or in a complex on contiguous parcels must pay interest on any security deposit held for **more than six months.**
6. **Assignment** occurs when the lease contract is transferred from the present lessee to an assignee. Assignment transfers a tenant's entire interest, but it does not transfer a tenant's entire liability under the lease. A **sublease** is when a tenant transfers only part of his right of possession or other interest in leased property to another person for part of the remaining lease term. In a sublease, the original tenant is responsible to the owner for all provisions in the lease.
7. Leases are terminated in a number of ways, including **expiration** (if no renewal agreement has been made, lessees are obligated to voluntarily vacate the premises and possession reverts to the owner), **surrender** (property owner and tenant mutually agree to terminate the lease agreement prior to its expiration), and **eviction** (forced removal, by legal means, of a tenant and his belongings from a leased premise). Leases are *not* terminated by the death of one party to the lease nor by the sale of the property.

Quiz

1. ***Which type of leasehold estate would probably be most affected by the death of either party?***
   a. estate for years
   b. periodic tenancy
   c. tenancy at will
   d. All are equally affected.

2. ***Lessors have a(n) _____ interest in real property.***
   a. absolute
   b. remainder
   c. reversionary
   d. temporary

3. ***Which situation provides the LEAST liability to an original tenant?***
   a. abandonment
   b. novation
   c. sandwich lease
   d. sublease

4. ***Roger signs a four-year lease on a townhouse in Collegetown when his daughter, Vanessa, goes to school. Vanessa flunks out after the first semester, so Roger transfers the remaining 3 1/2 years of the lease to his neighbor, Joy, whose son is on the dean's list. Joy sends her rent checks directly to the landlord. This is an example of***
   a. assignment.
   b. novation.
   c. sublease.
   d. surrender.

5. ***The most typical lease to be used in a residential rental is a***
   a. graduated lease.
   b. gross lease.
   c. net lease.
   d. percentage lease.

6. ***Peter leases space for his ice cream shop in Stella's building. He pays her $800 a month in rent plus a portion of his profits. It's been a cold summer and no one wants ice cream. When Peter's gross sales fall below a specified point, Stella reclaims possession of the space. Peter most likely has what kind of lease?***
   a. graduated lease
   b. ground lease
   c. index lease
   d. percentage lease

7. ***Of these property owners, who must pay interest on his tenant's security deposits?***
   a. Frank, who owns two 20-unit buildings, one on the west side of town and one on the south side of town
   b. Jeff, who owns a single 28-unit building
   c. Lester, who owns two 10-unit buildings on a single parcel of land
   d. Mark, who owns a 50-unit public housing building

8. ***Marcia lives in an apartment building owned by ACE Property. When ACE sells the building to TOP, what happens to Marcia and her security deposit?***
   a. TOP must give Marcia 60 days to vacate the premises; ACE must turn the security deposit over to TOP to distribute.
   b. TOP must give Marcia 60 days to vacate the premises; ACE must return her security deposit.
   c. TOP must honor the terms of the lease and let Marcia stay until it expires; both ACE and TOP are liable for handling her security deposit.
   d. TOP must honor the terms of the lease, but give Marcia the option of leaving early and collecting her security deposit.

9. ***The common guarantee found in a lease that means the property cannot be interrupted or invaded by anyone, including the property owner, without the lessee's consent is known as the***
   a. constructive tenancy warranty.
   b. covenant of quiet enjoyment.
   c. demising clause.
   d. fair use provision.

10. ***When Geoffrey's lease was up, he refused to move out of his apartment. He paid his rent on the first of the month as usual, which the landlord accepted. What type of leasehold estate does this represent?***
    a. estate at sufferance
    b. estate at will
    c. estate for years
    d. periodic estate

11. ***Which provision is required to be explicitly defined in an Illinois residential lease?***
    a. noise ordinances
    b. parking policy
    c. pet policy
    d. utility metering

12. ***Lisa has lived in the same apartment for 17 years on a year-to-year periodic tenancy. The landlord decides that when the year is up, he will let his grandson rent the apartment. How much notice must he give Lisa?***

    a. 30 days
    b. 60 days
    c. 90 days
    d. None is required since the lease will terminate automatically at the end of the year.



UNIT 6

REAL ESTATE APPRAISAL

Chapter 19 – The Value of Real Estate

Chapter 20 – Property Appraisal



19 The Value of Real Estate

To fully understand real estate valuation, there are several definitions and concepts that are important to know. The seven characteristics of real estate include four value characteristics that all items must have, as well as three physical characteristics that are unique to real estate. This chapter also discusses broad market factors and property-specific factors that can affect real property value. That's followed by the difference between value, price, and cost, before defining market value and the required elements of an arm's length transaction. Finally, assemblage, plottage, subdividing, and frontage as they relate to increasing the value of land are discussed.

You will learn:

- Several broad factors and specific principles impact the value of property.
- How to contrast value, price, and cost.
- Necessary factors for an arm's length transaction.
- Factors related to subdividing land that impact its value.

Key Terms

Arm's Length Transaction
Assemblage
Conformity
Contribution
Demand
Depreciation
Effective Demand
External Obsolescence
Frontage
Functional Obsolescence
Highest and Best Use
Immobility
Indestructibility
Law of Decreasing Returns
Law of Increasing Returns
Market Value
Neighborhood
Plottage
Price

Characteristics of Real Estate

Value is *the amount of goods or services offered in the marketplace in exchange for something else*. But value does not always equal price. Price is what a particular person feels something is worth—and hence the price she is willing to pay for something. Value is what a typical person would pay for something as determined by an examination of the marketplace. The problem is that there are many factors that can influence value. As such, it is important to understand these factors in order for an appraisal to be as accurate as possible. These factors include great forces that affect many aspects of the economy and the entire real estate market in a given region, all the way down to very specific factors that affect only one individual property.

Before anything can have value, though, there are certain things that an item must possess. Value is really a two-way street. If a person has something that no one else wants, value is diminished (except maybe to that person). In order to get the maximum value for property, there must be a realization of certain **value characteristics** by the user and other potential users of the property. Value characteristics, together with **physical characteristics**, make up the characteristics of real estate.

Value Characteristics

For anything to have value, certain value characteristics must be present and perceived by the user and other potential users of the property. All four of these characteristics must be present and in harmony for the item to achieve maximum value. The four value characteristics are **D**emand, **U**tility, **S**carcity, and **T**ransferability (remember the acronym **D-U-S-T**).

Demand

Demand is *the need or desire for a specific good or service,* and is an essential ingredient in creating value. Without demand, any amount of supply is meaningless. Sometimes though, demand can be created simply by lowering the price. On the other hand, prices can be raised too high even when there appears to be strong demand. High prices cause some people to look for alternatives in the marketplace. This is known as the theory of substitution, which is discussed later.

One final element of demand to consider is the ability of a particular market to afford a property, known as **effective demand**, or effective purchasing power. For example, when a multi-million dollar home is offered for sale in a market where there is significant poverty or unemployment, there may not be a presence of effective demand.

Utility

Utility is *the ability of a good or service to satisfy human wants, needs, or desires.* Utility is the degree of usefulness to prospective users. For example, there can be demand for housing, but your house must be perceived as useful (e.g., enough bedrooms) to someone interested in buying a house for it to have value to that potential buyer.

Furthermore, if there's no perceived use for something, then there's no perceived value. This is why public and private restrictions on land can impact value. For example, government restrictions on the size and placement of buildings may mean that a certain type of building can't be built on a lot. Any such restrictions can impact the utility, and hence the value, of land.

Scarcity

Scarcity is *the perceived supply of a good or service relative to the demand for the item.* If there's an unlimited supply of something, then it's perceived to have little value. Of course, the scarce item must also be useful (have utility). Scarcity and utility must both be present. Things that are scarce but not useful have little value (e.g., common fossils), just as things may have little value if they happen to be plentiful, even if useful (e.g., air or an abundant source of water).

People generally perceive land to be valuable because there's a limited supply of it. This notion of scarcity feeds the anticipation of real estate buyers who feel they're buying property as an investment that will increase in value. Value is also derived from scarcity due to uniqueness; for example, the fact that there's only one of a particular house in a given location. If people really desire a certain home in a certain location, then more value may be created.

Transferability

Transferability is *the ability to freely buy, sell, encumber, or dispose of property in any way that the owner sees fit.* Property value is derived from the freedom to transfer title readily from one person to another. The fewer restrictions there are on property, the more perceived value it has in the marketplace. If there are conditions on title to land, which restrict its future transfer, a buyer would likely not pay as much for the land (given that ready substitutes exist in the marketplace). Again, public and private restrictions are a factor. If there are any restrictions imposed on transferability, they may decrease the perceived value to potential buyers.

Finally, there's the added requirement that the person receiving the property must have the ability to pay for it. **Purchase ability** means a prospective buyer has enough disposable income available to satisfy her needs or desires. A person may want a million-dollar home, but if she can't afford to buy it, then that person's desires and demands go unfulfilled because property can't be transferred to the person who desires it.

Physical Characteristics

Real estate has three physical characteristics that give land some inherent value. These unique characteristics are not present as a group in other types of property. Only real estate has this combination of physical attributes and, as a result, they have the ability to affect value. As we discuss the three physical characteristics of real estate, note how they often intertwine with the four value characteristics.

Uniqueness

Uniqueness is a physical characteristic of real estate referring to the fact that *each piece of land, each building, and each house is said to be a different piece of real estate.* No two are exactly the same (also called non-homogeneity). Even if two houses or two buildings look the same, they are said to be different because of their location. Since more land cannot be created in a given location, this uniqueness leads potential buyers to view land as a scarce commodity. When people want to build in a certain area, they must compete with others for the limited supply of land in that area. Value is derived from this perceived scarcity due to uniqueness.

Immobility

Immobility is a physical characteristic of real estate referring to the fact that *it can't be moved from one place to another.* This is an equal benefit or detriment to all parcels of real estate in the same general area. This immobility of land helps its value in a good market, since other land can't be moved in to take away potential customers (as can be done with other products), but it can also hurt land value in a bad market. Note that customers are somewhat immobile as well. It's impossible to move a house and land from Boston to Chicago where there's a buyer, and usually a person in Denver won't buy a house in Atlanta if that person's job can't move too.

Indestructibility

Indestructibility is a physical characteristic of real estate referring to the concept that *it can't be destroyed.* Thus, real estate is said to always have some minimum value by virtue of its existence. Land is not consumed, nor does it wear out like other goods. But the actual and perceived utility of land can be affected by the marketplace or other forces. Land always has the potential to be useful, but its usefulness, and hence its value, can change over time. However, the land itself can move or change shape by natural forces, for example:

- Erosion, which is the wearing away of soil due to the action of wind, water, or other forces
- Accretion, which is the addition to land, such as through deposits by water of sand or silt

Broad Forces That Affect Value

There are four broad forces that affect all aspects of life and the economy. As such, they also have a significant impact on value in the real estate market. These broad forces are: **P**hysical, **E**conomic, **G**overnmental, and **S**ocial (remembered easily as the acronym **P-E-G-S**).

Physical Forces

Physical forces that can affect value in the real estate market include things *on* a property, *external* to a property, or both.

- **Topography.** The contour of the land can affect the value of a particular parcel of real estate, as well as all land in an area. Land that's too hilly may not permit desired building; land that's flat may be deemed not to have character.
- **Water.** Water can encompass a number of desirable or undesirable features which can affect real estate values. Waterfront property is usually more valuable; swamps or areas prone to flooding are less valuable. Lack of city water can also make real estate less desirable because wells and septic systems can be expensive.
- **Location. Location** is the exact position of real estate. Real estate in a growing neighborhood, city, or region is more valuable than in a declining area.
- **Popularity.** Areas go in and out of favor with the public because of location, jobs, climate, or for other reasons, and this can impact real estate values.
- **Environment.** This includes not only things on a property or external to a property, but also natural or man-made phenomena. Natural **soil composition** that makes ground unsuitable for building can have a negative impact on value; so can the presence of underground storage tanks. Positive value attributes could be a natural waterway or man-made lake. External factors can affect the entire area.

Economic Forces

Economic forces that can affect value in the real estate market include things like **business cycles**, **economic base**, **supply and demand**, **inflation**, and the **cost of money (interest rates)**. Each of these economic forces affects all businesses. But in the real estate market, there are additional realities which must be taken into account.

Economic Base

The **economic base** of an area is *the main business or industry which a community uses to support and sustain itself*. While the presence of a healthy economic base is important for all businesses, it's critical for the real estate market. Other business can "export" their products or services outside the area or simply move to a new location, but real estate cannot be moved.

Business Cycles

Business cycles are *general swings in business activity*, resulting in expanding and contracting activity at different phases of the cycle. Real estate cycles typically trail behind business cycles because they depend on many elements of business cycles (e.g., steady jobs) to be in full swing before they respond.

Supply and Demand

When considering broad economic forces, the law of **supply and demand** says that for all products, goods, and services, *when supply exceeds demand, prices will fall and when demand exceeds supply, prices will rise.* Real estate markets also respond to the laws of supply and demand, but there's a lag time for market forces to respond. This lag time is the result of the time it takes for a house to be bought, sold, or built. If an individual loses his job today, he can't expect to sell his home tomorrow. Or if construction companies see a need for housing, it takes time for them to build houses; when they see that there's no longer a need for housing, they may have some houses started which must be finished.

Buyer's Markets

A **buyer's market** is a situation in the housing market when *buyers have a large selection of properties from which to choose.* This may be due to population shifts away from an area, overbuilding by construction companies, or bad economic conditions like a plant closing. A buyer's market can be neutralized if some sellers pull their homes off the market. But a glut is a glut, and usually there's downward pressure on real estate values. When more homes are available, the increased supply tends to keep home values lower. Often, in this situation, a buyer is in a position to negotiate for a lower price or more favorable terms of sale.

Seller's Markets

A **seller's market** is a situation in the housing market when *sellers can choose from a large number of buyers who are looking for houses in a particular area.* This may be due to people moving into an area, little building by the construction industry in response to a prior oversupply, high construction costs for labor or materials, good economic conditions like a new plant opening, or lower interest rates. When fewer properties are available, the lower supply (relative to the demand) tends to keep home values higher. Often in this situation, a seller is in a position to stay closer to the original asking price or negotiate favorable terms.

During the lag time for market forces to respond, a supply and demand imbalance can have a real impact on the value of a house, positively or negatively. If the subject home's value is higher than expected because of a housing shortage in the area, this would likely be mentioned in the appraisal. Conversely, an appraiser may have to justify lowering a home's appraisal value because of a temporary glut in the market due to, for example, the closing of a major company that has hurt the economic base of an area.

The real estate market is said to be in **balance** when there are *slightly more homes available than buyers.* This keeps real estate prices in check and curtails the impact of people putting their homes for sale at a higher price to test the market. In fact, the market will determine if the price is too high.

Other Economic Factors

Inflation. An *increase in the cost of goods or* services mostly affects new home prices as builders pass on increased costs of labor and building materials. High inflation hits real estate harder than many other businesses because actual prices are much higher. For example, a 10% increase on a $200,000 home (a $20,000 increase) would make a buyer think harder about his purchase than a 10% increase on a $50 pair of shoes (a $5 increase).

Cost of Money. This is *the* ***interest rate*** *people or businesses must pay to use another person's money for their own purposes*. Inflation can be one factor that pushes interest rates higher or lower. And while high interest rates affect most big ticket items, high interest rates hinder real estate more than other goods since mortgages are long-term commitments.

Governmental Forces

There are a multitude of governmental forces that can affect value in the real estate market, some that impact all business and others that are directed specifically at real estate.

Revenue Generating Laws

Revenue generating laws consist of taxation and specific tax policies. **Taxation** is the governmental process of levying a charge upon people or things; specifically property taxes. Low taxes might encourage residential or commercial real estate activity in a certain area, whereas high taxes could have the opposite effect. **Specific tax policies** are tax laws enacted to encourage or discourage certain behaviors or activities. Just like property taxes, federal taxes can affect behavior, for example, the federal income tax deduction for home mortgage interest is designed to encourage home ownership.

Right to Regulate Laws

The right to regulate laws deals with the **police power** that governments reserve for themselves. This includes zoning laws, environmental protection laws, and eminent domain, all of which can affect real estate markets by limiting the types of real estate activity that occur in a certain area.

Fiscal and Monetary Policy

Fiscal policy is the government's plan for spending, taxation, and debt management. We just saw how taxation and specific tax policies can influence real estate markets. **Monetary policy** is the means by which government can exert control over the supply and cost of money. Through monetary policy, the Federal Reserve can make more or less money available to banks for lending; in effect, raising or lowering interest rates. The government uses monetary policy to try and influence real estate cycles, heating up demand to spur economic activity, or cooling off demand to control inflation.

Secondary Mortgage Markets

Secondary mortgage markets may be government-sponsored enterprises that buy and sell real estate mortgages. Since mortgages are bought and sold from all over the country, there are three important influences on real estate markets:

1. When secondary mortgage markets buy up mortgages from local banks, those banks then have more money to lend out again in the local market.
2. By selling mortgages from all over the country to local banks, those banks then have a diversified portfolio of loans, which helps to moderate their local real estate cycles.
3. Standardization of loan criteria across the country improves the overall quality of loans.

Government Programs

Government programs are assistance mechanisms enacted by legislation and administered by the executive branch of government. The two main federal government housing programs are the **FHA (Federal Housing Administration)** and the **VA (Veterans Administration)**. FHA-insured loans and VA-guaranteed loans affect real estate markets by making housing more (or less) accessible, depending on the current status of the programs, rules, and legislation.

Social Forces

Many social forces can actually affect value in real estate markets, some more than others.

Demographic Changes. This has to do with changes in the general population. These changes include such things as overall population growth and growth rates, population age, and size of families. As populations change, so do their housing needs. Growing populations need more housing; however, changes in family size may dictate that new housing should be downsized. An aging population may call for more residences geared to the lifestyle needs of older homebuyers and senior citizens.

Migrations of the Population. This involves general trends toward, for example, one city over another or one area of town over another. Migrations do affect all business, but migrations have a more significant impact on the real estate market because land cannot be moved or created to fill demand.

Social Trends. These encompass many aspects of the previous two categories, as well as such things as single parent households, people buying houses later in life, and the growing number of empty nest households. Each of these trends has the potential to affect the value of certain types of real estate (e.g., large houses may become less desirable as some of these social trends continue).

Buyer Tastes and Standards. This can include everything from specific features of a property to overall attitudes evident in the real estate market. For example, the number of condominium communities increases as people seek more active lifestyles with less maintenance responsibilities, and living space that is typically nicer (though smaller) than a home of equal cost.

Neighborhoods

The primary physical externality that affects real estate is **neighborhood**. A **neighborhood** is defined as *any constant, contiguous area that may be identified by similar characteristics or physical boundaries*. This is also referred to as a **market area**. These properties could share physical characteristics (e.g., similar style, age) or physical boundaries (e.g., natural boundaries such as a river or artificial boundaries such as a highway). Neighborhoods can also be defined by other characteristics. Properties that have similar uses or zoning, price ranges or income levels, or that share shopping, social, civic, or recreational facilities may all be considered part of the same neighborhood. In fact, almost anything can define a neighborhood **except** for race, ethnicity, or any other characteristic that describes a protected class. A neighborhood is simply a small part of a larger community. Defining a neighborhood, though, can be more complex than it may seem and should not be based on superficial boundaries.

Neighborhood Boundaries

Appraisers will often start to define a neighborhood by looking at the natural and artificial geographic boundaries of an area. Natural boundaries include obvious rivers and lakes, but also less obvious parks, mountains, or valleys. Artificial boundaries include man-made dividing lines such as streets, highways, and railroads and may also be drawn along school, zoning, or political districts.

Personal inspection allows an appraiser to see if there are perceptible changes in neighborhood characteristics at any of the physical boundaries defined. During this personal inspection, the appraiser is also looking for similarity of land usage and types of improvements, as well as consistency of building style and landscaping; even maintenance or upkeep can be evaluated as a means of confirming neighborhood boundaries.

Life Cycle of a Neighborhood

If a neighborhood has been defined correctly, there are usually minimal future changes or alterations to the boundaries. Occasionally, a new section may be added to a neighborhood, or a change in a road may exclude some houses that were once considered part of a neighborhood. However, a properly defined neighborhood—taking into account not only physical boundaries, but also style, age, usage, and income levels—will likely continue to age together. A neighborhood's life cycle includes four stages:

1. **Growth.** *Property values rise as development activity begins and continues*. Buyers fuel this growth by continuing to purchase property in the area. This demand equals acceptance of the area and of the prices being charged, and allows the area to grow to maturity.
2. **Stability/Equilibrium.** *The area is built up to the point where there is little, if any, vacant property*. At this stage in a neighborhood's life cycle, property values are at their highest. Demand typically remains high, as buyers continue to prefer this neighborhood as it enters a mature stage. Prices will rarely drop during this period as the real estate market is near equilibrium. Stability and maturity are characteristics of the equilibrium stage in a neighborhood's life cycle. There are some neighborhoods that never go beyond this stage.
3. **Decline.** *Property values begin to fall as demand falls*. Decline in a neighborhood is typically observable through decay or deterioration. This leads to the area becoming even less desirable, and the cycle feeds upon itself. A less desirable area where properties exhibit deferred maintenance translates into lower prices, and lower prices mean that lower-income residents with less money to spend on repairs will be attracted to the homes. As values decline, the problem is compounded by conversion of some properties to rental units (where upkeep is often not as meticulous as by owner-occupants), or to commercial uses. This can, in turn, help accelerate the decline.
4. **Revitalization.** *Property values rise again as demand increases, resulting in increased renovation and rehabilitation*. After a complete revitalization stage, the neighborhood can return to a stability/equilibrium stage, and the cycle begins again. Revitalization occurs when properties are again seen as attractive for their location, architectural features, or perhaps price. Whatever the reason, people begin to spend money to fix up these homes, and they again become desirable. Revitalization is generally a slow process. *The process of rapid revitalization of properties where current residents are displaced* is called **gentrification**. While this benefits the neighborhood, it can create problems for tenants who are forced from the area due to higher rents or a trend of owner-occupied rather than tenant-occupied homes.

Effects of the Four Broad Forces

The four broad forces that influence all aspects of the real estate market (P-E-G-S) also influence neighborhoods. Of course, the effects can be positive or negative.

Physical Effects

Physical factors are a major determinant in establishing the boundaries of a neighborhood. Roads and rivers are obvious examples. Other physical boundaries include everything from parks to areas of similar land usage or properties that have comparable maintenance and upkeep. Physical factors affecting a neighborhood's life cycle can include road or zoning changes, or the maintenance and upkeep of homes in a neighborhood. Conformity of architectural styles of buildings or homes in an area can help a neighborhood; too many homes straying from the norm can hurt a neighborhood's overall appeal. Additional physical factors are nuisances or environmental hazards.

Economic Effects

Economic factors can play a role in determining the boundaries of a neighborhood, primarily through housing prices, the income level of the residents, the level of business development in the area, or even property usage. Economics can also come into play with regard to the construction industry, where increased activity on previously vacant land may result in a redefinition of neighborhood boundaries.

Economic factors can also affect a neighborhood's life cycle. Like all real estate, neighborhoods benefit from a good economic base or suffer from a weak one. A good economic base can help with growth and stability. A bad economic base can accelerate a decline, or may even be the cause of it. While high interest rates can actually hurt all neighborhoods, they hit low income neighborhoods the hardest. Low interest rates spur growth and help with revitalization. Income levels and general business activity can also affect the life cycle of a neighborhood.

Governmental Effects

Government factors often contribute to defining the boundaries of a neighborhood. In fact, city streets and other man-made barriers are often one of the main determinants of a neighborhood's boundaries. For example, the re-routing or widening of a street can have significant effects on a neighborhood. Growth would be fostered in a commercial neighborhood that had a street widened; decline would be fostered if a street was re-routed or closed off. Widening a residential street can help a neighborhood grow if traffic congestion is eased, but may cause decline in the neighborhood that borders the street.

Other governmental factors that can contribute to establishing a neighborhood's boundaries include zoning, school or taxing districts, the designation of a historical district, or the boundaries of governmental services (e.g., fire and police departments).

Social Effects

Social factors that may help determine the boundaries of a neighborhood include such things as recreational and cultural activities. Accessibility to commercial, retail, and jobs can also play a role in defining boundaries. Additional factors may be the level of education, social status of a given area, or buyer perceptions of a neighborhood's social factors. Similarly, the perception of convenience is likely to influence a neighborhood's life cycle. Another social factor that can influence a neighborhood's life cycle is demographic trends (e.g., population age, family size).

Property-Specific Factors Affecting Real Estate Value

There are additional factors to consider when valuing a specific piece of property. More or less in their order of importance, these are: Highest and best use, location, substitution, conformity, contribution, and depreciation.

Highest and Best Use

Highest and best use is *the use that is the most physically possible, legally permissible, economically feasible, and maximally profitable or productive.* This is the most important property-specific factor that an appraiser considers before making a determination of value. As you can see from the comprehensive definition, a number of factors contribute to this determination. Of course, with most houses this isn't necessary since they're in the middle of residential neighborhoods. Highest and best use becomes a vital consideration, though, when examining vacant land or land that has changed zoning since the original structure on it was built.

Highest and best use is such an important and complex topic that entire real estate and appraisal courses are taught on it. For our purposes here, it's important to understand the basic concept. If a house sits on a widened street and is surrounded by commercial buildings, it's very likely that land would be more valuable if it were also put to a commercial use. We must consider other parts of the definition, as well. That is, the zoning laws must permit the intended use and the owner must be able to build the proposed structure on the land. All of these factors must be considered when valuing a piece of real estate.

Location

Location is *the exact position of a piece of real estate.* Location can be talked about with respect to a given neighborhood, and even within the neighborhood itself. It's easy to understand that homes in a growing, popular, and prosperous neighborhood are more highly sought after and valued than those in other neighborhoods. It's also important to recognize, though, that each individual home's location within that neighborhood affects its value. A home on a corner lot, next to the park, or on a cul-de-sac would usually have a higher value than that same home sitting next to a railroad track.

Progression and Regression

An important corollary to the concept of location is the **effect of surrounding homes** on valuation. Basically, the theory is that *the value of the "worst" home in a given area is increased by the other homes in the area.* The value of this theoretical "worst" home can only go so low, because the desirability of the other homes in the neighborhood keeps it from falling too far. This is known as the concept of **progression**.

Conversely, *the value of the "best" home in a given area is decreased by the other homes in the area.* The value of this theoretical "best" home can only go so high, because if the other homes in the neighborhood are less expensive, people that can afford this "best" home will be attracted to other neighborhoods. This is known as the concept of **regression**.

Case in Point

For example, if each of the homes in a neighborhood average $200,000, a run-down home in that area, that may only command $120,000 in another area, is helped by the fact that people will pay more than that in this particular neighborhood. The reason being is that they anticipate a higher value for the investment they make by improving the property. Conversely, in another neighborhood where the average home price is $180,000, a much larger-than-average home with a swimming pool and other amenities, that would command $300,000 in another area, is hurt by the fact that people who can afford this home probably want to live in a neighborhood with homes closer to that average price, and they may fear a lower future resale value in the less expensive area.

Substitution

Substitution says that *an informed buyer will not pay more for a home than a comparable substitute.* Although each home is said to be unique, there's a price point beyond which a buyer won't select a particular home. Of course, no one really knows what that point is until trying to sell a home for too much, with no resulting sale. The theory of substitution can also be applied to items within a home. When an appraiser determines the value of a fireplace in an area where most homes don't have one, the appraiser must take into account that a buyer is not going to pay more for that home than for a similar home plus the cost of adding a fireplace. In other words, if a fireplace costs $2,500 to add to a typical home in the area, an appraiser can't justify adding much more than that to the value of a home.

Conformity

Conformity says that *a particular home achieves its maximum value when surrounded by homes of similar style and function.* This applies to neighborhoods as well. Neighborhoods as a whole are more desirable when there is a general similarity in utility and value for all homes in it. This relates to our best/worst home scenario. Most people want to live in areas with like homes. A home that stands out as being too different from the rest is worth less than that same home would be if it were in a different, more homogeneous neighborhood. If too many homes stand out as different, the neighborhood's desirability is hurt, as well.

Contribution

Contribution says that *a particular item or feature of a home is only worth what it actually contributes in value to that piece of property.* Thus, if a five-bedroom home is not desirable, putting an addition onto a house to add a fifth bedroom doesn't increase the value of the home that much. The owner of the house may want or need a fifth bedroom, but he should not expect it to add significantly to the value of the home when it's sold. The value of an item or improvement is only equal to what a prospective buyer is willing to pay for it, not what it actually cost the owner to install or construct it.

The theory of contribution is trickier when it comes to repairs. Necessary repairs may or may not add value to a property, depending on where the value started. Just because a $100,000 house needs a new $5,000 roof does not mean the value of the house automatically increases to $105,000. The new roof may be a nice feature that helps to sell the home, but it isn't necessarily worth $5,000 more.

On the other hand, if a home is in serious need of repair, the $4,000 spent on new siding could add significantly more value than just $4,000. This is especially true in a **progression** situation. Of course, not every repair will have this effect.

Anticipation

When a *future benefit or event may affect a particular parcel of land, its value may increase or decrease* based simply on the **anticipation** of that benefit or event. For example, if the owner of a farm sells the property to a developer who proposes a golf course surrounded by luxury homes, homeowners in the subdivision across the street may anticipate an increase in their property values.

Laws of Decreasing and Increasing Returns

It's important to understand the **law of decreasing returns**, which says that *beyond a certain point, the added value of an additional feature, addition, repair, etc., is less than the actual cost of that item.* This is also called the law of diminishing returns. In other words, you can add too much to a property and not be able to increase the price enough to recoup the money you've invested. You may still want or need to do something to the property, just don't expect to get the full cost of the labor and materials back when you sell.

The corollary to this is the **law of increasing returns,** which says that *the added value of an additional feature, repair, etc., is more than the actual cost of that item.* Consider the example of a house in such need of repair that doing anything would have a dramatic increase in its value. Of course you can go too far, and beyond a certain point, you'll be back at the law of decreasing returns.

Depreciation

Depreciation is the *loss in value to property for any reason*. Factors contributing to depreciation can be classified as **curable**, which means that they can be *remedied at a reasonable cost*, or **incurable**, which means that the *cost to remedy the issue would exceed what it contributes to the value of the property.* Depreciation is usually attributed to one of three causes:

- **Physical Deterioration.** *Actual wear and tear due to age, the elements, unrepaired damage, or other forces*. While physical deterioration is usually curable (e.g., replacing a roof, painting), it could be incurable (e.g., severe structural damage due to a flood or fire). Regular maintenance can slow the process of normal physical deterioration.
- **Functional Obsolescence.** Describes a building that is less desirable because of something *inherent in the structure itself,* such as a house with an outdated style, inadequate fixtures, impractical floor plan, etc. This too may be curable or incurable. For example, if adding a second bathroom to a house with five bedrooms results in an increase in value that is greater than the cost of the improvement, it is curable functional obsolescence.
- **External Obsolescence.** Also known as economic obsolescence, occurs when something *outside the control of the property* makes it less desirable. Some examples are the general decline of a neighborhood, loss of an area's economic base, a nearby landfill, or the construction of a new highway that creates noise or re-routes traffic. External obsolescence is always considered incurable since the property owner cannot remedy it.

Case in Point

A homeowner spends $50,000 for kitchen cabinets in a neighborhood where the high-end value of homes is $125,000. The expenditure for kitchen cabinets is no doubt an over-improvement and is a prime example of the effects of the law of diminishing returns. Conformity and regression are at work here, too. Does the typical buyer in this price range want, need, or maybe most importantly, expect this level of cabinetry? It may influence the buyer's opinion of quality of the property, but almost certainly not dollar-for-dollar. Let's look at another example.

A property owner has been in his home for just over a year. During that time, he spent $3,000 converting the previous three bedrooms into one large bedroom, replaced the five-year-old roof (with a different shade/pattern), spent over $12,000 repainting walls and replacing floor coverings (to shades of purple to match his furniture), replaced the nearly new 95% efficiency heating system (with a $10,000 98% efficiency system), and spent $5,000 converting half of the two-car garage into an office.

Strange and unlikely, you say? Not necessarily. In such a scenario, it is very likely the property owner will add the costs of these items to the initial property price paid, and probably apply some factor of appreciation. This process won't likely yield a reliable indication of market value because, in essence, the property may be worth less than what the owner paid for it. The question is: Will the expenditures be perceived to hold contribution value by the typical buyer? If three bedrooms is the norm for the market, the conversion of three to one creates a functional obsolescence—conformity and regression once again.

The same would be true of the garage conversion if a two-car garage mostly conforms to the market. In such a case, the costs incurred would be lost, in addition to the loss of value due to the decrease in functional utility. Unless the roof was aesthetically unpleasant before it was replaced, the only advantage may be the five-year extension of the roof's life, certainly not the cost of replacement. And, yes, certain buyers like purple walls and flooring, but would that buyer represent the typical buyer, and how long would it take for that party to surface? Even if this buyer is recognized as "the market" for the property, the anticipated marketing time may increase. The benefit of the slight increase in efficiency of the heating system might not be fully recognized by market participants and probably not to the extent of the replacement cost.

The previous example helps to answer the question, "How much will replacing or updating an item increase the (market) value?" The logical response might be to consider how unacceptable that item is to the market currently.

Defining Value

Although at times the term "value" seems to be synonymous with "price," these two words actually have very different meanings. **Value** is *what a typical person would pay for something*; **price** is *what one person actually paid.* Price is a fact. Of course, both value and price may have nothing to do with cost. **Cost** is *the dollars needed to develop, produce, or build something*. The value of a piece of real estate should never be confused with its price.

Market Value

Most residential appraisals are used to determine the **market value** of property. Market value is *the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale.* Recent marketplace activity is the best objective evidence of what a typical buyer would do or pay. This value conclusion is the most frequently specified in an appraisal and, therefore, is likely to be the most common type of value used in typical real estate transactions in which real estate agents take part.

Price

A property's market value should never be confused with its **price.** A property's price is *the amount a ready, willing, and able buyer agrees to pay for a property and a seller agrees to accept under the terms of the transaction.* In theory, the market value and price should be equal, but that is not always the case. For example, an appraiser assigns the value opinion of $230,000 to a property, and the seller accepts $220,000 as the sale price.

Cost

A property's **cost** can be defined as *the total amount of money needed to develop, produce, or build something.* Based on this definition, it is easy to see how the value and price of the property may not correspond with its cost. Depending on many factors, such as the economic climate, real estate market, and the seller's situation, a property could, in fact, sell for less than its cost to develop, build, and maintain.

Costs can be classified as either **direct (hard) costs** or **indirect (soft) costs**, for example:

Direct Costs	Indirect Costs

• Land
• Materials
• Labor
	• Fees:
	  ◦ Engineering
	  ◦ Architectural
	  ◦ Appraisal
	  ◦ Accounting
	  ◦ Legal
	• Insurance during construction
	• Marketing costs and commissions
	• Construction loan interest/expenses

Other Types of Value

Additional types of value real estate professionals should understand include:

- **Mortgage Value.** The amount of money a lender is willing to let someone borrow to finance, or re-finance, property. Mortgage value may also be referred to as loan value. Usually, this figure is a percentage of appraised value or the sales price, whichever is lower, and is known as a **loan-to-value ratio** (**LTV**).
- **Investment Value.** The highest price investors would pay for a property based on how well they believe it will serve their financial goals.
- **Insurable Value.** The amount a property can be insured for, usually representing only the replacement cost of the structure and disregarding any value for the land.

- **Assessed Value.** The amount used to calculate taxes due, and sometimes representing a percentage of market value.
- **Value in Use.** The present value to an owner of property that is not currently being put to its highest and best use; also called utility value.
- **Liquidation Value.** The value a property could get if sold under the duress of a must-sell situation with less than typical market exposure.

Arm's Length Transaction

The definition of market value talks about a "competitive and open market." This assumes that property is part of a typical "arm's length" transaction. An **arm's length transaction** is *a transaction that occurred under typical conditions in the marketplace with each party acting in his own best interest.* Those "typical" conditions are:

- The buyer paid cash for the property at closing or obtained a conventional mortgage through a lender so as to pay the seller the agreed upon price at closing.
- The seller did not grant any unusual payment concessions, such as owner financing or other payment terms.
- The buyer and seller are not related in any way.
- The buyer and seller are both acting in their own best interests.
- The buyer and seller are not acting out of undue haste or duress.
- The buyer and seller are both reasonably informed about all aspects of the property, its potential uses, market value, and market conditions.
- The property has been available on the market for a reasonable period of time.

All of these factors should be considered when evaluating comparable properties to use when determining a property's value. If the seller was forced to sell because of a lost job, this would tend to lower the selling price of the subject home. Or, if the seller agreed to some type of owner financing, this may contribute to a higher selling price. When such properties are used as comparable sales, an appraiser must take these factors into consideration when making adjustments. A good appraiser makes a serious effort to research all of these factors, takes them into account, and describes any relevant impact on value in the final appraisal report. This is important for determining what a typical buyer would do in a typical transaction.

Making Land More Valuable

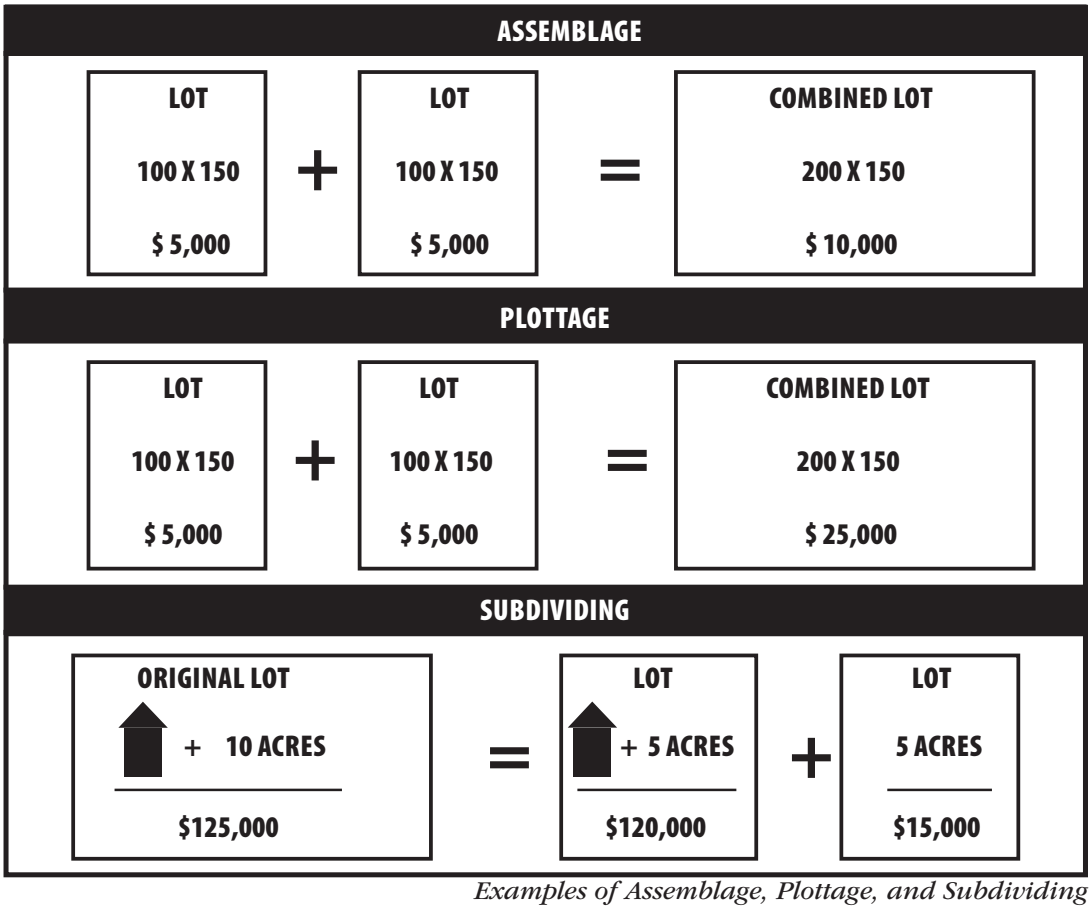
Although the focal point of a real estate appraisal is the improvement or structure on the land, the land itself has some inherent value derived from its location and scarcity. This inherent value, though, is only changed by market conditions. Improvements to raw land to make it into a site can add some value to the land, but the inherent value of the land is still the same. And if buildings are added, the value of the real estate is increased, but not the inherent value of the land. About the only way to increase the value of land without waiting for market appreciation is to have more of it.

Assemblage and Plottage

Assemblage is *combining two or more parcels of land into one larger parcel.* This is typically done to increase the usefulness of the land. By allowing one larger building to be constructed on the larger parcel than could have been built on the smaller individual parcels, the value of the land has also increased. In fact, this one large parcel is likely worth more than the sum total of the smaller parcels. This is referred to as plottage. **Plottage** is *an increase in value (over the cost of acquiring the parcels) by successful assemblage, usually due to a change in use.* By creating a larger parcel with more utility and higher and better use than the individual sites, the owner has successfully achieved an increase in the inherent value of the land. Actually, individual landowners can benefit as well. Let's look at an example.

Case in Point

Mega Company wants to build a new shopping center. They've selected an ideal location where ten homes now sit. Each of those homes is worth about $100,000. Mega knows, though, that the value of all ten parcels together is $2,000,000. Instead of trying to buy each home for only $100,000, Mega is likely to offer the owners, say, $120,000 as an incentive for them to sell. If every home were purchased for $120,000, Mega's total cost would be $1,200,000—much less than the total value of the combined larger parcel. This strategy will likely work at first, but become less effective as time goes on and the last few owners learn about it. These last few homes will likely cost Mega more, but the owners have to be careful, too. If they're unrealistic about the worth to Mega's project or how high Mega is willing to go with its offer, they may get nothing. If these owners hold out too long for too much money, Mega may decide to design the project around them.



Examples of Assemblage, Plottage, and Subdividing

Subdividing

There are times when **subdividing** property by *splitting it into multiple smaller parcels* can increase value. Suppose a house sits on 10 acres of land. If the property is not being used for farming or another specialized use that requires that much land, the owner might want to consider splitting it into two parcels: One parcel of five acres with the house and another, separate five-acre parcel. Of course, the specific property and market would need to be analyzed, but it's very likely that the value of the house and five acres would not be worth much less than the house and 10 acres. But now the owner has an additional parcel of land to sell or develop, thus increasing the total maximum productivity and profitability of the land. (Zoning may allow subdividing the land into smaller lots, but many areas require platting and place restrictions on lots of less than five acres, hence this example.)

Value of Frontage

As a correlation to assemblage and plottage, it's important to understand that the addition of some land is more valuable than other land. This is especially true for commercial property, which is compared by the front foot. Adding more **frontage**, which is *the dimension across the access side of a property*, makes land more valuable than adding more depth, even if the total amount of land added is the same. When giving the size of a lot, frontage is expected to be the first number. Let's explain. If a lot is 200 feet by 100 feet, and a person buys another lot that's 100 feet by 200 feet, both lots have the same total area (20,000 square feet). However, the first lot would be worth more because it has greater frontage—and, therefore, access along the road—rather than depth.

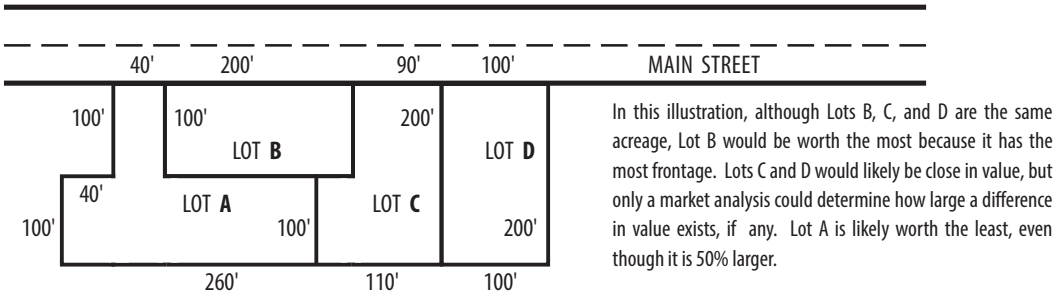
Real Success

With commercial properties, frontage is valued more since it is more useful for business purposes. Adding depth still increases the value of the lot, but as the depth of a lot increases, the value per front foot increases at a decreasing rate. If a lot is 100 feet wide and 10,000 feet deep, how much would someone be willing to pay to make the lot 10,005 feet deep? Not much. The total value increase to the lot would be small.

Now consider this, how much would someone be willing to pay for a few more feet of road frontage to that lot that is 100 feet wide and 10,000 feet deep? More than someone would pay for more depth! Remember, our examples are primarily concerned with commercial properties.

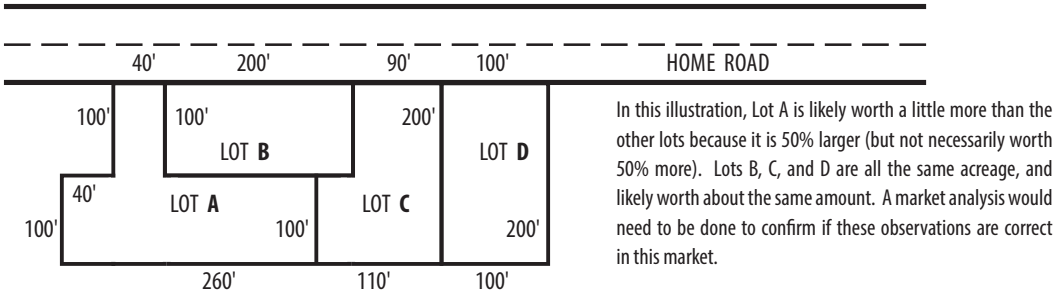
Generally, the marketplace does not make the same distinction for frontage when valuing residential properties. An increase in lot size (whether frontage or depth), generally contributes the same amount of extra value to a lot based on the total size of the lot. When comparing two lots that are not the same size, the marketplace ultimately determines how much additional lot area is sufficient to warrant an increase in value. A sales comparison of comparable properties in the market is the best way to determine if a larger lot is worth more, how much more the larger lot is worth, and what amount of additional land is needed for an increase in value.

COMMERCIAL LOTS



In this illustration, although Lots B, C, and D are the same acreage, Lot B would be worth the most because it has the most frontage. Lots C and D would likely be close in value, but only a market analysis could determine how large a difference in value exists, if any. Lot A is likely worth the least, even though it is 50% larger.

RESIDENTIAL LOTS



In this illustration, Lot A is likely worth a little more than the other lots because it is 50% larger (but not necessarily worth 50% more). Lots B, C, and D are all the same acreage, and likely worth about the same amount. A market analysis would need to be done to confirm if these observations are correct in this market.

Lot Value Examples.

Summary

1. **Value** is the amount of goods or services offered in the marketplace in exchange for something. There are seven characteristics of real estate. Maximizing value requires all four value characteristics—**Demand, Utility, Scarcity, Transferability** (D-U-S-T)—plus the three physical characteristics—immobility, indestructibility, uniqueness. Buyers must want a site, feel it's useful to satisfy needs, perceive limited supply, and be free to transfer the site later. To have value, scarcity must be coupled with utility. Without demand, supply is meaningless, but a person must also have an ability to purchase (effective demand).
2. Four broad forces that affect value are (P-E-G-S): **Physical** (topography, water, location, popularity, and environment), **Economic** (business cycles, economic base, supply and demand, inflation, and cost of money), **Governmental** (revenue generating laws/taxes, right to regulate laws/police power, fiscal and monetary policy, secondary mortgage markets, and government programs—FHA/VA), and **Social** (demographics, migrations, trends, and tastes/standards).
3. Factors that affect the value of a particular piece of real estate include many of the same economic, governmental, and social factors that influence the broad real estate market. Some of the most relevant broad market factors that influence the value of a particular piece of real estate include **supply and demand**, **uniqueness**, and **scarcity**. Property-specific factors include **highest and best use, location, substitution, conformity,** and **contribution**.
4. **Neighborhoods** or **market areas** are groups of homes or properties with common characteristic(s). They share physical traits (e.g., style, age) or boundaries (e.g., rivers, roads). Almost any other characteristic can also define neighborhood (**excluding** race, ethnicity, and other protected classes). Properly defined neighborhoods generally age together through four phases of a life cycle: Growth, stability/equilibrium, decline, and revitalization. Rapid revitalization is called **gentrification**.
5. **Market value** is the theoretical price that a piece of real estate is most likely to bring in a typical transaction, not to be confused with market **price**, which is the actual price paid for a piece of real estate. A typical real estate transaction is often referred to as an **arm's length transaction,** meaning the transaction occurred under typical conditions in the marketplace. Typical conditions are: 1. Buyer paying cash or getting a mortgage. 2. Seller not offering financing or unusual terms. 3. Buyer and seller are not related. 4. Buyer and seller acting in their own best interests. 5. Buyer and seller not acting out of undue haste or duress. 6. Both are reasonably informed about the property. 7. Property has been on the market for a reasonable period of time.
6. Inherent value of land can be increased through assemblage or subdivision. **Assemblage** is combining two or more parcels of land into one larger parcel, increasing the usefulness of the site. If the larger parcel is worth more than the sum total of the smaller parcels, this is called **plottage**. **Subdividing** a larger parcel of land can also result in more utility and more value. **Frontage** is the dimension across the access side of a parcel of land. With commercial property, frontage is usually more valuable than depth. The first number in a lot size is always the frontage. With residential land, usually, only total size is compared. In both cases, a market study must be done to determine any amount of value difference.

Quiz

1. ***The amount that one particular person paid for property is its***
   a. cost.
   b. market value.
   c. price.
   d. value.

2. ***A new company that moves to an area helps the local real estate market by helping maintain a healthy***
   a. balance.
   b. economic base.
   c. economy of scale.
   d. environment.

3. ***What are the value characteristics that properties must have in harmony to maximize value?***
   a. demand, utility, scarcity, transferability
   b. supply and demand
   c. uniqueness, immobility, indestructibility
   d. utility and scarcity, coupled with a lack of purchasing power

4. ***Which CANNOT define a neighborhood's boundaries?***
   a. artificial physical boundaries
   b. ethnicity of residents
   c. income level of residents
   d. upkeep and maintenance

5. ***Tom and Margo find their dream house, which includes the stainless steel appliances they wanted, but it's priced high. They decide to buy a house two blocks away with nearly identical features, minus the appliances, for $20,000 less. They figure they can replace the appliances later if they choose and still come out ahead financially. What theory is at work?***
   a. conformity
   b. contribution
   c. regression
   d. substitution

6. ***Which is an example of real estate put to its highest and best use?***
   a. a flat, paved parking lot in downtown Chicago
   b. a house in a residential subdivision
   c. an old house on a major highway surrounded by commercial buildings
   d. a vacant lot

7. ***Which house will hold its value best?***
   a. "best" house in the "worst" neighborhood
   b. "worst" house in the "best" neighborhood
   c. $50,000 house that overlooks a huge landfill
   d. $500,000 house in an area of apartment complexes

8. ***Market value is the***
   a. dollars needed to rebuild the property.
   b. price determined by Freddie Mac, Fannie Mae, and/or USPAP.
   c. price a property actually sold for.
   d. theoretical price that real estate is most likely to bring in a typical transaction.

9. ***Each of the following is a characteristic of an arm's length transaction EXCEPT***
   a. buyer and seller are not related.
   b. each party acts in its own best interest.
   c. neither party is acting under duress.
   d. seller offers financing concessions.

10. ***The real estate market is said to be in balance when there are more***
    a. buyers than houses for sale.
    b. buyers than sellers.
    c. houses for sale than buyers.
    d. houses than apartments.

11. ***Someone buys two adjacent parcels of land for $20,000 each. An appraisal shows that the combined larger parcel is now worth $50,000. What has occurred?***
    a. assemblage
    b. frontage
    c. plottage
    d. subdividing

12. ***A fast food chain is looking for a new location. Assuming the cost of the lot is less of a concern than customer convenience of entering and exiting the property, which of these lots would the restaurant likely choose?***
    a. 100' x 200'
    b. 125' x 150'
    c. 150' x 125'
    d. 200' x 100'



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Property Appraisal

As a real estate professional, it is important to understand the purpose and use of appraisals. Appraisal reports document an opinion of market value for a property based on objective data. This chapter introduces the appraisal process and its three accepted approaches to value, focusing on the sales comparison approach, which is the primary method for determining market value for residential property. After a discussion of selecting comparable sales, the chapter focuses on the rules and procedures for making adjustments. Then, some points are made about the reconciliation process and developing a final opinion of value. The chapter also looks at the elements involved in the cost approach and the income approach.

You'll learn:

- The steps necessary to complete a real estate appraisal.
- The best use of the three appraisal approaches.
- Strategies for choosing comparables for the sales comparison approach.
- How adjustments are made to comparable properties.
- How appraisers arrive at an opinion of value.
- Elements of the cost approach.
- Elements of the income approach.

Key Terms

Appraisal
Capitalization Rate
Comparables
Cost Approach
Depreciation
External Obsolescence
Functional Obsolescence
Gross Living Area (GLA)
Gross Rent Multiplier
Income Approach
IRV Formula
Matched Pair Analysis
Net Operating Income
Reconciliation
Sales Comparison Approach
Subject Property
URAR
USPAP

Real Estate Appraisal

An **appraisal** is an *estimate or opinion of value as of a certain date that is supported by objective data.* There are many important concepts in that short definition. First, an appraisal is only an **estimate** or **opinion**. While it is an opinion of value, it must be supportable and based on facts. The other equally important part of the definition of appraisal is that the estimate of value is as of a **certain date**. Change is constantly occurring, and so value is also subject to constant change. This is why an appraisal is only valid as of its effective date, which establishes terms, conditions, and economic circumstances upon which the value is estimated. An appraisal is **NOT** a:

- Guarantee of value.
- Prediction of future worth.
- Determination of what someone will pay for a piece of real estate.
- Inspection of the property.
- Guarantee that the house is free of defects.

Uses for Appraisals

The most common reason for an appraisal is performed is for lenders and mortgage companies to determine the value of property used as collateral for mortgages or investments. Appraisals may be performed for a variety of other reasons, such as to determine property values for the following:

- Sellers wanting an appropriate listing price
- Purchasers wanting to confirm an appropriate offer price
- Civil lawsuits
- Divorces
- Bankruptcies
- Estates and trusts
- Eminent domain valuations
- Insurance coverage or claims
- Tax matters
- Determining construction or remodeling costs

The Appraisal Profession

Appraisal as a discipline and a profession has its origin in the 1930s. People had always made their own estimates of value when making a buying, selling, or lending decision with regard to real estate. But in the 1930s, as lenders began to make more and more mortgage loans to people trying to buy homes, it became necessary to create a more standardized process of determining value so that the lenders could make consistent and informed decisions with regard to these loans. To meet the needs of lenders, the American Institute of Real Estate Appraisers was formed in 1932, and the Society of Residential Appraisers was formed in 1935. These two organizations were merged in 1990 to create the **Appraisal Foundation**.

Appraisers need a good understanding of real estate and each appraisal approach, as well as the education and experience necessary to carry out assignments. The Appraisal Foundation is the parent organization of the **Appraiser Qualifications Board** (AQB), which exercises authority over the establishment of education, experience, and other criteria for licensing, certification and recertification of appraisers. The requirements to become a licensed or certified appraiser are quite extensive.

Illinois Real Estate Appraiser Licensing

225 ILCS 458/1

The **Illinois Real Estate Appraiser Licensing Act of 2002** was enacted to license and regulate professional appraisers. This Act is intended to be consistent with and bring the state of Illinois into compliance with the provisions of **Title XI of the federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989**. The following types of appraisers are licensed in Illinois:

- **State Certified General Real Estate Appraiser.** An appraiser who is licensed to appraise all types of real property without restrictions as to the scope of practice.
- **State Certified Residential Real Estate Appraiser.** An appraiser who is licensed to appraise one (1) to four (4) units of residential real property without regard to transaction value or complexity, but with restrictions as to the scope of practice in a federally related transaction.
- **Associate Real Estate Trainee Appraiser.** An entry-level appraiser who is licensed with restrictions as to the scope of practice in accordance with the Illinois Real Estate Appraiser Act.

A licensed or certified appraiser is subject to a review of his or her peers and is obligated to understand and consider any material factor that may affect the value of a piece of real estate.

Uniform Standards of Professional Appraisal Practice (USPAP)

The **Uniform Standards of Professional Appraisal Practice (USPAP)**, established and promoted by the Appraisal Foundation, dictates a number of standards, rules, and guidelines that licensed appraisers must follow when completing an appraisal report. Many of these rules relate directly to the appraisal report itself. For example, whenever an appraiser undertakes an assignment to develop an opinion of value, it is unethical for the appraiser to accept compensation contingent upon the reporting of a predetermined value, a direction in value that favors the client, etc. Any interest the appraiser may have in the subject property or the outcome of the appraisal must be clearly documented in the appraisal report.

State Appraiser Certification and Licensing Boards; federal, state, and local agencies; appraisal services; and appraisal trade associations require compliance with USPAP.

The Uniform Residential Appraisal Report (URAR)

The **Uniform Residential Appraisal Report (URAR)** is the predominant appraisal report form. The URAR form is based on the appraiser performing **both an interior and exterior inspection** of the subject property. Additionally, the appraiser is to inspect the exterior of the comparable sales used to support the conclusion of value. This exterior inspection from the street verifies that the comparable's condition in relation to the subject generally conforms to the neighborhood and otherwise represents a comparable property.

Keep in mind that the URAR is used not only to report a final opinion of value for the subject property, but also as a means of communicating with the client and anyone else authorized to read the appraisal report. For example, the lender is considered an authorized user of the report regardless of who orders or who pays for the appraisal.

The appraiser's report should be clear and concise, logical and consistent, but it must also be supported and documented with market evidence in defense of the conclusions reached to ensure the integrity of the appraisal process. The reader should be led to the same conclusion the appraiser reached in evaluating the available data. The URAR form can offer a process, but it does not substitute the standards for compliance as set forth by USPAP. Under USPAP rules, the appraiser must also prepare a complete workfile for each assignment that includes, among other things, all data and documentation necessary to support the appraiser's opinions and conclusions in the report.

The Appraisal Process

Appraisers follow an orderly step-by-step process to ensure their appraisal results are thorough, comprehensive, and accurate. The steps in the appraisal process are:

1. Define the appraisal (state the problem, identify the property, identify the effective date).
2. Define the data and sources necessary to perform the appraisal.
3. Collect and analyze the relevant data.

4. Determine the highest and best use for the subject property.
5. Determine the value of the land separately from the structures.
6. Estimate the value of the subject property considering all three approaches.
7. Reconcile estimates of value from the three approaches (results are weighted, never averaged).
8. Report conclusions of the valuation process, including all data used and the final value estimate.

Appraisal Approaches

Appraisers value properties using three different approaches. Each approach is independent of the others and is performed separately to arrive at an opinion of value. Many factors can drive the appraiser's choice in the application of the approaches, such as the type of property being appraised and the type and extent of research and analysis needed in an assignment. As a result, the appraiser could elect to use one, two, or all three approaches.

- **Sales Comparison Approach.** Develops an opinion of value of real property by comparing the property being appraised with other similar properties, called comparables or comps, which have sold recently in the same market area as the subject property.
- **Cost Approach.** Develops an opinion of value for a property by calculating the cost of the land, site improvements, and the cost to build the structure on the land.
- **Income Approach.** Sometimes called the capitalization approach, it estimates the value of real estate by analyzing the revenue, or income, the property currently generates or could generate often comparing it to other similar properties.

The Sales Comparison Approach

The **sales comparison approach** compares the subject property with other recently sold properties in the same location as the subject in order to assign value. The **subject property** is *the property being appraised or for which a value opinion is sought.* The *properties used to support the opinion of value* are the **comparables**, also called comps. For residential appraisals, USPAP rules state that when the sales comparison approach is applicable, an appraiser must analyze as many comparable sales as are necessary. The URAR form is designed for inclusion of three comparables, but additional sheets can be used if more comparables are needed to support the appraisal conclusions.

The sales comparison approach is considered the most useful and accurate of the three appraisal methods because it's rooted in actual market activity. It is also sometimes referred to as the **market data approach**. This approach, however, only considers *past sales that have actually closed.* Properties currently for sale are not used as comparables since their final selling price hasn't been determined. Appraisers must look at past sales for the objective evidence to support their analyses of property value based on what a typical buyer would pay. With a truly objective appraisal, another buyer should agree with the value and be willing to pay the same price for the property. By looking at enough comparable sales, the assumption is made that the resulting appraisal analysis reflects the actions of typical real estate buyers in the marketplace.

Substitution and the Typical Buyer

The integrity of the appraisal process depends on basing property value on the actions of a **typical buyer,** *one acting in his or her own best interest, without undue pressure, influence, or emotional attachment, and who would rationally and readily accept a less expensive substitute if available.* Recall that the theory of **substitution** says that *an informed buyer will not pay more for a home (or a feature in a home) than a comparable substitute.* Appraisers must take this into account as it limits a property's worth in the marketplace.

But a *buyer* who employs the theory of substitution considers *all* properties currently for sale, not just those already closed, as the appraiser does. Acknowledging this inherent limitation to the sales comparison approach, the URAR form has a place (at the top of the Sales Comparison section) for information on comparable properties currently for sale and all comparable properties that have sold within the past 12 months. This ensures these figures are considered when determining whether the subject property should be at the high or low end of the indicated value range.

Finding Comparable Sales

The sales comparison approach typically uses between three and five comparable sales to arrive at a value figure in a residential appraisal. A **minimum of three** comparables is required by most secondary market lenders to ensure an accurate appraisal from sufficient data. Ideally, comparables should be **recent sales**, usually *within six months prior to the date of the appraisal.* If any comparables used are older than six months, the appraiser must comment on the reasons for using them as supporting data and make any necessary value adjustments to reflect any differences in market conditions.

Same Market Area

The ideal situation is to use recently sold comparables in the same neighborhood or market area as the subject property. If there aren't enough properties that have recently sold in a given area, other similar areas may be researched. The appraiser must use knowledge and judgment to select the best areas for comparably valued properties, and make appropriate price adjustments, along with clear explanations as to why they were necessary to use.

While physical location is important, any comparable property must be close in style and other features to the subject property. Similarity in use and other externalities ensures that a typical buyer would see the properties as ready substitutes for one another.

Same Transfer of Rights

The subject property and the comparables chosen for comparisons should involve the same transfer of rights. Most often, the subject of a residential appraisal will involve a fee simple transfer, in which the entire bundle of rights is sold to the new owner. The appraiser should verify that the comparables used in the appraisal report were also a fee simple transfer. When part of the bundle of rights (e.g., mineral rights) is sold separately, it is best that the subject and the comparables involve the same transfer of rights to avoid potentially complex calculations that may or may not be a true measure of market value impact in that particular area.

Part of an Arm's Length Transaction

The comparables used as the basis for comparisons must have been part of an **arm's length transaction** that occurred *under typical conditions in the marketplace, with each party acting in his or her own best interests.* The transaction should have involved payment for the property in cash or with a mortgage through a lender, where the seller did not make any unusual payment concessions or owner financing. Comparables with related parties, that sold as part of a liquidation sale (e.g., foreclosure), or with other unusual terms or concessions, should be eliminated.

Adjusting Comparable Sales

Since it may be difficult to find properties that are the same as the subject property in all respects, the sales comparison approach allows for adjustments. **Adjusting properties** is *the process of making chosen comparables come as close as possible in features to the subject so that meaningful price comparisons can be made.*

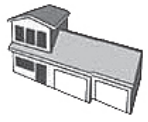
An adjustment can be applied for any **amenity** or **condition** which, in the marketplace, results in a difference in price between two properties. An **amenity** is *any tangible or intangible feature that enhances and adds value to real estate*.

The rules for adjusting properties are simple:

- The subject property is the starting point and *never changes*.
- If the comparable is missing a feature that the subject has, the appraiser *adds* to the comparable to make the properties equal.
- If the comparable has a feature that the subject property does not, the appraiser *subtracts* from the comparable to make them equal.

This process is repeated for each significant feature that is different between the subject property and the comparables *on the day they were sold.* After all adjustments are made, an appraiser can reconcile the adjusted prices of the comparables to estimate the value of the subject property, weighting the comparables as appropriate—**never averaging them**.

Below is a very elementary illustration:

	SubjectProperty	Comparable 1	Comparable 2	Comparable 3
Feature	 1-car garage	 No garage	 1-car garage	 2-car garage
Adjustment Needed	Never adjust!	(*Missing feature; add to make equal to subject property*) + $5,000	(*Equal to subject property; no need to adjust*) +/- $0	(*Additional feature; subtract to make equal to subject property*) - $5,000
Pre-adjustment Value	--	$91,000	$100,000	$110,000
Final Value	$100,000	$96,000	$100,000	$105,000

Matched Pair Analysis

Once the necessity of an adjustment to a comparable property is determined by an appraiser, he must know how much of an adjustment to make before it can be made. In the previous example, a garage was the amenity in question. How did we know a garage was worth $5,000? The value of the garage likely would have been determined by performing a **matched pair analysis**. Matched pair analysis is *the process of developing the contributory value of specific property characteristics or features by comparing pairs of similar properties*. (This may also be called **paired data analysis**.)

Ideally, there should be only one different characteristic between the pairs of properties being analyzed so the difference in sale price can be attributed directly to that feature. Of course, in reality, the analysis may be more involved, with multiple adjustments derived in some instances.

Case in Point

An appraiser is trying to find the contributory value of a fireplace for a given subject property. In researching recent sales in the area, the appraiser finds ranch homes that have nearly identical features—same number of bedrooms and baths, both with basements, both on a cul-de-sac, and both sold within the past six months and were on the market for about the same amount of time. One sold for $210,000, the other sold for $212,500. The only difference is one had a fireplace and one did not. From this the appraiser may conclude that the fireplace is worth $2,500 for this property type, in this area.

Adjustments as of Sale Date

Adjustments are made to comparables for differences between the subject property and the comparables, *only as of the day the comparables were sold.* Changes to the comparables after they sold don't count because they would not be reflected in the price. If an appraiser is considering a comparable, but then learns it needed extensive repair or rehabilitation work when sold, it's not a good choice unless the subject property also needs similar work.

Significant Features

Adjustments are only made to comparables for significant features, generally physical features, but they can also be *features of the transaction,* such as when a sale occurred or financing terms. Some features are objective, such as the number of bedrooms, while other features are subjective, such as the condition. Also, significant features can change from area to area; for example, a view of the golf course in a golf course community or access to a waterway for riverfront property. Every feature doesn't need to be considered every time, since the object is to find comparables that are already as close as possible to the subject.

If differences in features between the comparables did *not* result in differences in sale prices, then only those features that appeared to contribute to any price differences should be noted. For example, if two similar comparables sold for almost exactly the same price, even though one has central air conditioning and one has a heat pump, one could conclude that the presence of central air or a heat pump did not have a significant effect on the price. Therefore, this is not a significant feature.

Gross Living Area

When performing an appraisal, below grade areas should be considered separately from the gross living area of the house. **Gross living area** (GLA) is ***residential space that's finished, heated, and above grade.*** Garages, finished basements, and storage areas don't count in GLA. Even areas partially below grade should not count as part of the gross living area. Instead, finished areas below grade must be considered as separate items, and adjusted according to their presence or absence in the comparables and the subject. Also, room counts do not include bathrooms or foyers, and bedrooms must have a closet. Other considerations may be customary in the local market. Room count and square footage of the gross living area should be similar between the subject and the comparables. The market will dictate when to make adjustments and the amount of adjustment to be applied.

Limits on Adjustments

Total adjustments that may be made to comparables are limited by Fannie Mae and others in the secondary market. The reason for limitations is to provide some sort of benchmark as to how close the comparables actually are to the subject property. If they are too dissimilar, this will result in excessive adjustments. **Gross adjustments** are *the overall total of all adjustments applied regardless of whether the adjustment is applied as a positive or negative.* In comparison, **net adjustments** are *the sum of the adjustments, taking into account whether the adjustment was a positive or negative.* Net adjustments reflect the percent of absolute adjustments when compared to the sale price of the comparable.

When making adjustments, most lenders, therefore, prefer the comparables to fall within the following guidelines unless there's an appropriate explanation and justification.

Total Net Should Not Exceed 15%. The total net value of all adjustments should not exceed **15%** of the comparable sale price. With this guideline, all adjustments must be added or subtracted together, following the sign of the adjustment. So, all positive adjustments (for missing features) are added together, and all negative adjustments (for additional features) are subtracted from that total. This final figure generally should not exceed the 15% limit.

Total Gross Should Not Exceed 25%. The total gross (absolute) value of all adjustments should not exceed 25% of the comparable sale price. With this guideline, all adjustments are added together, but without regard to their sign; it doesn't matter if adjustments are positive or negative. Total adjustments generally should not exceed 25%.

	Within Guidelines	Exceeds Guidelines
Net Adjustments	A comparable sold for $85,000. It had positive adjustments for a garage (+$3,000) and a half bath (+$1,500), and a negative adjustment for a basement (-$2,500). So, 3,000 + 1,500 - 2,500 = $2,000. This total is within acceptable parameters.	A comparable sold for $55,000. It had a positive adjustment for a half bath (+$1,500), and negative adjustments for owner financing (-10% = -$5,500), basement (-$2,500) and garage (-$3,000). So, 1,500 - 5,500 - 2,500 - 3,000 = -$9,500. Total net adjustments of $9,500 exceed the 15% limit ($55,000 x 15% = $8,250).
Gross Adjustments	A comparable sold for $95,000. It had positive adjustments for a basement (+$2,500) and bedroom (+$2,000) and negative adjustment for a garage (-$3,000). So, 2,500 + 2,000 + 3,000 = $7,500. Total absolute value of all adjustments (without regard to sign) is less than 25% ($95,000 x 25% = $23,750).	A comparable sold for $55,000. It had positive adjustments for a garage (+$3,000) and half bath (+$1,500) and negative adjustments for owner financing (-$5,500), a basement (-$2,500), and bedroom (-$2,000). So, 3,000 + 1,500 + 5,500 + 2,500 + 2,000 = $14,500. Total absolute value of all adjustments exceeds 25% limit ($55,000 x 25% = $13,750).

Sequence of Adjustments

As adjustments made are based on an analysis of market data for the various elements of comparison, the sequence of adjustments is important to follow so all values are adjusted consistently. Some adjustments must be made first because they are adjusted as a **percentage** of the comparable's sales price, rather than a set dollar amount. The rationale is to make adjustments for features affecting the overall property before adjusting for individual features. With percentage adjustments, the appraiser extracts the difference in a dollar figure from market data and converts it to a percentage that is applied to the comparable sale. When applying percentage adjustments, property rights, financing, condition of sale, and market conditions are adjusted *individually and in sequence.* Then, all other adjustments may be combined.

The sequence of adjustments, in order of priority, is as follows:

1. Property Rights Conveyed

Most residential transactions involve the **fee simple interest**, meaning that *all property rights typically transferred with real property in the market are being conveyed*. A rare exception might be when the property interest is subject to a **leasehold interest**, such as when the improvements are constructed on lands subject to ground rent. When a property is appraised subject to a leasehold interest, a detailed analysis is required. Comparable properties are preferred that reflect similar leasehold scenarios. However, if necessary, comparable properties sold in fee simple could be utilized with appropriate **percentage** adjustments.

2. Financing Terms

Financing concessions may include the following:

- Interest rate buydowns
- Below market rate financing
- Loan discount points
- Fees or closing costs paid by the seller (if customarily paid by the buyer)
- Refunds or credits for borrower's expenses
- The inclusion of non-realty items

Other items considered are assumptions and owner/seller financing. In fact, any type of sale concession the seller may have made to sell the home should be considered, such as paying for inspections or repairs. Any or all of these items might need to be adjusted by the appraiser if the concessions are not typical for the market and may have influenced the transaction. After an adjustment is made for financing concessions, the result is what's referred to as the (sale price adjusted to) **cash equivalency**.

With financing terms, straight dollar amounts do not yield accurate adjustment figures, therefore a **percentage** adjustment is used.

3. Market Conditions (Date of Sale)

The date that a sale took place is always a consideration. The appraiser should select comparables that sold as recently as possible to avoid making adjustments for date of sale. Since market conditions are always changing, an older sale may have fluctuated due to market conditions related to supply, demand, economic trends, interest rates, etc. Some think of market conditions as a direct relationship to time, which might not necessarily be true. Looking back at a 12-month period, property may have appreciated 3% during the first six months of the year but then decreased 2% in the most recent six months when interest rates rose sharply. In actuality, this would represent a 1% upward adjustment to a one-year-old comparable. However, if a six-month-old comparable were being used, a 2% downward adjustment would be warranted. In most circumstances, though, without unusual volatility in the market, it could be concluded that using older transactions will most likely require adjustments. This is why the secondary market prefers comparables that are not older than six months. However, in some markets and market segments, it is necessary to use comparable sales that exceed this guideline. The appraiser must always survey the market to consider whether an adjustment is warranted.

Property values, whether increasing or decreasing, do so in percentages, not whole dollar amounts. Here too, the **percentage** adjustment is made to the market rather than to the actual comparable.



Fannie Mae requires **at least three comparables** that have actually closed be used for the sales comparison approach. The appraiser must comment on any comparables used that were sold more than six months prior to the appraisal, and provide a reasonable explanation for why this had to be done. Beyond the three required comparables, the appraiser may use older sales, pending sales, or even a prior sale of the subject property if it can be shown in the appraisal report why the information provides additional support to the conclusion of value.

4. Location

The location of the comparables relative to the subject is an important value factor and encompasses several aspects. The two primary aspects the appraiser considers are the market area where the comparable is located, and the exact position within a neighborhood. In most situations, the appraiser should try not to use comparables from different market areas. For established neighborhoods, the appraiser should use comparables from within the same subdivision because they are the best indicator of value. Newer subdivisions may require the appraiser to use at least one comparable from a similar subdivision to support value if there are not enough sales without builder financing and subsidies.

Position differences within a neighborhood are usually handled as part of the adjustment process for physical differences. The appraiser checks to see if there is any discernible value difference for properties based on lot position in a particular market, and then determines an appropriate adjustment based on a matched pair analysis.

Rural properties can pose a challenge to appraisers because the only comparables available may be a significant distance from the subject. When no other comparables are available, the appraiser may use some from the nearest similar market area with an appropriate explanation and any necessary value adjustments.

The matched pair analysis method produces a **dollar value** for location differences that is applied dollar-for-dollar to the home's value.

5. Physical Characteristics

The rest of the sales comparison grid on the URAR form focuses on various physical differences that may or may not warrant an adjustment. At the end of the features and amenities listed, there are additional blank spaces where more items can be inserted if other elements of comparison are responsible for value differences between a comparable and the subject. Ideally, only comparables that need as few adjustments as possible should be chosen. Those needing only adjustments for physical differences are preferable.

When entering descriptions for items that are not quantifiable, for example, quality of construction, appraisers rate them as excellent, good, average, fair, or poor.

Matched pair analysis produces a **dollar value** for physical differences that is applied dollar-for-dollar to the home's value. Deriving the adjustment value from actual sales is the best reflection of market value of a feature or amenity. Many items do not add market value equal to their cost to install. In colder climate areas, an in-ground swimming pool is a great example of this.

Adjustment Sequence Example

The following example shows how the adjustments to a comparable property were made in the prescribed sequence.

Element of Comparison	Market Indicated Adjustment	Adjustment to Comparable
Sale Price	—	$136,000
Property Rights Conveyed	+5%	+ $6,800
Adjusted Price	—	$142,800
Financing Terms	-3%	- $4,284
Adjusted Price	—	$138,516
Market Conditions	+7%	+ $9,696
Adjusted Price	—	$148,212
Location	+11,000	+ 11,000
Physical Characteristics	-$7,500	- $7,500
Value Indication		$151,712

Researching the Sale and Transfer of Properties

An important step to ensure the integrity of the appraisal process is research, verification, and analysis of the **transfer history** of the properties. This applies to the subject as well as the comparables. Analysis of the purchase contract normally only shows price and financing concessions. Determining the recent sales history of the property is important for an appraiser. The appraiser is trying to ascertain whether the transactions represent *bona fide transfers at market value.*

Transfer History of the Subject

USPAP requires the appraiser to analyze the purchase contract, current listing, and recent prior sales for the *past three years.* In addition, the URAR form asks for research of the subject's transfers from **three years prior to the effective date of the appraisal**. This is designed to give the lender or client a complete picture of the subject property value. It may also lead the appraiser or lender to seek more information or data on the subject property. For example, if a comparable property was transferred just two months ago for half of the current contract price, the appraiser would need to research this to determine if the current sale price represents true market value. The property could have been sold in a distressed situation, there may have been legitimate repairs done that can be documented with receipts, or the property could be part of a property-flipping scheme.

Property Flipping

Property flipping is defined by Fannie Mae as ***the process of purchasing existing properties with the intention of immediately reselling them for a profit.*** While property flipping is not automatically illegal, it has gained a bad reputation because of the amount of fraud associated with it. The fraud occurs when a property's value is inflated and the final purchaser pays more than the property is worth. Appraisers can get caught in the scheme wittingly or unwittingly. Researching the transfer history of the property is one way for the unsuspecting appraiser to become aware of any possible fraud and alert others. Frequent transfers with escalating values in a short period of time are one red flag that merits further investigation. Even distressed properties can be subject to fraud if repairs were done poorly or not performed at all. The appraiser is ***not*** a home inspector, but the lender or client is relying on the appraiser as a collector and conveyor of information. The appraisal report must be carefully and thoroughly prepared to avoid misleading the lender or client with an inflated property value.

Again, property flipping is not illegal by definition, but if the seller has held the property for an unusually short period of time—or has not even taken title to the property—then there must be some justification and documentation for the increase in value. The appraiser and the lender/client must be satisfied that the current contract is legitimate and that the current price represents the true market value of the property.

Fannie Mae Guidelines

Fannie Mae expects the appraisal report to include an analysis of the sales contract, property listing, and the sales history of the subject when the information is "reasonably available." This presumably means the appraiser must thoroughly search public records. If the appraiser does not have the data resources or expertise in the market area as expected by Fannie Mae, then Fannie Mae expects the appraiser to reject those appraisal assignments.

One of Fannie Mae's goals is to reduce and eliminate instances of fraud where predatory transactions cause an uninformed buyer to pay more for a property than it is worth. Fannie Mae's position is that the likelihood of fraud and misrepresentation increases when the seller is not the owner of record for a property. Furthermore, reviewing and analyzing the prior sales of the subject property as compared to the sale price trends in the area can help confirm the current value for the subject property is reasonable and representative of true market value.

Transfer History of the Comparables

The URAR form asks for information on comparable transfer activity for **one year prior to the comparable's sale date**. The goal for researching them is the same as for researching the subject property—to determine if the transfer price is an accurate reflection of market value. If the property has been transferred several times in a short period of time with escalating values, then the comparable should be investigated further or discarded. There are other things you can learn from the transfer history of a property that may influence its choice as a comparable sale. For example, if a lender is shown as the prior owner, this might indicate that the comparable is a distressed property with a transfer value that did not reflect market value.

In an effort to reduce fraud, Fannie Mae recommends rejecting comparables if the prior transfer involved "back-to-back," "simultaneous," or "double" transaction closings where the price increased from one transaction to the next. Such comparables are problematic and should be discarded early in the data collection process.

Reconciliation

Reconciliation is *the appraisal process of analyzing the values derived from the different appraisal approaches to arrive at a final value opinion.* Reconciliation is actually an ongoing process the appraiser should consider throughout the entire appraisal.

When using the sales comparison approach this step involves reconciling the values of the comparables to reflect an opinion of value for the subject. This is important because it is rare for the adjusted values of all comparables to be equal. An appraiser considers each comparable and gives the most weight to the one that is most similar to the subject property as indicated by the fewest adjustments. The final values are **never averaged** in this step.

The appraiser must present a brief narrative that accurately describes the thought process that went into the final indicated value. This includes any special notes about the subject or comparables, any relevant items in the prior transfer history of the properties, and an explanation of the reconciliation process, including which comparables were given the most weight and why.

Real Success

It is against USPAP rules for the appraiser to steer a value to a target price. The appraiser must see the purchase contract for the subject property because any special terms or conditions may affect the appraisal, but the appraiser cannot ethically appraise the property to the target contract price. Only if the contract price falls within the appraiser's developed value range, and the transaction of the subject is concluded to be an arm's length transaction, is it then acceptable for the final value to equal the contract sales price.

Final Reconciliation on the URAR Form

Estimates of value derived from the various appraisal approaches (sales comparison, cost, income) must be reconciled to arrive at a final opinion of value for the subject property. This is the appraiser's opportunity to bring together all the data collected, verified, and analyzed during the appraisal process.

After the appraiser decides which appraisal approach should be given the most consideration, he must explain the reasoning that went into reaching the final opinion of value in the appraisal report. Although the appraiser's final reconciliation statement is broken down into only a few sentences, this belies the amount of thought and experience that goes into these statements. The Reconciliation section of the URAR form is brief but powerful. In it, the appraiser sums up the entire appraisal process and provides a final opinion of value for the lender or client.

When appraising residential homes using the URAR report, the sales comparison approach is usually given the most weight. If this is not the case, then there must be an appropriate explanation. For example, if the subject is a newly built home in an area with insufficient sales or market activity, it might be reasonable to give the cost approach the most weight in developing a final opinion of value. The explanation is important here so the lender or client understands the process and reasoning involved. Fannie Mae, however, will not accept any appraisals where the cost approach is used as the only indicator of value because cost alone is not deemed to be a reflection of true market value.

Market Value

Fannie Mae guidelines state that the final value entered on the URAR report should represent the appraiser's opinion of market value, as defined in the appraisal report itself: *"Market value is the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus."*

The final indicated value should represent true market value as much as possible, and thus the comprehensive explanation of market value in the URAR form is designed to ensure uniform treatment of adjustments across all properties. Special attention is paid to sales and financing concessions because they have the greatest potential to alter the price paid for property.

Indicated Value Range

Analysis of the adjusted sales data results in an indicated value range. Depending on the scope of work, the entire range could be used as a value conclusion or the opinion could reflect a relationship to a benchmark, such as the mid-point of the range. However, the URAR form and other forms require the value opinion to be stated as a single number. It is unethical for the appraiser to simply value a property at the target value the client requests or that is stated in the purchase contract. But if the appraiser can justify that number based on the data, and that value falls within the appraiser's indicated value range, then it may be acceptable to place that number on the final report.

Value Adjustments Example

The following is a sample sales comparison exercise using value adjustments for three comparable properties in a fictitious neighborhood.

Sales Comparison Approach: Math Adjustments to Comparables								
Feature	**Subject**	**Comparable #1**	**Adjustments**	**Comparable #2**	**Adjustments**	**Comparable #3**	**Adjustments**
Address	61 Lake Ave.	127 Dock St.		39 Lake Ave.		168 Shore Dr.	
Sale Price	?	$137,900		$149,500		$142,700	
Date	---	21 Days		60 Days	+ $1,495	85 Days	+ $2,854
1. Location	Waterfront	Waterfront		Waterfront		Waterfront	
2. Lot Size	100' x 115'	105' x 110'		130' x 130'	- $3,000	105' x 125'	- $1,000
3. Condition	Good	Average	+ $2,000	Good		Good	
4. Age	20 Years	17 Years		24 Years		21 Years	
5. Exterior	Brick	Brick		Stone	- $3,000	Stucco	- $1,000
6. Sq. Ft.	1,750 sq. ft.	1,675 sq. ft.	+ $750	1,875 sq. ft.	- $1,250	1,800 sq. ft.	- $500
7. Total Rooms	7	6	+ $1,000	8	- $1,000	7	
8. Bedrooms	3	3		3		3	
9. Bathrooms	2.5	2.5		3	- $500	2	+ 500
10. Basement	Full	Full		Full		Full	
11. Garage	2-Car Attached	2-Car Attached		2-Car Attached		2-Car Attached	
12. Utilities	N/A	N/A		N/A		N/A	
13. Other	None	None		Pool	- $2,500	Deck	- $2,000
14. Terms of Sale	---	VA	- $1,000	Conventional		Assumption	- $1,000
Total Adjustments	---	+ $2,750		- $9,755		- $2,146	
Adjusted Values	---	$140,650		$139,745		$140,554	

In forming a conclusion of the subject's value based on the comparable properties analyzed, the appraiser looks at the quality and quantity of data and uses his experience and judgment for reaching a final indication. In this example, the appraiser recognizes that Comparables #1 and #3 require the least total adjustments. Likewise, these same sales most closely reflect the subject's size in terms of square feet. Finally, the age of the subject is most closely related to Comparables #1 and #3. The adjusted values of Comparables #1 and #3 range from $140,554 to $140,650. Therefore, a final value opinion could logically be supported at a rounded conclusion nearest to these indications.

Final Value Opinion: $140,500

"As Is"

An important part of the Reconciliation section is the indication of whether the appraisal was performed "as is," or subject to other hypothetical conditions or extraordinary assumptions. A typical appraisal is done "as is," meaning the property value was determined based on a complete and thorough examination of the subject property as it currently sits and in its present condition.

Comparative Market Analysis

A comparative market analysis (CMA) is a service that real estate brokers perform for sellers to help decide on an appropriate list price of the home. A CMA, sometimes called a competitive market analysis or a residential market analysis, is a method of estimating the approximate market value of a home by comparing the subject property to other homes in the same neighborhood or vicinity that:

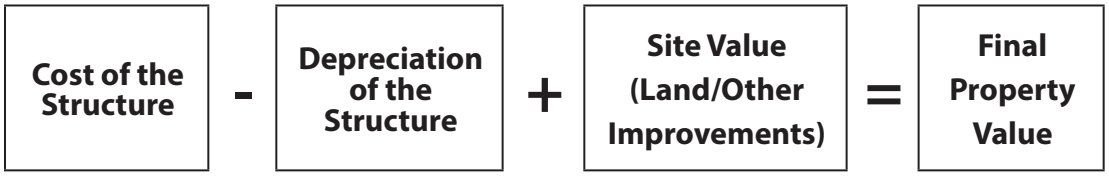
- Have sold.
- Are presently for sale.
- Did not sell before the listing expired.

Although similar in concept to the sales comparison approach, a CMA is never the equivalent of an appraisal.

The comparative market analysis is covered in detail in Chapter 32: The Listing Appointment.

Cost Approach

The **cost approach** is a *valuation method that develops an opinion of value for a property by calculating the cost of the land, site improvements and the cost to build the structure on the land.* The cost approach to value is best for relatively new construction or for unusual residential properties, for example a log cabin or an A-frame in a neighborhood of ranches and split levels. It's also used for special purpose properties that have few or no comparables and do not produce income, for example, hospitals, schools, or churches. The formula for determining value using the cost approach is simple:



When evaluating a property using the cost approach, the appraiser first determines whether the cost estimate is based on replacing or reproducing just the structure.

- **Replacement** is building the *functional equivalent* of the original building using modern materials, design, and functional layout.
- **Reproduction** is building an *exact replica* of the original building, duplicating the materials, design, functional layout, workmanship, inadequacies, etc.

In most residential appraisal assignments, cost estimates are done for replacing a building with one that is of similar size and function. Reproduction costs are more likely to be used, as an example, for historical buildings where it is important for a new structure to have the exact look, materials, and feel as the original.

Costing Methods

Two common methods for estimating the cost are the square foot method and the quantity survey method.

- The **square foot method** for determining the cost of replacing a building typically relies on **cost manuals**, which are *books or online services that give estimated local construction costs per square foot for each element of a building*, such as structure, interior, mechanical, etc. Once the appraiser determines the square footage of the building, she can reference a current cost manual to estimate the cost per square foot to build that type of structure with those features in that part of the country. The appraiser then makes any necessary adjustments for variations in materials used or other features not reflected in the cost manual.
- The **quantity survey** method requires the appraiser to calculate all direct costs of the building by first determining the quantity of each type of part and material used to construct the building. He multiplies the unit price of each material by the quantity needed, then adds the cost of labor, builder's profit, permits, etc. This method is used more frequently for estimating reproduction cost.

Depreciation

Depreciation is the *loss in value to property for any reason*. Factors contributing to depreciation can be classified as **curable**, which means that they can be *remedied at a reasonable cost*, or **incurable**, which means that the *cost to remedy the issue would exceed what it contributes to the value of the property.* Depreciation is usually attributed to one of three causes:

- **Physical Deterioration** is *actual wear and tear due to age, the elements, unrepaired damage, or other forces*. While physical deterioration is usually curable (for example, replacing a roof, painting, etc.), it could be incurable (for example, severe structural damage due to a flood or fire). Regular maintenance can slow the process of normal physical deterioration.
- **Functional obsolescence** describes a building that is less desirable because of something *inherent in the structure itself,* for example, a house with an outdated style, inadequate fixtures, impractical floor plan, etc. This too may be curable or incurable. For example, if adding a second bathroom to a house with five bedrooms results in an increase in value that is greater than the cost of the improvement, it is curable functional obsolescence.
- **External obsolescence,** also known as economic obsolescence, occurs when something *outside the control of the property* makes it less desirable. Some examples are the general decline of a neighborhood, loss of an area's economic base, a nearby landfill, or the construction of a new highway that creates noise or re-routes traffic. External obsolescence is always considered incurable since the property owner cannot remedy it.

Calculating Depreciation

With the cost approach, an appraiser must estimate the accrued depreciation, which is the total amount of loss due to depreciation. There are a number of methods an appraiser may use to do this. For example, she could evaluate each of the causes of depreciation separately and estimate the loss of value for each line item, then add them together to find the accrued depreciation.

A common, straightforward method is the **age-life** method, which compares the structure's effective age to its useful life. When a structure is first built, it has an expected **useful life.** The useful life (or economic life) of a structure is the time during which it can be used for its intended purpose. Rather than considering the actual age of the structure, the appraiser considers how old the building *appears* to be based on deterioration, which is its **effective age.** This may or may not be the same as its actual age. After determining the effective age, the formula to find the age-life ratio is:

Effective Age / Useful Life = Age-Life Ratio

This ratio can be applied to the replacement or reproduction cost of the structure determined earlier to arrive at the accrued depreciation, and therefore, the value of the structure.

An appraiser could also use other methods or a combination to find the accrued depreciation, for example, itemizing certain items and applying the age-life ratio to the rest of the property.

Case in Point: Using the Age-Life Method

Appraiser Jim is evaluating a 30-year-old structure. He determines that the replacement cost (RC) of the structure is $200,000. The useful life (UL) of the structure should be 100 years, and Jim determines, based on its excellent condition, that the effective age (EA) is 25. Here's how he arrives at the value of the structure:

Step 1: **25 years (EA) / 100 years (UL) = .25 (age-life ratio)**

Step 2: **$200,000 (RC) x 0.25 (age-life ratio) = $50,000 (accrued depreciation)**

Step 3: **$200,000 (RC) – $50,000 (accrued depreciation) = $150,000 (value of the structure)**

Site Valuation

Once the value of the structure is determined, the last element to consider is the site value, which must be added to arrive at a final opinion of value for the property. Site value is most often determined using the sales comparison approach. Although land itself is said never to suffer depreciation, if the current or proposed improvements are *not* consistent with the highest and best use of the property, that factor would be addressed as an obsolescence and result in depreciation of the improvements.

The contributory value of other site improvements not already considered in the cost calculations—such as driveways, landscaping, walkways, and, in some cases, utility provisions—must also be added to the equation.

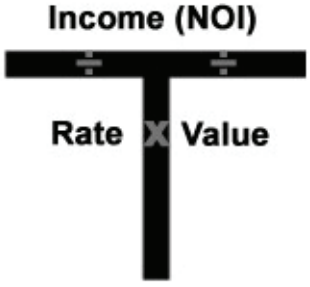
Cost Approach Example

Structure Cost (2,000 sq ft @ $100/sq ft)		$200,000
Depreciation		
Physical Deterioration	$28,000	
Functional Obsolescence (central air)	$12,000	
External Obsolescence	-0-	
Total Depreciation		- $40,000
Depreciated Value of Building		$160,000
Site Value		
Land (140' x 260' @ $320/front foot)	$44,800	
Other (landscaping, concrete drive)	$24,000	
Total Site Value		+ $68,800
Final Opinion of Property Value		$228,800

Income Approach

The **income approach**, sometimes called the **capitalization approach**, is an appraisal method that *estimates the value of real estate by analyzing the revenue, or income, the property currently generates or could generate often comparing it to other similar properties.* This approach is most widely used with commercial or investment properties. There are many ways to analyze real estate income depending on the purpose. The two most common methods are the capitalization rate and gross rent multiplier.

Capitalization Rate



Investors and appraisers use the **capitalization rate** method to estimate the *present value of future income.* This calculation, called the **IRV** formula, relies on three variables: Income, rate and value. When any two variables are known, the IRV formula can be used to solve for the third variable.

Income

Income is the amount of money a property earns. Income can come from many sources in addition to rents, for example, income from parking fees, association fees, vending machines, etc. All of this is added together to find gross income, or income before expenses. The capitalization rate method needs the **annual net income** or net operating income (NOI), which is the income *after expenses* (does not include depreciation or debt service). To find NOI:

Annual Gross Income – Vacancy Loss – Expenses = Net Operating Income (NOI)

To verify the expected future income of the property, an appraiser usually evaluates the property's operating statement. Although it's impossible to predict every variable, if the property's income is fair in the marketplace, it's reasonable to expect the income stream to continue into the future.

Rate

The **rate** represents the *return on the purchase price of the property*. When deciding what to offer for property, investors determine what rate of return is acceptable. For example, one investor may be looking for a 15% return, while another would be content with an 8% return. An appraiser, on the other hand, evaluates comparable properties in the marketplace to determine the appropriate rate to use in the IRV equation for estimating value.

Value

Value is the *worth of the investment*, what someone is willing to pay for a property at a given moment in time. This value figure does *not* take into account the fact that the real estate may appreciate in the future. Most investors buy real estate with this in mind, but since this is an uncertain event, it is not included in an appraisal.

Gross Rent Multiplier

The **gross rent multiplier** (GRM) is *a rate of return, stated as a factor or multiplier, used to derive a value opinion from the anticipated monthly rent a property could generate.* Once this factor or multiplier is determined, it can be used to estimate the value of another rental property. The GRM is most commonly used for **one- to four-unit residential properties** and is based on the total gross monthly rent of a property.

The GRM, which may also be referred to as the GMRM or gross monthly rent multiplier, is most useful in determining the value of residential homes in areas where there are many other rental properties. The GRM identifies the subject property's ranking within the market of similar properties by giving a means of comparing gross monthly rent and sale prices or value. This method can also help support value estimates derived from other appraisal methods.

The GRM gives **no consideration to a property's profitability** since it does not take into account expenses or losses. Rather, the GRM is a **benchmark** to gauge the property's *potential* profitability by analyzing the potential gross income against the investment dollars needed to buy that future income stream.



A similar calculation may be used on small commercial investment properties, though typically, **annual income** is used instead of monthly rent. You may see this referred to as **gross income multiplier** or GIM.

Deriving the GRM

The GRM is derived with a very simple formula. Data are collected on a number of rental properties that have recently sold in a certain area. The selling price for each is divided by the gross monthly rent the property commanded in the marketplace (the market rent), thus arriving at a GRM figure:

Rental Home Sale Price / Gross Monthly Rent = GRM

GRMs are calculated for a number of comparable properties which are similar to the subject property. The GRMs are then analyzed and weighted, giving the most consideration to properties most like the subject. From these comparables, a GRM figure is selected to apply to the subject property to estimate a value.

Using the GRM

The subject property's determined GRM is then put into another simple formula to arrive at an estimate of value. The gross monthly market rent from the subject property is then multiplied by the GRM derived in the first step:

Gross Monthly Market Rent x GRM = Estimated Value



When calculating GRM, make certain that you are clear about whether you are using *monthly* figures or *annual* figures. If the annual rental figure for a one- to four-unit residential property is provided, make sure to divide the figure by 12 to get a *monthly* rent figure before performing the GRM calculation.

Advantages and Disadvantages of the Three Appraisal Approaches

Approach	Advantages	Disadvantages
Sales Comparison	• The most accurate of the three appraisal methods (if good data is available) as it relies on actual market activity • Adjusts comparables so they more closely approximate the actual features and conditions of the subject property • Works for most residential and commercial property	• Requires comparable properties to have been sold recently in the area • Not suitable for special-purpose properties, such as schools, churches, etc., and other unusual or unique properties • Fails to take into account properties currently for sale, which may skew results
Cost	• A very useful and accurate estimate of value for special-purpose properties • Uses extensive data and considers depreciation • Excellent for new properties and for insurance purposes	• The cost of a building does not necessarily equal its value • Consideration of several market factors is necessary to make an accurate estimate of value
Income	• Most useful when analyzing income-producing properties, such as commercial or residential rental real estate • Ability to solve for any variable: income, value, rate of return • Gives a method to analyze the value of a future income stream	• Not useful for non-rental residential property • Income figures and expenses represent past income performance of property • Attempts to introduce vacancy, collections, and other losses into the equation are merely a guess

Summary

1. An **appraisal** is an opinion of value of property, as of a specified date, supportable by objective data. Appraisers follow a well-defined process to value properties using three different methods: Sales comparison approach, cost approach, and income approach. **Uniform Standards of Professional Appraisal Practice** (USPAP) rules and guidelines must be followed so work is seen as complete, accurate, and unbiased. The result of an appraisal is an appraisal report, which communicates the opinion of value and the supporting data. The **Uniform Residential Appraisal Report (URAR)** is the primary form used by lenders for residential property appraisal.
2. USPAP recognizes three approaches to appraisal: 1. The **sales comparison approach** estimates property value by comparing the subject property with other recently sold comparable properties in the same market area. 2. The **cost approach** develops an opinion of value by calculating the cost of the building, subtracting depreciation, and adding the site value. 3. The **income approach** estimates the value of real estate by analyzing the revenue, or income, the property currently generates or could generate.
3. When using the sales comparison approach, Fannie Mae requires that **no less than three comparables** be analyzed in the process, but additional comparables may be used for added support. Only past sales are used since they are objective evidence. Fannie Mae's definition of **market value** is the most probable price a property should bring in a competitive and open market. Typical buyers, acting in their own best interest, won't pay more for a home or feature than a comparable substitute.
4. **Comparables** must be similar to the subject, recent sales, and in the same market area. **Adjustments** are made to comparables for differences; the subject never changes. If a comparable lacks something the subject has, add value to it to make it like the subject; if a comparable has something extra, subtract value from it. Adjustments are only made for features present or absent as of the day a comparable was sold; adjustments are only made for significant features.
5. Elements of comparison are any aspects of property that cause a difference in value. The **sequence** of adjustments is: 1. Property rights conveyed (percentage). 2. Financing terms (percentage). 3. Conditions of sale (percentage). 4. Market conditions/date of sale (percentage). 5. Location (dollar amount). 6. Physical characteristics (dollar amount). Total adjustments made to comparables are limited by the secondary market. Accepted adjustment guidelines are that total **net** adjustments should not exceed **15%** of comparable's price, and total **gross** adjustments should not exceed **25%** of comparable's price.
6. The URAR form asks for the subject's **transfer history** for the past three years to check for inflated prices. While not illegal, fraud can occur if the property value is inflated. Frequent transfers with escalating values in a short time period are warning signs. The URAR form also asks for comparable transfer history for the year prior to the date of transfer to determine if the transfer price actually reflects market value.
7. **Reconciliation** is the process of analyzing values derived from different appraisal approaches to arrive at a final opinion of value. Values of the different approaches are never averaged to reach a final value. The reconciliation section also indicates if the appraisal was performed "as is" or is subject to other conditions or assumptions, which require additional explanation.
8. The **cost approach** is an appraisal method that estimates the value of real estate by figuring the cost of the improvements, minus (-) depreciation, plus (+) the value of the site (vacant land and site improvements). A typical buyer won't pay more for a property than they would for a comparable substitute. **Replacement** is building the functional equivalent of the original building; **reproduction** is building an exact replica of the original building. Except for historical buildings, replacement is usually used.

9. **Depreciation** is loss in value of real estate, for any reason. Land does not depreciate. **Economic life** is the amount of time a building can be used for its intended purpose, or generate more income than cost. **Age-life depreciation** is the effective age of the building divided by economic life. This determines depreciation percentage. Loss of property value occurs from physical deterioration, functional obsolescence, and external obsolescence. **Physical deterioration** is the actual wear and tear due to age, elements, and other forces. Items become **incurable** when the cost to repair them exceeds the contribution to sale value. **Functional obsolescence** occurs when a property is less desirable due to the design of building (this is **curable** if cost adds value to property). **External obsolescence** occurs when things outside the property boundaries make it less desirable—**incurable** because it is outside the control of the property owner.

10. The **income approach** estimates the value of real estate by analyzing the revenue, or income, the property currently generates or could generate. This can be accomplished a number of ways. The **capitalization method** evaluates the property's annual net operating income and an appropriate rate of return compared to similar properties to arrive at an opinion of value. With some residential rental property (four units or less), the **gross rent multiplier** is used to compare rental income to value. To derive a GRM, the prices of other similar rentals are divided by the monthly rent. The GRM is then multiplied by the subject's rent to indicate a value.

Quiz

1. ***An appraisal***
   a. is a prediction of future worth.
   b. guarantees the value of a piece of real estate.
   c. is an opinion of value.
   d. establishes the selling price of a property.

2. ***Allen determined that the two-unit rental property he's appraising should bring in $6,600 annually per unit in rent, and he also determined that the GRM should be about 135. What is Allen's estimate of value?***
   a. $97,778
   b. $135,000
   c. $89,100
   d. $148,500

3. ***Which homes should an appraiser consider when finding comps?***
   a. homes currently listed for sale in the market
   b. homes where the listing agreements have expired
   c. homes that have sold recently in the subject's area
   d. All homes should be considered.

4. ***Paul is doing an appraisal for Fannie Mae. What is the minimum number of comps he needs to consider when using the sales comparison approach?***
   a. 2
   b. 3
   c. 4
   d. 5

5. ***Comp #3 has five bedrooms; the subject property has four bedrooms. Through matched pair analysis, the appraiser has determined that a bedroom in that neighborhood is worth $7,500. What is the appropriate way to apply this information when performing the sales comparison approach to valuation?***
   a. Add $7,500 to Comp #3 value.
   b. Subtract $7,500 from Comp #3 value.
   c. Add $7,500 to the subject base.
   d. Subtract $7,500 from the subject base.

6. ***When using the income approach to value, the income capitalization method is seen as more accurate than the gross rent multiplier because it***
   a. uses annual income.
   b. uses monthly income.
   c. considers expenses.
   d. doesn't consider depreciation.

7. ***When using the sales comparison approach to arrive at an opinion of value, an appraiser***
   a. looks into the future to anticipate the home's appreciation.
   b. looks at current prices of all homes on the market in a given neighborhood.
   c. looks into the recent past to analyze similar sales.
   d. looks into the past to see what an owner originally paid for a property.

8. ***When completing the sales comparison approach, which is considered first in the sequence of adjustments?***
   a. date of sale
   b. location
   c. physical differences
   d. property rights conveyed

9. ***Which form is used most frequently for residential appraisals?***
   a. FNMA
   b. UDAP
   c. URAR
   d. USPAP

10. ***Vincent is tasked with deriving the value for a large, custom home that was constructed nine months ago on a secluded 10-acre lot. Which approach could be considered the most reliable for valuation?***
    a. cost approach
    b. income approach
    c. sales comparison approach
    d. All are equally reliable.

11. ***The second bedroom of a house must be accessed through the first bedroom. This is an example of***
    a. an amenity.
    b. external obsolescence.
    c. functional obsolescence.
    d. physical depreciation.

12. ***Using appraiser Maria's notations, determine the final estimate of value using the cost approach: Replacement Cost=$465,000; Deterioration=$32,000; Site value=$85,000***
    a. $412,000
    b. $433,000
    c. $518,000
    d. $550,000



UNIT 7

REAL ESTATE FINANCE

Chapter 21 – Overview of Real Estate Finance

Chapter 22 – The Mortgage Lending Process

Chapter 23 – Real Estate Finance Options



21 Overview of Real Estate Finance

Most buyers do not have the ready cash on hand to purchase real estate without financing. While a real estate licensee should not give financial advice, it is important to have a solid understanding of the available real estate finance options. This chapter provides an overview of the mortgage lending industry, beginning with a brief history of mortgage lending in the United States. It introduces the participants in the mortgage industry and the roles they play, including a look at the primary mortgage market and how it is sustained and renewed by the secondary mortgage market. This chapter also discusses what constitutes mortgage fraud as well as key indicators of predatory lending.

You will learn:

- The historical events affecting today's mortgage industry, including the seeds of the subprime mortgage crisis.
- Entities involved in the mortgage industry and the roles they play.
- The difference between the primary mortgage market and secondary mortgage market.
- Participants and their roles in mortgage fraud schemes.
- Indicators of predatory lending.

Key Terms

Fannie Mae
Federal Housing Administration (FHA)
Freddie Mac
Ginnie Mae
Mortgage Banker
Mortgage Broker
Mortgage Fraud
Predatory Lending
Primary Mortgage Market
Secondary Mortgage Market
Straw Buyer
TRID Rule

A Brief History of Mortgage Lending

Real estate cycles are part of the mortgage industry. However, in the past few years we have experienced an unprecedented economic and real estate crisis, and the outcome is still uncertain. Economists and industry experts continue to analyze, asking: What caused this crisis? Whose fault was it? What could we have done differently to avoid this? What can we do to make sure this never happens again? All of these questions will be answered in time. For now, we can provide some background on these issues, with the understanding that almost every aspect of the mortgage industry has influenced the current state of affairs:

- Political leaders and housing advocates felt it was everyone's right to own a home, even when perhaps not everyone was ready for the commitment of homeownership.
- Wall Street and investors paid higher priced incentives for subprime loans.
- Government-sponsored enterprises (GSEs) relaxed underwriting standards for conventional mortgage guidelines through automation.
- Unethical appraisers inflated values under pressure from clients.
- Unethical loan originators placed borrowers in loan programs based upon personal profit and not suitability.
- Consumers purchased homes they could not realistically afford.
- Mortgage products allowed financing with no loan documentation.

The Seeds of Today's Mortgage Industry

In the United States from the 1900s through the 1930s, buying a home was a much different process than it is today. When banks first started making home mortgage loans, a purchaser would typically have to make a large down payment (as much as 50% of the purchase price) and accept a loan that had a balloon payment due after a very short term (as short as a year or two, but almost never more than five years). This meant that borrowers were forced into a constant cycle of refinancing, with no interest rate security.

Several events led to the mortgage industry we have today. First, the Federal Reserve Act of 1913 created the **Federal Reserve System**. This Act established a federal charter for banks that permitted them to make real estate loans. Although these loans were initially the short-term, high down payment loans just referenced, the Act established the framework for government involvement with mortgage lending. Furthermore, the Federal Reserve Act was instrumental in implementing a system for the government to influence interest rates.

Federal Housing Administration (FHA)

The **Federal Housing Administration** (FHA) was created by the National Housing Act of 1934 with the intent of helping the housing industry recover from the Great Depression. The FHA was not intended to fund loans; instead, the FHA provided **mortgage insurance** so banks would not have to incur losses for defaults on home loans. The creation of the FHA allowed banks to commit more of their funds to home mortgage loans, while at the same time improving the quality of those loans by requiring them to conform to FHA standards. Banks that followed FHA guidelines would be reimbursed for the insured amount of any borrower's default. Under the FHA program, there are no income limits on borrowers who can take advantage of the program, although the government does limit the mortgage amount that can be insured, based on a sound appraisal and the median price of homes in a particular area.

Because banks are not at risk for borrower default, the FHA was able to create innovative programs and terms over the years for the mortgages they insure. For example, when mortgages required as much as 50% down, the FHA introduced loans that required only a 20% down payment. When short maturities were the norm, the FHA created loan programs with 20-year maturities. This eventually grew to 30 years as the market changed (with 40-year loans not uncommon in some high-cost areas). Finally, the FHA innovated amortizing loans, where the monthly payments would retire the debt over the life of the loan instead of leaving the borrower with a large balloon payment due at the end.

In 1965, the Federal Housing Administration became part of the Department of Housing and Urban Development (HUD). Today, the FHA is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception.

Primary Mortgage Market Lenders

Mortgages are *written instruments using real property to secure repayment of a debt*. The process of originating, processing, underwriting, closing, and funding a mortgage occurs in the **primary mortgage market** (or simply, primary markets). This is where borrowers and mortgage loan originators come together to negotiate terms and effectuate mortgage transactions. The functions of the primary mortgage market include the following:

- **Origination** is the process of *making or initiating a new loan*. Almost all primary mortgage market entities originate loans. Origination involves taking a loan application, pulling a credit report, ordering an appraisal, and assembling all other forms and documents required by the person or company underwriting the loan.
- **Underwriting** is the process of *evaluating and deciding whether to make a new loan.* This is most often done by the funding source. Underwriting involves evaluating credit scores, credit history, appraisals, job history, assets, and other measures of strength or weakness in the borrower and collateral. Aspects of underwriting may be automated, though final decisions are usually made by skilled human underwriters.
- **Servicing** is the *continued maintenance of a loan* after it has been made. This can be done by any entity, with some companies set up solely to perform this function. Servicing involves maintaining direct contact with borrowers, sending mortgage statements, collecting payments, and pursuing late payments. Often primary lenders sell mortgages to the secondary market, but still service them for a fee.

The primary market is comprised of various lending institutions.

Commercial Banks

Commercial banks are *financial institutions that provide a variety of financial services, including loans*. Although banks remain the largest source of investment funds in the country today, until recently, their activities were focused on relatively short-term commercial and consumer loans. Residential mortgages were not a significant part of their business, primarily due to government regulations that limited the amount of long-term investments they could make. These limitations were imposed on commercial banks because the vast majority of the deposits they hold are **demand deposits**—money that a customer may withdraw from the bank at any time. Demand deposits that are immediately accessible—such as consumer checking accounts—are considered less reliable for reinvesting in long-term real estate loans than other types of bank deposits, such as savings accounts or certificates of deposit (CDs), which customers are expected or required to leave in the bank for longer periods of time.

Recently, commercial banks have increased their participation in home mortgage lending for several reasons:

- Banks want to take advantage of existing customer relationships built through checking accounts and other traditional services.
- Banks anticipate that mortgage borrowers will become bank customers for other services.
- Changes in state and federal banking regulations require banks to hold different percentages of funds on reserve for different types of loans, based on the perceived risk of those loans. First lien home mortgages with loan-to-value less than 80% are in the lowest risk category. Thus, banks need to maintain fewer funds on reserve to cover losses for home mortgage loans than for other types of loans, leaving more funds available for other loans or investments.

Savings and Loan Associations

Savings and loan associations (S & Ls) —sometimes called **thrifts**—are *financial institutions that specialize in taking savings deposits and making mortgage loans.* Traditionally, S & Ls were the major real estate lending institutions, able to dominate local mortgage markets—even though commercial banks had more assets to invest—mainly because deposits placed with S & Ls were savings deposits less frequently subject to immediate withdrawal than demand deposits (checking) held by banks.

When interest rates surged in the late 1970s and early 1980s, S & Ls, which are limited by law as to how much interest they could pay on savings deposits, were unable to offer attractive returns to depositors. This resulted in widespread **disintermediation**, which is the *loss of deposits to competing investments (e.g., money market funds and government bonds) that offered much higher returns.*

Worse, S & Ls were saddled with long-term, non-liquid mortgages at low interest rates (by 1980s standards) that they were unable to sell to the secondary market since, at that time, S & Ls were not using the uniform qualifying standards set by major secondary market investors.

Management mistakes, risky investments, economic slumps—and sometimes fraud—resulted in a dramatic increase in the failure rate of S & Ls, which cost the federal government and taxpayers billions of dollars, leading to a massive restructuring of the industry. Despite this crisis, S & Ls continue to participate as home mortgage lenders, and now follow secondary market qualifying standards. While perhaps a smaller player in the mortgage industry than in the past, S & Ls are required to keep 65% of their assets in mortgage-related activities or change their federal charter to a state charter.

Mortgage Banker

Mortgage banking companies, or mortgage bankers, are institutions that *specialize in making only mortgage loans to consumers.* Unlike banks and other financial institutions, they do not take deposits from customers. Technically, a **mortgage banker** can be a *company, individual, or institution that originates, processes, underwrites, closes/funds, and services mortgage loans.* While mortgage bankers close loans in their own name, they may fund loans with the company's own capital or through a **warehouse line of credit** until it is sold in the secondary market, often immediately. Even if loans are sold on the secondary market, mortgage bankers may continue to act as agents and service the loans for a fee. Alternatively, they can sell the servicing rights.

Other Primary Residential Mortgage Lenders

The following are among the other types of financial institutions that make originate, process, underwrite, close/fund loans for residential first or second mortgages:

Credit Unions. *Cooperative financial institutions owned and controlled by their members in order to pool their deposits, receive better interest rates, and loan money to fellow members*. Traditionally, credit unions only made home improvement loans and other types of consumer loans. More recently, some credit unions have begun making mortgage loans, both second mortgages, such as home equity loans, and even first mortgages since credit unions can sell qualifying, standardized loans to the secondary market.

Finance Companies. *Organizations that specialize in making higher-risk loans at higher interest rates.* Finance companies are sources of second mortgages and home equity loans made directly to borrowers. Although banks and other lenders also make these types of loans, finance companies are often in a position to loan higher percentages of the borrower's equity and work with borrowers who have blemished credit, pricing loans accordingly.

Mutual Savings Banks. *State-chartered banks that are owned by depositors and operate for their benefit.* They are conservative by nature, and often hold a large portion of their assets in home mortgages. Their activities are usually oriented toward the communities they serve to maintain close supervision of their loans, but modern economic realities have forced mutual savings banks to increase their pool of funds and diversify their mortgage holdings via the secondary market. While they are found mostly in the northeastern United States, there are a number of savings institutions in other areas that continue to operate as mutuals. Like S & Ls, mutual savings banks are known as **thrifts**.

Mortgage Brokers. *Company or individual who, for a fee, negotiates, processes, or places loans with lenders, but who does not service such loans.* Nor do mortgage brokers underwrite or fund their loans, but, rather, act as a conduit in residential mortgages. It's the mortgage broker's job to help the borrower get the best loan rates and terms available. Mortgage brokers generally assist a buyer with:

- **Pre-qualifying**, which is the process of *pre-determining how much a potential homebuyer might be eligible to borrow*. An agent or a mortgage broker can pre-qualify a buyer; however, it does not guarantee approval nor is it binding on any lender.
- Helping the borrower gather the necessary documentation to assist the lender with **pre-approval**, the process by which *a lender determines if, and for what amount, potential borrowers can be financed.* The lender gives the buyer the pre-approval information in writing, which is sometimes referred to as a certificate or letter of pre-approval.
- Submitting loan applications to lenders.

- Explaining the terms of various loan options, such as interest rates, discount points, origination fees, etc.
- Negotiating a **rate lock**, which is when *the agreed-upon interest rate and points are frozen until the loan closes*.
- Securing a **mortgage commitment** from a lender, which is *a written letter that confirms the lender's willingness to loan the money*.
- Scheduling the closing of a loan.

A mortgage broker and a buyer/borrower enter into an agency relationship through a **fee agreement**, *the contract that determines the role the mortgage broker will play and the fee that the buyer will pay*. Mortgage brokers can also be compensated by the lender.

Mortgage Loan Originators

The **Housing and Economic Recovery Act of 2008 (HERA)** is a major housing law designed to assist with the recovery and the revitalization of America's residential housing market **(**Pub.L. 110-289). HERA has multiple purposes: The modernization of the Federal Housing Administration, foreclosure prevention, and the enhancement of consumer protections. **Title V**, the **Secure and Fair Enforcement for Mortgage Licensing Act** or **SAFE Act**, is a key component of HERA. It is designed to enhance consumer protection and reduce fraud by requiring national minimum standards for **mortgage loan originators**. A mortgage loan originator is a ***person who solicits, negotiates, explains, or finalizes the terms of a mortgage loan for residential real estate***. MLOs must be employed by or affiliated with a licensed mortgage banker or a registered mortgage broker.

The SAFE Act requires all states to implement a mortgage loan originator (MLO) licensing process that meets certain standards through the **Nationwide Mortgage Licensing System & Registry (NMLS).** In order to be licensed as a mortgage loan originator, an individual must complete at least 20 hours of NMLS-approved prelicensing education, pass a national exam, and complete required continuing education annually. Each state may impose additional education and exam requirements.

Secondary Mortgage Markets

Originally, banks and other lenders made home mortgage loans to borrowers from deposits they collected directly from other customers. As more people saved more money, the lender could make more loans. But if depositors were not saving money, funds for mortgage loans were not available. This, along with a desire to maximize returns on investment dollars and shift credit risk, led to the creation of the **secondary mortgage markets** (or simply, secondary markets). Secondary markets are generally defined as *private investors or government agencies that buy and sell real estate mortgages.*

The first secondary mortgage markets were established by the federal government in an attempt to moderate local real estate cycles:

- When the secondary market players buy mortgages from local banks, those local banks then have more money to lend again to other potential homeowners in their area.
- When local banks invest surplus funds in real estate investments from other regions of the country, the effects of local real estate cycles can be moderated as the banks also have stable investments from other areas that may be going through different phases of the real estate cycle.

An important by-product of secondary mortgage markets is the **standardization** of loan criteria. Any changes implemented by secondary mortgage markets become requirements around the country for those wanting to sell mortgages in the secondary market.

Secondary Market Participants

While secondary markets may be made up of private investors such as brokers, high-risk investors, insurance companies, or pension plans, this discussion will focus on three organizations responsible for the vast majority of the secondary mortgage market activity:

- Federal National Mortgage Association (FNMA or Fannie Mae)
- Government National Mortgage Association (GNMA or Ginnie Mae)
- Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)

Fannie Mae and Freddie Mac, both government-sponsored enterprises, securitize and keep loans and mortgage-backed securities in their portfolios. They both have substantially similar charters and regulatory structures and are both under the conservatorship of the Federal Housing Finance Agency. Ginnie Mae, on the other hand, is a wholly-owned government corporation, not a GSE. Also, unlike Freddie Mac and Fannie Mae, Ginnie Mae does not purchase mortgages from lenders, nor does it buy, sell, or issue securities.

Federal National Mortgage Association

The **Federal National Mortgage Association** is the nation's largest investor in residential mortgages. Fannie Mae was originally chartered as a GSE by Congress in 1938 to provide liquidity and stability to the U.S. housing and mortgage markets, primarily as a place for lenders to sell their FHA-insured loans.

Fannie Mae funds its operation by **securitization**—the *act of pooling mortgages, then selling them as mortgage-backed securities*. The lender, who must own a certain amount of stock in Fannie Mae, assembles a pool of loans, and then a participation interest in that pool (usually 50% to 95%) is sold to Fannie Mae. Loans sold to Fannie Mae are usually serviced by the originating lender or another mortgage servicing company, for which Fannie Mae pays a service fee. Fannie Mae pools loans that generally conform to their standards and converts them into mortgage-backed securities, which they guarantee as to timely payment of principal and interest. In this way, both the lender and Fannie Mae own an interest in the loans.

Government National Mortgage Association

The **Government National Mortgage Association** was created in 1968 as a government-owned corporation, operating under the Department of Housing and Urban Development (HUD). A primary function of Ginnie Mae is to promote investment by guaranteeing the payment of principal and interest on FHA, VA, Rural Housing Service, or HUD's Office of Public and Indian Housing federally insured or guaranteed mortgages through its mortgage-backed securities program. Ginnie Mae's mortgage-backed securities are the only ones that carry the full faith and credit guarantee of the United States government. Therefore, regardless of whether the mortgage payment is made, investors will receive payments.

Federal Home Loan Mortgage Corporation

The **Federal Home Loan Mortgage Corporation** was created in 1970 as a nonprofit, federally chartered institution controlled by the Federal Home Loan Bank System. Like Fannie Mae, Freddie Mac buys mortgages on the secondary market, pools them, and sells them as a mortgage-backed security to investors on the open market. Also like Fannie Mae, Freddie Mac is currently under the conservatorship of the Federal Housing Finance Agency.

Freddie Mac actively sells the mortgage loans from its portfolio to investors throughout the world by issuing its own mortgage-backed securities, thus acting as a conduit for mortgage investments. The funds generated by the sale of the mortgages are then used to purchase more mortgages. While its MSBs are not backed by the full faith and credit of the federal government, Freddie Mac, like Fannie Mae, has special authority to borrow from the U.S. Treasury in order to continuing operating in the secondary market.

Secondary Market Standards

An important reason why the secondary market is able to function as it does is that standardized underwriting criteria are used to qualify borrowers and property. Once lenders realized the advantages of selling their home mortgages in the secondary market, they were quick to conform to the underwriting guidelines—such as loan-to-value and income expense ratios—established by Fannie Mae and Freddie Mac, along with other secondary market agencies.

Furthermore, both Fannie Mae and Freddie Mac rely on automated underwriting systems (AUS) that they have developed to further streamline and standardize the underwriting process. Fannie Mae uses Desktop Underwriter® (DU®) and Freddie Mac uses Loan Prospector® (LP®).

While the agencies may relax or tighten their standards in response to current economic or market factors, this standardization of loan qualifications and other lending procedures helped reduce or eliminate much of the variation in loan quality, types of loan programs offered, and aspects of home loans that were made in different parts of the country. These underwriting standards also create some degree of confidence in purchasers of the mortgage-backed securities. The purchasers know that the mortgages backing the securities must be of a minimum quality, lessening their risk in investing in properties they can't view or assess.

Present Day Mortgage Lending

The creation of Fannie Mae was really the birth of the mortgage industry that we have today. Over the years, changes in the industry, along with rising interest rates and a desire to shift credit risk, caused lenders to place even greater emphasis on the ability to sell their loans. As more and more options became available, the secondary mortgage market, led by Fannie Mae, grew in importance as a source of funds for lenders and a means of readily available capital for potential homeowners at attractive interest rates. In order to make more and more residential loans, lenders created many new loan programs, some of which had relaxed qualifying standards, such as:

- Requiring little or no income or asset documentation.
- Not considering a borrower's impaired credit or ability to repay the loan.
- Waiving the need for an appraisal to verify value of the property being financed.
- Requiring minimum or no down payment.
- Allowing borrowers to avoid mortgage insurance with a first and second mortgage combined for up to 100% of the value of the property.
- Adjustable rate mortgages (ARMs) that allowed for frequent rate adjustments.

Seeds of the Mortgage Crisis

However, the demand for safe, mortgage-backed securities is considered one of the factors that led to the mortgage crisis that has caused such upheaval in the global financial world. These risky loan programs may have been offered to "subprime" borrowers, those who may have poor credit history, higher debt, lower income, previous bankruptcy, short employment history, and other less than ideal characteristics. While most of these loan programs are no longer offered today, such loans frequently resulted in a high rate of delinquency and foreclosure. When mortgaged-backed securities declined in value, investors quit purchasing them, tightening credit around the world. The impact of such a credit crunch on the current market is significant. For example:

- Available financing for jumbo loans is limited.
- Most high-risk loan programs are no longer available.
- Risk-based pricing continues to be a factor.
- Underwriting guidelines are tightened up.
- Mortgage insurance availability may be restricted.

Wall Street Reform and Consumer Protection Act

The industry continues to evolve. The comprehensive **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010**, which was signed into law in July, 2010, has had significant impact on nearly every aspect of mortgage lending. Two titles in particular have changed the landscape of the mortgage industry forever:

- The **Consumer Financial Protection Act** created the **Consumer Financial Protection Bureau** whose task is to enforce consumer financial protection laws. While the Bureau is within the Federal Reserve, it is intended to function independently.
- The **Mortgage Reform and Anti-Predatory Lending Act** takes several steps to address what Congress considers to be abusive or predatory lending practices in the mortgage industry. For example, the Act requires mortgage lenders to determine—based on "verified and documented information"—that the borrower has a "reasonable ability to repay" the loan. The law requires creditors to document the factors contributing to that determination, including the borrower's credit history, income, debt obligations, debt-to-income ratio, employment status, etc. Violation of this section could be raised as a defense against foreclosure by a borrower under certain circumstances.

Key Federal Laws

While it's not critical that real estate brokers know all the ins and outs of the many federal mortgage-related laws that are in place to protect consumers, some familiarity with the principal laws is helpful.

Truth in Lending Act (TILA)

The **Truth in Lending Act** (TILA) was enacted as Title I of the Consumer Credit Protection Act in 1968 and implemented by **Regulation Z.** TILA applies to all real estate loans made to consumers (not companies) primarily for personal, family, or household purposes (not for business or commercial purposes) if the loan is subject to a finance charge or payable by written agreement in more than four installments.

The TRID Rule

In 2013, the Consumer Financial Protection Bureau (CFPB) issued a final rule to integrate disclosures and regulations required by the Real Estate Settlement Procedures Act and the Truth in Lending Act. The purpose of the final rule, called **TILA-RESPA Integrated Disclosure (TRID)**, is to improve consumer understanding of the mortgage process, aid in comparison shopping, and help to prevent surprises at the closing table.

The TRID rule mandates that lenders provide consumers with a **Loan Estimate** disclosure no later than **three business days** after the lender receives the borrower's completed application. The TRID Loan Estimate replaces the initial Truth in Lending Statement, required by the Truth in Lending Act, and the Good Faith Estimate, required by RESPA, that were standard in the mortgage industry for decades.

WAITING PERIODS There is a mandatory **seven-day waiting period** from the time the MLO delivers the required Loan Estimate to a borrower before a home loan can close. Once a Closing Disclosure has been delivered to the borrower, if the initial APR or other specific terms change by a statutory amount, an updated Closing Disclosure will be required, after which the borrower is given another **three business-day period** to review the disclosures before the loan can close. A borrower may be able to waive the waiting periods and expedite the closing if there's a **bona fide personal financial emergency**, such as to avoid foreclosure.

Annual Percentage Rate

The main disclosure on the Loan Estimate is the **annual percentage rate** (APR). APR:

- Reflects the true cost of borrowing money.
- Is a combination of the interest rate and all other charges for obtaining the loan calculated on an annual basis.
- Is referred to as the **effective rate** of interest versus the **nominal rate** of interest. The nominal rate of interest is the interest rate stated on the promissory note.

Knowing the APR enables a borrower to more easily compare the total cost of the loan from among different prospective lenders rather than considering the nominal interest rate alone, which may be misleading or confusing to the borrower.

Fair Credit Reporting Act (FCRA)

Passed in 1970 and implemented as **Regulation V**, the **Fair Credit Reporting Act** (FCRA) deals with the granting of credit, access to credit information, the rights of debtors, and the responsibilities of creditors. FCRA gives consumers access to the same information about themselves that lenders use when making credit decisions and allows consumers to seek damages for violations of their rights.

Under the FCRA, consumers are entitled one free disclosure every 12 months upon request from each of the three nationwide credit bureaus as well as a free copy under these circumstances:

- Information in a credit report resulted in adverse action.
- The consumer was a victim of identify theft and a fraud alert was inserted in credit file.
- The credit file contains inaccurate information as a result of fraud.
- The consumer is on public assistance or is unemployed.

Consumers also have the right to ask for a **credit score** from any consumer reporting agencies that create or distribute scores used in residential real property loans, though not for free. However, Title X-Consumer Financial Protection Act of 2010 (§ 1100F) amends the Fair Credit Reporting Act to require a creditor to provide a consumer with a written or electronic disclosure of the numeric credit score used in taking any adverse action, including a risk-based pricing notice.

Equal Credit Opportunity Act (ECOA)

Implemented as **Regulation B**, the ECOA was enacted in 1974 and applies to any creditor who regularly extends credit, including banks, small loan and finance companies, retail and department stores, credit card companies, credit unions, as well as mortgage brokers and real estate brokers who arrange financing. It prohibits discrimination in granting credit to **individuals** and **businesses** based on sex, age, marital status, race, color, religion, national origin, receipt of public assistance, or the exercise of rights under the Consumer Credit Protection Act. The ECOA gives consumers the right to receive a copy of any **appraisal report** on the property that was used in the decision-making process. It also requires creditors to notify applicants of their lending decision—whether credit was extended or rejected—**within 30 days** of the filing of a complete application.

Illinois Fairness in Lending Act

815 ILCS 120/3

The **Illinois Fairness in Lending Act** states that no financial institution, in connection with or in contemplation of any loan to any person, may:

- Deny or vary the terms of a loan on the basis that a specific parcel of real estate offered as security is located in a specific geographical area (a practice known as redlining).
- Deny or vary the terms of a loan without having considered all of the regular and dependable income of each person who would be liable for repayment of the loan.
- Deny or vary the terms of a loan on the sole basis of the childbearing capacity of an applicant or an applicant's spouse.
- Deny or vary the terms of a loan on the basis of the borrower's race, gender, disability, or national origin.
- Utilize lending standards that have no economic basis and which are discriminatory in effect.
- Engage in equity stripping or loan flipping.

Real Estate Settlement Procedures Act (RESPA)

RESPA, implemented as **Regulation X,** was passed in 1974 with the intention of helping consumers become better shoppers for settlement services and to eliminate unnecessary increases in the costs of certain settlement services due to kickbacks and referral fees. It covers most loans secured with a mortgage placed on a **one- to four-family residential** property, but does not apply to an all-cash sale, a sale where the individual home seller takes back the mortgage, a rental property transaction, temporary construction loans, other business purpose transaction, property of 25 acres or more, or vacant or unimproved property unless a dwelling will be constructed or moved onto the property within two years.

RESPA requires lenders to provide consumers with certain disclosures in the Loan Estimate as well. The Loan Estimate must indicate the dollar amount of settlement charges the borrower is likely to pay, with mandated tolerances on how much the charges on the Loan Estimate can deviate from the actual settlement charge. RESPA also requires settlement agents to itemize all charges imposed on the buyer and seller—and the person to whom fees are paid—on the standardized **Closing Disclosure** settlement statement, mandated by the TRID Rule.

You will find more detail on RESPA in other chapters of this textbook as appropriate.

Mortgage Fraud

Fraud is *intentional or negligent misrepresentation or concealment of material facts.* Failing to disclose information you're required to disclose can be a form of fraud. Fraud also includes actively concealing information and making false or misleading statements. Mortgage fraud involves any misrepresentation or concealment used in an attempt to obtain a mortgage loan. It can generally be divided into two main categories: Fraud for **profit**, which is usually perpetrated by industry insiders, and fraud for **property**, which is usually perpetrated by borrowers. This is a serious federal crime when done for any federally related loan (which includes most loans, since HUD, Fannie Mae, or a federally chartered bank are involved at some point in the process). In the mortgage industry, the three primary ways in which fraud is committed are:

- **Material misrepresentations**, such as altered paycheck stubs and tax returns.
- **Material misstatements**, such as the intent to occupy a home as a primary residence when it really is intended to be used as a rental.
- **Omission**, such as failing to mention the borrower is taking an early retirement in six weeks.

Fraud Participants

Since many people are involved in the process of making loans for property, the opportunity for fraud exists on several levels. A fraud scheme could be simply the initiative of a desperate borrower, or it could involve the participation of multiple industry insiders, such as an appraiser who provides an inflated property value or by a mortgage broker who ignores derogatory information to get a loan approved. This also includes not reporting all items on the closing statement accurately, creating phantom documents for verification, or concealing the true nature of a borrower's down payment.

Borrowers

Borrowers who knowingly supply false documents, such as verifications of employment (VOEs) or forged W-2s, or false information on the loan application, commit mortgage fraud, whether or not they're working in partnership with anyone else. Borrowers who commit fraud typically do so in order to obtain ownership of property. The borrower usually plans to make regular payments and has no plans to default. The purpose of the fraud is to make the mortgage loan happen at desirable terms for the borrower, not to enter into foreclosure or flip a property for profit.

A borrower might also act as a **straw buyer**, which is *someone who allows his name and personal details to be used to obtain a mortgage loan for a property he has no intention of inhabiting*. Sometimes straw buyers are paid for their participation in the scheme, and sometimes a straw buyer has no idea that his personal information was used.

Borrowers can also get involved in **credit enhancement** schemes. In an effort to show the necessary assets or credit to qualify for a loan, borrowers may look for fraudulent ways to enhance their financial situation. For example, they may add their names to the bank accounts of friends or family to show that they have sufficient assets on deposit. Another scheme is where friends, family—or even builders or loan originators—temporarily park assets into a borrower's account until the underwriter qualifies the borrower and the loan closes. This type of fraud can be very sophisticated, even to the point of borrowers "buying" seasoned credit account lines and creating fraudulent retailer relationships in an effort to improve the borrower's credit history and credit scores.

As home values continue to fall, many homeowners find themselves underwater with their mortgage—owing more than the property is worth. This has led to record foreclosures, of course, as well as homeowners with little or no equity in the property just walking away from the house and the loan. The current mortgage market has led to some "creative" schemes by borrowers to get out from under an unsustainable mortgage payment:

- **Buy and Bail.** Homeowners apply for a mortgage to purchase a similar home that, because of the market, sells for less money. The homeowner may claim that they are renting out the original property, perhaps engaging a family member or friend to claim to be the renter and even supplying a fake lease. Then after getting the new property, the borrower simply walks away from the first home and bails on that mortgage.
- **Short Sale Fraud.** A borrower who is facing default may offer to short sell the property so that the lender will not have to foreclose. If the lender agrees, a short sale will bring in less than the balance owed, but the lender would be able to sell more quickly and get the property off its books. Some lenders even agree to forgive any deficiency between the sale and the balance owed. A short sale is not necessarily fraudulent. However, if a borrower intentionally stopped making mortgage payments to force default, then enlists the assistance of someone else—a straw buyer—to purchase the property at a reduced price, fraud has most likely occurred.
- **Arson.** In order to avoid foreclosure, some homeowners may actually resort to the crime of arson in order to file fraudulent insurance claims.

Lenders and Mortgage Brokers

Lenders and mortgage brokers commit mortgage fraud by falsifying loan documents, making loans to straw buyers, illegally flipping properties, and through other schemes. Lenders benefit by making loans that should probably never have been made and selling them to the secondary market as quickly as possible. Mortgage brokers benefit by collecting fees and yield spread premiums for putting together fraudulent mortgage packages. Dishonest lenders and mortgage brokers see the opportunity to make a loan resulting in a commission with high profitability. Often, these loans are knowingly made to unqualified buyers, or even straw buyers who will never make a payment on the loan, resulting in foreclosure.

Appraisers

Appraisals are a critical aspect of mortgage lending. An appraisal with inaccurate information—whether completed because of fraud or negligence—can have a serious impact. An **inflated appraisal** scheme occurs when a property is intentionally appraised with a higher-than-market value by an appraiser acting in collusion with a real estate agent, mortgage broker, or lender. Lenders hiring these appraisers use only those who agree to "hit the number," "push the value," or "work with us on the number" regardless of its relationship to actual market value. If the mortgages are part of sales transactions, continued inflation of values in the same neighborhood (with inflated sale prices) can result in continued appraisals at higher-than-market values that appear justified. Even unsuspecting appraisers are caught in this when they unknowingly use the inflated sale prices as comparables.

While inflated appraisals may be the more common type of appraisal fraud, deliberately **understating** the value of a property is also fraud. An appraiser may do this, for example, to allow someone to purchase a foreclosed home or short sale at a lower price. Understated appraisals may also be used to get more favorable terms from a lender with a loan modification.

Rules on Valuation Independence

The issue of inflated appraisals is addressed by an interim final rule on **Valuation Independence** amending the Truth in Lending Act's Regulation Z (12 C.F.R. § 226.42). The rule, which applies to any consumer credit transaction secured by a consumer's primary dwelling, requires creditors and their agents to provide customary and reasonable compensation to fee appraisers. It prohibits **coercion** in connection with a covered transaction in any way (including extortion, inducement, bribery, intimidation of, compensation of, or instruction to) of a person who prepares valuations or performs valuation management functions. The rule also prohibits an appraiser from **materially misrepresenting** the value of the consumer's principal dwelling and prohibits someone performing a valuation from having a direct or indirect **conflict of interest**, financial or otherwise, in the property. The rule prohibits creditors from extending credit based on appraisals if they know beforehand of violations involving appraiser coercion or conflicts of interest unless the creditor documents that it has acted with reasonable diligence to determine that the valuation does not materially misstate or misrepresent the value of the consumer's principal dwelling. The rule also mandates that creditors or settlement service providers who have information about appraiser misconduct file a report with the appropriate state licensing authorities.

Other Industry Insiders

- **Attorneys** may prepare bogus deeds and get them duly recorded on public records with the participation of government workers.
- **Accountants** may falsify tax returns, profit and loss statements, and other documentation required by lenders to qualify loans.
- **Title companies** may charge borrowers fees for services never provided at the closing or may complete incorrect title reports that omit valid liens or that create false chains of title.
- **Government workers** may falsify deeds and other records.
- **Real estate licensees** may assist in the preparation of false documentation, such as sales contracts or property inspections, and even finding straw buyers for the property. Real estate licensees may collude in flipping schemes by finding borrowers for scams and by raising listing prices of homes after a deal is put together to make the over-inflated appraisal value appear valid. Unscrupulous real estate licensees may also steer borrowers to a specific lender in exchange for a kickback or other consideration.
- **Rehabbers** and **FSBO (For Sale By Owner) flippers** may use sub-par material, removing materials or fixtures after an appraisal, providing straw buyers, and improperly influencing appraisers, loan officers, and title companies.

Flipping

One of the most common and well-known mortgage fraud schemes is **property flipping.** Many people are confused by the term "flipping," as it has long been understood to mean that an investor has remodeled a property and quickly sold it for a profit. If the investor bought the property below market, and remodeling has brought it up to true market value, this is the good side of flipping, and is completely legal. It also serves the public well, as it increases property values, improves neighborhoods, and provides housing that otherwise might not be available.

Illegal flipping is something else entirely. Illegal property flipping generally requires collusion between the seller, buyer, appraiser, and lender/broker. An illegal property flipping scheme occurs when a property is purchased at a low price, appraised at an inflated value without any valid reason for the increase, and then resold at a much higher price. It may involve a series of sales and quick re-sales, with one property and a group of sellers and buyers changing ownership among them.

The home in a flipping scheme is typically resold at a new, higher price fairly soon after its initial purchase at the lower price. Statistics show that the criminals involved in these schemes do not wait long time periods, often only weeks, or perhaps a few months at most.

Attributes of Flipping Schemes

Typically, flipping schemes are more prevalent in mixed value areas where higher-priced homes are located near lower-priced homes in poor repair, and home values fluctuate extremely. These neighborhoods often include rental properties and tend to have a higher rate of crime, which can hinder property values.

The distressed nature of the properties can include broken pipes, no electrical wiring, or other items in poor condition. Homes involved in flipping schemes are often purchased at low prices because they are in poor condition. If repairs are made after the purchase, they are generally cosmetic or exterior-only repairs.

Another common attribute of illegal flipping is that perpetrators rarely use local entities to handle the loan. If local lenders are not used for the mortgage loan, underwriters who review the loans are not based locally and are unfamiliar with the property and neighborhood.

Red Flags of Mortgage Fraud

A red flag is a situation that requires additional scrutiny. According to the **Federal Financial Institutions Examination Council** (FFIEC), one red flag by itself may not be significant; however, multiple red flags may indicate an operating environment that is conducive to fraud. The following are some red flags that could signal mortgage fraud:

- **Steering Buyers to a Specific Lender.** Buyers may choose any lender they want for a purchase transaction. However, it is not unusual for real estate agents to recommend the use of a certain lending institution. Lenders often solicit loans through these real estate agents by forming alliances with them. If a transaction will close only if a certain lender is used, ask questions because it is unlikely that only one lender would offer a buyer certain favorable terms. Unfortunately, in many mortgage fraud scams, the buyer is unsophisticated in seeking financing, and may have credit issues that make lending more challenging. The buyer may be told this is the only chance for a home purchase when, in fact, it is a scam.
- **Stated Income.** Since the inception of no-doc or low-doc loans, the documentation required for the loan may be limited. These loans allow the borrower to indicate, without verification, employment history, income, and debt. Be suspicious if a borrower only had to produce minimal documentation to qualify for the loan.
- **No Money Due at Closing.** If a buyer is not required to pay anything at closing, questions should be asked. What this means is the buyer has been able to get around down payment requirements, and the seller is paying all the points and closing costs involved with the buyer's loan. In theory, the sales price may have been inflated to cover these costs. Even with less stringent lending guidelines and requirements, it is unusual for a buyer to need no money for a closing.
- **Sale Subject to the Seller Acquiring Title.** A huge red flag in a transaction is when the seller on the purchase contract is not the owner of record. There could be legitimate reasons for this, like the seller could be the buyer of the property via land contract or the seller could have recently purchased the property at a sheriff's sale and will not gain title until confirmation of the sale. Participants in the sale should ask why the seller is not the owner of record and verify that the reason is legitimate.
- **Difference in Sale Price.** The sales contract is supposed to guide the title agency or closing agent to the terms of the settlement statement, and there should be no discrepancies. Buyers have the right to review their closing statements one business day before closing. They should compare this document to the purchase contract and to the Loan Estimate received from the lender.
- **Sale Price Changes to Fit Appraisal.** To carry out this scheme, an appraisal is ordered and completed. The appraiser is then contacted regarding alterations or addendums to the purchase contract, typically made after the lender is told the appraised amount. The new, altered contract now matches the appraisal value. These schemes enable the lender to profit more from the transaction, because more money was available through a higher-than-expected appraisal.
- **Related Parties Involved.** Certainly, there is no law against a mother selling her property to her son or daughter, even at a discounted price. However, mortgage fraud scams often involve family members. So, when the transaction is not an arm's length transaction, full disclosure is imperative. Cases of mortgage fraud involving entire families have been reported. Many times, the straw buyer in a scam is a family member. Purchase contracts between family members should specifically state their relationships so it does not appear intentionally hidden.

- **Funds Paid to Undisclosed Third Parties.** In certain mortgage fraud schemes, unknown third parties who appear to have no relevance to the transaction are paid out of the funds received at the closing. The implication, of course, is there may be debt not revealed in the closing statements. Once again, a closing statement that is not followed to the letter is a red flag to the borrower. It may be prudent to have legal representation to review all the closing paperwork before signing any of the documents.
- **Cash Paid to Seller Outside of Escrow.** The seller receives cash from the sale of the property; however, it is not stated in closing statements or in the purchase contract. The motive, of course, is unstated profits. No paper trail exists to show the payment.
- **Cash Paid to Borrower.** The borrower receives cash when purchasing the property. Usually, in these cases, the borrower does not have a down payment and the purchase contract calls for the seller to pay all loan costs. Although seller-paid costs are becoming more typical in today's economy, schemes in which the borrower receives money from the transaction are not.

Predatory Lending

Along with the advantages of subprime lending, which extends credit to people who might not otherwise qualify for a home mortgage, come some of the inevitable negative by-products—lenders taking advantage of borrowers. **Predatory lending** involves loans that *take advantage of ill-informed consumers through excessively high fees, misrepresented loan terms, frequent refinancing that does not benefit the borrower, and other prohibited acts.* Predatory lending targets borrowers with little knowledge of, or defense against, these practices.

New regulations require that complete and clear disclosures be made to borrowers and specifically prohibits certain practices, including:

- Packing a loan with credit insurance and other extra fees.
- Extending credit to people with little or no income and who have little chance of repaying the loan (the lender forecloses on the property and keeps the excess equity to cover costs).
- Refinancing the lender's own high-cost loan with another fee-rich loan in less than a year's time (unless a lender can show that the new loan benefits the borrower).

The motive for predatory lending is profit. The goal of a predatory lender is to take the property or strip its equity, or to profit from the exorbitant fees charged. Undoubtedly, the lender claims to help borrowers achieve the dream of homeownership. Predatory loans are approved without regard for the borrower's ability to repay. Interest rates are higher than the level of risk justifies. And, lenders may bundle unrelated products—such as a life insurance policy—into the mortgage loan to further their profit.

Subprime Lenders and Predatory Lending

Legitimate subprime lenders offer loans to low-income and risky borrowers, and must charge higher interest rates to accommodate the risk. The higher-than-typical closing and processing fees allow them to take on that risk. Without these lenders, riskier borrowers could not tap into their home equity or even own a home. Subprime lenders may be mainstream lenders who also offer conventional loans to borrowers or mortgage brokers specializing in working with the "credit impaired." These lenders usually do not make government-backed loans and, therefore, often operate outside of federal regulations.

While many instances of predatory lending involve subprime loans, it's certainly not reasonable to say that all subprime lenders are predatory lenders. Still, it may be difficult for potential borrowers to discern who is legitimate and who is not.

Excessive Fees

Predatory lending costs the borrower in many ways. Although it is understandable a higher-risk borrower would pay higher interest rates than someone with good credit, it still forces borrowers to pay more than they would for a typical transaction. If the terms are difficult to understand, the borrower may be paying exorbitant loan origination, settlement, and servicing fees.

Total fees greater than 4-5% of the loan amount are usually too much, which should be a red flag to look for **junk fees**—multiple fees under a variety of names alleging services done on the borrower's behalf. Some scams have involved fees of 10-20% or more of the loan amount.

Exorbitant **prepayment penalties** may lock borrowers into abusive loans that cannot be easily refinanced when credit scores improve. Prepayment penalties may be tens of thousands of dollars and be enforced for many years into the loan. The reason? To discourage payoff of the highly profitable loan. In reality, the majority of lenders do not charge prepayment penalties or, if they do, only in the first years of the loan.

Documentation

For many borrowers, but particularly those not well informed, loan documents may be difficult to understand. Legal jargon, small print, and page after page of confusing documentation may be presented for immediate signature. Often, the pressure is on finishing the closing with no time allowed to read the documents carefully. What is the solution for the borrower? Have an attorney review all documents before signing, or get a credit counselor or other expert to review them.

Equity Skimming

Equity skimming involves lenders making various types of loans knowing the borrowers will not be able to make the monthly payments and thus setting them up for foreclosure. The borrower loses everything—the home and the equity in it. Some common types of equity skimming schemes include:

Loans Exceeding Ability to Repay. Borrowers typically rely on a lender's advice regarding debt-to-income ratio, believing there are reasonable limits in place on what they can borrow. Equity skimming schemes may falsify loan documents so the borrower does not realize the amount being borrowed is too much, with a monthly payment amount that is too high. The lender makes the loan, knowing the borrower will not be able to make those monthly payments, setting them up for foreclosure. The borrower loses everything—the home and the equity in it.

Home Improvement Scams. In these instances, a contractor working in conjunction with a predatory lender recommends repairs to the home, driveway, basement, etc. (Work may or may not actually need to be done.) The quote for the work is typically extremely high, and the contractor indicates arrangements for financing are available. Enter the lender—offering a loan that will strip the equity out of the home, again resulting in possible foreclosure.

Loan Flipping. This involves refinancing over and over again, usually with minimal to no net tangible benefit to the borrower in terms of lowering the interest rate or saving fees. The borrower is promised benefits that never materialize. Since the lender profits every time a loan is made, there is no incentive for the lender to recommend otherwise. Often, the refinancing actually raises the interest rate to the borrower. With higher monthly payments, the borrower may wind up defaulting on the loan, undergoing foreclosure, or being forced to refinance into even more unfavorable terms. Once again, the high-risk borrower takes a hit financially—a price he can ill afford to pay!

Extreme Lending. Some borrowers fall victim to extreme lending. Borrowers with extremely high debt in relationship to income are targets. With typical lending guidelines restricting borrowers to around 30% of income toward the mortgage payment, this extreme lending—often as much as 50% of income going toward the mortgage payment or more—puts borrowers at risk. If this borrower is laid off, loses a job, or experiences unanticipated expenses due to injury or illness, the risk for foreclosure is great because of the high percentage of income going to the mortgage loan.

Foreclosure Rescue Scams

In the current housing market, the number of foreclosures is staggering. Honest homeowners are desperate to save their homes, and unscrupulous schemers are eager to take advantage of their vulnerability. The Federal Trade Commission warns borrowers about certain schemes, including:

Phony Counseling or Phantom Help. A scam artist tells homeowners that he can negotiate a deal with their lender to save their homes for an upfront fee. Homeowners may be told not to contact their lenders, lawyers, or credit counselors, and to let the scam artist handle all the details. Once they pay the fee, the scam artist takes off with their money. Sometimes, the scam artist insists that homeowners make all mortgage payments directly to him while he negotiates with the lender. In this instance, the scammer may collect a few months of payments before disappearing.

Rent-to-Buy Scheme. A homeowner is told to surrender the title as part of a deal that allows him to remain in the home as a renter with the intention of buying it back during the next few years. The schemer may tell the homeowner that surrendering the title will permit a different borrower with a better credit rating to secure new financing and prevent the loss of the home. But the terms of these deals usually are so burdensome that buying back the home becomes impossible. The homeowner loses the home, and the scam artist walks off with all or most of the home's equity. Worse yet, when the new borrower defaults on the loan, the original homeowner is evicted. In a variation, the scam artist raises the rent over time to the point that the former homeowner can't afford it. After missing several rent payments, the renter—the former homeowner—is evicted, leaving the "rescuer" free to sell the house.

Indicators of Predatory Lending

Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, designated as the **Mortgage Reform and Anti-Predatory Lending Act** of 2010, § 1403, prohibits loan originators from steering borrowers to any loan that the borrower lacks the ability to repay or that has predatory characteristics, such as equity stripping, excessive fees, or abusive terms. The following are other indicators of predatory lending:

Steering Borrowers to High-Rate Programs. Many vulnerable borrowers mistakenly believe the only way they can secure a loan is to pay an above-market interest rate.

Falsely Identifying Loans as Lines of Credit or Open Mortgages. For a home equity line of credit (HELOC), borrowers typically are charged only on the outstanding loan balance each month and can make payments at will. In this scheme, the unsuspecting borrower later discovers the loan is not a line of credit but rather a typical mortgage arrangement with an obligation to pay on the entire principal balance.

Structuring Costly Loans with Unaffordable Payments. The practice of structuring costly loans with payments the borrower cannot afford goes far beyond charging risky borrowers higher interest rates. Instead, the borrower is intentionally given a loan with increasing interest rates or other adverse arrangements, ensuring he cannot possibly pay off the loan. The home will eventually go to foreclosure, and the lender will buy it back for resale, probably at a profit**Falsifying Loan Documents.** Unfortunately, falsifying loan documents is a common practice in predatory lending. Since the lender assumes the borrower will not agree (and rightfully so) to unfavorable terms, they are put in place anyway, without the borrower's knowledge. This is accomplished with loan documents, verification of income statements, and closing papers that are forged. The borrower later discovers she has a mortgage loan with unfavorable terms she cannot afford to repay.

Making Loans to Mentally Incapacitated Homeowners. Although unable to understand the loan process and fees involved, these people are targets for unethical lenders and may end up with high interest rates and ridiculous fees. These borrowers should have an advisor who represents their interests involved in the transaction. Such individuals may have a guardian, parent, attorney, or other responsible person supervise the loan process.

Forging Signatures on Loan Documents. Forging signatures on loan documents is closely related to falsifying loan documents. Since unethical loan officers assume borrowers will not agree to the loan terms, they simply forge signatures. Clearly illegal, and sometimes easily discovered, this scheme is committed either by loan officers, title company representatives, bank wholesale representatives, real estate brokers, processors, or any other person with the ability to profit from the loan closing.

Changing Loan Terms at Closing. Changing loan terms at closing was historically one of the most common predatory lending schemes. Borrowers discovered closing documents do not reflect the loan terms and fees originally stated in the Loan Estimate, and often feel as though they had no choice but to go through with the loan. A difference between the sale price on the settlement statement and the price on the sales contract is a red flag. Of course, it could be an honest mistake, but as the sales contract is supposed to guide the title agency or closing agent to the terms of the settlement statement, and there should be no discrepancies, otherwise an additional waiting period is imposed.

Signing Documents with Blanks. Borrowers must be cautious not to sign any documents with blanks, as they may find later the blanks are filled in with new loan terms.

Requiring Credit Insurance. In these instances, loan officers state that the loan cannot be made without an insurance policy, typically with a significant one-time fee. This insurance is said to cover the mortgage in the event of the borrower's death or disability, but may not really be a requirement of the loan. Legitimate lenders do not require credit insurance, and in fact, many states forbid it, since the loan balance would be paid off when the property was sold.

Increasing Interest Rates for Late Payments. This scam involves raising interest rates if payments are late. Chances are the borrower did not read the mortgage documents, where this penalty may have been discovered. This new, higher interest rate may mean eventual foreclosure due to the resulting higher (potentially unaffordable) payment. In some cases, interest rates will continue to rise with continued delinquency, with the cycle feeding on itself. Even if a borrower makes up delinquent payments, the new, higher interest rate means future payments may still be unaffordable.

Charging Excessive Prepayment Penalties. As noted earlier, some limited prepayment penalties are becoming common, usually only for the borrower who pays down or pays off the loan within five years. But, in this scheme, excessive prepayment fees are charged, possibly tens of thousands of dollars, in the event the loan is paid down or paid off early.

Failing to Report Good Payment History on a Borrower's Credit Report. This scheme prevents a borrower from refinancing a mortgage through another institution, as the borrower's good payment record is never conveyed to the credit bureaus. As a result, only the borrower's previous inferior credit history is on record, making it difficult for the borrower to find better loan terms.

Failing to Provide Accurate Loan Balance and Payoff Information. The lender receiving high-interest payments may fail to provide payoff information in a timely manner when the borrower or a new lender requests it. The motive is to keep receiving these higher-rate payments. Or, the lender may require a borrower to pay with money outside of the closing to pay off the debt and clear the title.

Laws Against Predatory Lending

Because the impact on consumers is so consequential, laws have been passed at the federal and state level to address predatory lending practices. These laws are intended to better inform and consumers and offer some degree of protection.

Home Ownership and Equity Protection Act (HOEPA)

To address the problem of predatory lending, the federal **Home Ownership and Equity Protection Act** (HOEPA) was passed in 1994 as an amendment to the Truth in Lending Act. Contained in **Section 32** of Regulation Z, it is intended to establish disclosure requirements and prohibit deceptive and unfair practices in lending by defining restrictions on high cost loans. When a loan meets the defined triggers necessary to be considered a high cost loan, additional disclosures are mandated, including text stating the consumer is not required to complete the credit transaction. This disclosure is intended to protect consumers from pressure tactics that imply being locked into the agreement, or that canceling is extremely complex or expensive.

Among the provisions of HOEPA is the prohibition against equity stripping, whereby a homeowner loses equity in a home due to excessive fees, and other abusive lending practices. HOEPA also imposes restrictions on balloon payments, negative amortization, acceleration clauses, prepayment penalties, and loan flipping.

A violation of HOEPA may enable a consumer to rescind the loan for up to **three years.**

Illinois High Risk Home Loan Act

815 ILCS 137/

Similar to the Home Ownership and Equity Protection Act, the **Illinois High Risk Home Loan Act** is intended to protect borrowers who enter into **high risk** home loans from abuse that can occur in the credit marketplace when creditors and brokers are not sufficiently regulated. Provisions related to high risk home loans include:

- Verification of borrower's ability to repay required
- Restriction on prepayment penalties
- Limitation on prepaid insurance products and warranties (no **packing of loans** permitted)
- Refinancing prohibited under certain conditions
- Restriction on financing of points and fees
- Restriction on payments to contractors
- Negative amortization and/or negative equity not permitted
- Limitation on late payment fees, advance payments, and payment compounding
- Loan call provision not permitted
- High cost loan disclosure required
- Counseling required prior to foreclosure proceedings
- Notification of right to cure required prior to foreclosure proceedings
- Reporting on foreclosure rates required
- Process for remedies, enforcement, and limited liabilities
- Prohibition of division into separate loans to avoid high cost loan requirements
- Process for reporting of violations

Mortgage Awareness Program

As specified in the Illinois High Risk Home Loan Act, the **Mortgage Awareness Program** is a counseling and educational component that must be provided in Illinois by the Director of Financial Institutions. To ensure consumer protection, the Mortgage Awareness Program must provide a complete and objective explanation to the prospective borrower of a high cost loan informing them about commonly misunderstood concepts that can cause concerns. The following are key terms and topics that must be included in the required instruction:

- Amount financed
- Finance charge
- Annual percentage rate (APR)
- Total payments
- Loan costs, including broker's fees, finance charges, points, and origination fees
- Right of rescission
- Foreclosure procedures
- Significant debt ratios including total debt to income, loan debt to income, and loan debt to value (LTV) of residence
- Adjustable rate mortgage
- Balloon payments
- Credit options
- Each item that appears on a Loan Estimate
- Pre-payment penalties

Summary

1. **Mortgages** are written instruments using real property to secure repayment of a debt. Their use in the home purchasing process continues to evolve. The Federal Reserve Act of 1913 created the Federal Reserve, established a federal charter for banks to make real estate loans, and set up a way to influence interest rates. The National Housing Act of 1934 created the **Federal Housing Administration** (FHA) to insure banks against losses for defaults on home loans. The **Federal National Mortgage Association** (Fannie Mae) was created in 1938 as the first secondary market to address the problem of uneven supply of money for mortgage loans.

2. The **primary market** consists of lenders making mortgage loans directly to borrowers. Primary lenders include commercial banks, savings and loans (S & Ls), savings and mutual savings banks, and mortgage companies such as mortgage bankers who may originate/fund/service loans.

3. Mortgage brokers do not make loans to lenders**.** A **mortgage broker** earns a fee to act as an intermediary to bring together borrowers and the lenders who originate the actual loans. A mortgage broker may solicit, process, place, and negotiate residential loans. Typical duties of the mortgage broker include pre-qualifying lenders, getting pre-approval, negotiating a **rate lock** in which the agreed-upon interest rate and points are frozen until the loan closes**,** and securing a **mortgage commitment** from the lender**.**

4. The **secondary market** consists of private investors and government entities that buy and sell home mortgages; created to moderate local real estate cycles, give lenders new money to lend again, and standardize loan criteria. The **Federal National Mortgage Association** (Fannie Mae) is the largest investor in residential mortgages, buying and selling **mortgage-backed securities**. The **Federal Home Loan Mortgage Corporation** (Freddie Mac) also issues mortgage-backed securities. The **Government National Mortgage Association** (Ginnie Mae) is government-owned and managed by HUD. Ginnie Mae guarantees payment of principal and interest on government insured or guaranteed loans (such as FHA and VA) for its mortgage-backed securities.

5. Federal laws affecting mortgages include the **Truth in Lending Act**, which requires the disclosure of the **annual percentage rate** (APR) in the Loan Estimate within three business days of application; the **Fair Credit Report Act**¸ which gives consumers access to information lenders use when granting credit; the **Equal Credit Opportunity Act**, which prohibits discrimination in granting credit to people based on sex, age (if at least 18), marital status, race, color, religion, national origin, receipt of public assistance, or exercised rights under the Consumer Credit Protection Act; the **Real Estate Settlement Procedures Act** (RESPA) regulates settlement and closing procedures and requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures.

6. **Fraud** is the intentional misrepresentation or concealment of a material fact. Mortgage fraud can be perpetrated by borrowers who lie on applications, by an appraiser who provides an inflated property value, or by a mortgage broker who ignores derogatory information to get a loan approved. Mortgage fraud also includes not reporting all items on the closing statement accurately, creating phantom documents for verification, or concealing the true nature of the borrower's down payment.

7. **Predatory lending** involves loans that take advantage of ill-informed consumers through excessively high fees, misrepresented loan terms, frequent refinancing that does not benefit the borrower, and other prohibited acts. Predatory lending targets borrowers with little knowledge of, or defense against, these practices. Laws such as the **Home Ownership and Equity Protection Act (HOEPA**) and the **Illinois High Risk Home Loan Act** establish disclosure requirements and prohibit equity stripping and other abusive practices.

Quiz

1. ***Which is NOT a function of the secondary markets?***
   a. moderate effects of local real estate cycles
   b. provide lenders with money to make more loans
   c. serve as a depository for consumer assets
   d. standardize underwriting guidelines

2. ***Mortgage bankers typically make loans in the***
   a. money market.
   b. primary market .
   c. secondary market.
   d. stock market.

3. ***Mortgage brokers***
   a. act as intermediaries between borrowers and lenders.
   b. originate and service mortgage loans.
   c. provide funding for mortgage loans.
   d. underwrite mortgage loans.

4. ***Which entity is responsible for setting the country's monetary policy and thereby affecting interest rates on mortgage loans?***
   a. Department of Housing and Urban Development (HUD)
   b. Department of the Treasury
   c. Federal Housing Administration (FHA)
   d. Federal Reserve

5. ***To sell loans to Fannie Mae, the primary market lender must***
   a. allow the secondary agencies to audit its books.
   b. be a federal government-affiliated lender.
   c. be willing to suffer significant discounting losses.
   d. follow the underwriting guidelines of the secondary market agencies.

6. ***Which federal law prohibits discrimination in granting mortgage loans based on a borrower's receipt of public assistance?***
   a. ECOA
   b. FCRA
   c. RESPA
   d. TILA

7. ***A lender must make a decision on a completed loan application within _____ days.***
   a. 7
   b. 10
   c. 21
   d. 30

8. ***Which federal law requires lenders to provide consumers with a "good faith" estimate of closing costs within three business days of loan application?***
   a. FCRA
   b. HOEPA
   c. RESPA
   d. TILA

9. ***Mortgage fraud can be committed by***
   a. appraisers only.
   b. borrowers only.
   c. lenders and brokers only.
   d. any party to a mortgage loan.

10. ***Which situation does NOT involve a straw buyer?***
    a. Ann revises her pay stubs so she can qualify for a loan to buy her dream house.
    b. Bob uses his twin brother's Social Security number and credit information to apply for a loan.
    c. Dave agrees to secure a loan under his name even though only his sister with bad credit will live in the house.
    d. Tina tells Rob, who is facing foreclosure, that if he deeds the property to her, she will refinance on good terms and let him stay in the house.

11. ***Predatory lending involves***
    a. forcing the borrower to refinance a loan with inferior terms.
    b. misrepresenting the loan terms by the lender.
    c. requiring excessively high fees, such as for credit life insurance.
    d. all of the above

12. ***Which situation is LEAST likely to be an example of predatory lending?***
    a. ABC Mortgage Co. offers a subprime loan to Mark, who is coming out of bankruptcy.
    b. Dave shows up at closing and finds that the lender has changed the terms of the loan.
    c. Ellie was 12 days late paying her mortgage, and the lender raised the interest rate 1/4%.
    d. Frank paid off his mortgage loan early with lottery winnings and the lender charged a $12,000 prepayment penalty.



22 The Mortgage Lending Process

This chapter walks you through the loan process and discusses the important differences between pre-qualification and pre-approval. It provides an overview of the tasks of the mortgage professional, qualifying buyers, and documenting mortgage files. Standards relating to income, credit history, and net worth are also discussed. You will also calculate housing expense ratios and total debt-to-income ratios using secondary market guidelines.

You will learn:

- The difference between pre-approval and pre-qualification.
- The steps in the loan process.
- Information necessary to complete a standard loan application.
- Criteria for evaluating borrowers, including income and debt ratio calculations.
- How credit scores impact borrowing.
- The steps in the settlement process, including reconciliation.

Key Terms

Assets
Bankruptcy
Broker Price Opinion (BPO)
Closing Disclosure
Credit History
Credit Scoring
Debt-to-Income Ratio
FICO Score
Float
Housing Expense Ratio
Liabilities
Loan Estimate
PITI
Point
Pre-Approval
Pre-Qualification
Rate Lock
Reserves
Stable Income
Usury

The Loan Process

Generally speaking, with today's federal disclosure requirements, borrowers should complete a loan application only when they are ready to buy a particular home. Even if the borrower is *not* ready to make an offer on the house, the borrower may be pre-qualified. This is ***not*** the same as pre-approving buyers. The two terms are not interchangeable, so it is important to thoroughly understand the differences between them.

Pre-Qualification

Pre-qualification is *the process of pre-determining how much a potential homebuyer* ***might*** *be eligible to borrow.* This may be done by a real estate broker or a mortgage broker; it **does not guarantee approval**. Pre-qualification of a borrower is *not* binding on the lender—which is why the distinction is important. It is a free "test run" of the loan application process that usually takes only a few hours. The lender is only saying that it looks *favorable* that the borrower will be approved. Often there's more background research, documentation, and information that the lender must obtain, but won't until the borrower has actually applied for the loan. However, if the lender renders a credit decision, the pre-qualification becomes an application and the required disclosures need to be delivered.

The pre-qualification process involves asking prospective borrowers questions about income and debts. A credit report may be pulled by a lender, or the borrower may just be asked questions about his or her financial situation. A real estate broker's pre-qualification of a prospective buyer may be as simple as making sure that the buyer has a steady job and no glaring credit report problems, like a recent bankruptcy. Often, a real estate broker will compute the buyer's income and debt ratios to get an idea of how much house the prospective buyer may be able to afford.

Some lenders offer a loan pre-qualification certificate form, which is not binding. Assuming a credit decision is not anticipated as a result of this, it does not trigger required disclosures. Lenders may also provide a closing cost worksheet while the loan is still in the pre-qualification state.

Pre-Approval

Pre-approval is *the process by which a lender determines if potential borrowers can be financed through the lender, and for what amount of money.* They are rendering a credit decision. A real estate agent or mortgage broker *cannot* give a borrower a pre-approval; only the lender can pre-approve. For a pre-approval, a borrower goes through most of the same steps in the loan process, such as completing an application and providing documentation of income and assets. With a pre-approval, a lender is stating that the prospective borrower's situation has been investigated and, provided all circumstances stay the same, the lender is willing to loan a certain amount of money to purchase a particular house. A borrower may be able to get **conditional pre-approval** before a signed purchase contract is in place. This is especially helpful when working with buyers because it is a powerful negotiation tool in getting an offer accepted by a seller and, in most cases, is a requirement of contract acceptance.

Of course, a borrower's circumstances can and do change which is why there are always **conditions** listed on a pre-approval. Depending upon internal pre-approval procedures, some pre-approvals are more specific and binding. Pre-approvals are always in writing and always follow the policies and procedures established by the mortgage lender.

Traditional Steps

The real estate loan approval process traditionally consists of four steps, including:

1. Consulting with the mortgage loan originator
2. Completing a loan application
3. Processing a loan application
4. Analyzing the borrower and property

Consulting with the Mortgage Loan Originator

Whether a prospective borrower wishes to consult with a mortgage loan originator in person or online, the first step to choose the right one. If a borrower already has a relationship with a MLO, this may be a good place to start. On the other hand, if a borrower has past credit problems, it may be helpful to use a mortgage company that deals with many different lenders. Although, in today's tight market and stringent credit score qualifying standards, this is not the fix for credit issues it once was.

After the lender is selected, initial discussions usually involve the various types of mortgages they offer (e.g., 30-year, 15-year, fixed rate, ARM) so the borrower can decide which loan best suits his or her needs. A borrower will need to give the lender a good deal of personal and financial data on which the lender will base the lending decision. Providing the borrower with a complete list of required documents and reviewing these documents early in the application will help speed up the approval process.

When the goal is an actual loan approval (not pre-qualification), the **sales contract** will be examined as well. The MLO wants to ensure that it's possible to comply with the terms of the agreement. Of particular concern are the **financing commitment date** and the **closing date**. Often a contract calls for a closing date that is too early to be realistic. If it's impossible for the lender to meet the closing date, a more feasible date can be agreed upon by all parties to the contract to avoid frustration. Loan fees and pricing adjustments may also be listed in the sales agreement.

Interest Rates

One topic that inevitably arises very early in a borrower's conversations with a loan originator is the interest rate that may be available. The **interest rate** is the *amount charged by a lender to a borrower for the use of assets, expressed as a percentage of the loan amount (the principal).* When considering interest rates, you may hear the term **basis point**, which is 1/100th of a percentage point. For example, 325 basis points equal 3.25% or 3 1/4%.

A couple of other interest-related terms:

- **Par rate** is a term that describes the rate that lenders offer only to mortgage brokers, also known as the "wholesale" rate, that does not create an additional charge or provide for a credit for the borrower.
- **Rate Lock.** This is a commitment guaranteed by a lender that an interest rate will not change on a specific loan for a specific period of time. Since a **lock-in agreement** generally requires that the loan close by a specific date, the anticipated close date should be carefully considered. If a loan closes after the rate lock expires, the lender may choose to offer the current market rate or the original lock-in rate.
- **Float.** Between the time of application and closing, a borrower may choose to bet on interest rates decreasing by electing to float. Floating is essentially choosing not to lock the interest rate. Since it is the borrower's responsibility to lock his or her rate before closing, choosing to float is considered risky and may result in a higher interest rate.

Usury

Usury laws are state laws enacted to protect individual borrowers from being charged **excessive interest rates** by lenders. Presently, the general **usury** limit in Illinois is set at 9% annually (815 ILCS 205/4) on **personal loans only**. There are **no state limits** on the interest a lender may charge on residential mortgage loans. However, if a residential first mortgage loan is insured or guaranteed by a federal agency (such as FHA or VA) or is made by a federally chartered lending institution, it is subject to any federal limits that may be in place.

Common Fees Associated with Real Estate Loans

In addition to the **interest**, there are other fees associated with processing a real estate loan, for example, fees for pulling a borrower's credit bureau report, securing a property appraisal report, and for completing inspections. Other items like title insurance and recording fees are paid if and when a loan closes. Fees that occur only when a loan closes are likely to be paid out of closing funds, but other early expenses incurred must be paid, even if the loan doesn't close.

Some mortgage loan originators may require a deposit to ensure fees will be paid, even if a loan does not close. More costly items, such as a property appraisal, may have to be paid for by the borrower before a final underwriting decision is made.

Loan Origination Fees

For loans that actually close, lenders charge a loan **origination fee** to *cover the administrative costs of making and processing the loan*, including setting up the loan on the lender's books. Such fees may be referred to collectively as **points**. A point is simply *one percent of the loan amount*. So, on a $120,000 loan, the borrower would have to pay an additional $1,200 for every point the lender charged as an origination fee. Points can be charged for many reasons, such as closing fees, underwriting fees, documentation fees, etc. Origination fees must be disclosed to the borrower on the Loan Estimate within three business days of completing a loan application.

Discount Points

Discount points are *points the borrower chooses to pay at the beginning of a loan for the purpose of* ***reducing the note interest rate*** *charged.* This is essentially a way for the borrower to pre-pay some of the interest in return for lowering monthly payments. This could allow the borrower to qualify for a loan that he would not otherwise be able to get. Although paying discount points to get a lower interest rate would seem to be of benefit primarily to the buyer, discount points can also benefit the seller. Who pays the points is open to negotiation; a seller or builder may be willing to pay discount points to make the property more marketable. Discounts points may be permanent or temporary.

The difference between origination "points" and discount points is apparent on the Loan Estimate. All origination points must be lumped together as the origination fee on the Loan Estimate; while discount points used to buy down the rate must be indicated as a **charge** the borrower incurs for the interest rate selected.

Yield Spread Premium

Yield spread premium (YSP) is *a tool that mortgage brokers can use to* ***lower the upfront closing cost*** *for a borrower.* YSP allows a borrower to accept an interest rate that is slightly **above par rate** in exchange for lowering or eliminating fees and closing costs. Yield spread premium must be disclosed to the borrower on the Loan Estimate as a **credit** the borrower receives for the interest rate selected.

Loan Estimate

RESPA requires mortgage loan originators to provide the borrower, without charge, a Loan Estimate that includes the dollar amount of settlement charges the borrower is likely to pay, in addition to other pertinent loan terms and characteristics such as the APR. Lenders must provide this to borrowers no later than three business days of a completed application.

FICUS BANK

4321 Random Boulevard • Somecity, ST 12340

Save this Loan Estimate to compare with your Closing Disclosure.

Loan Estimate

DATE ISSUED 2/15/2013
APPLICANTS Michael Jones and Mary Stone
123 Anywhere Street
Anytown, ST 12345
PROPERTY 456 Somewhere Avenue
Anytown, ST 12345
SALE PRICE $180,000

LOAN TERM 30 years
PURPOSE Purchase
PRODUCT Fixed Rate
LOAN TYPE ☒ Conventional ☐ FHA ☐ VA ☐ _____
LOAN ID # 123456789
RATE LOCK ☐ NO ☒ YES, until 4/16/2013 at 5:00 p.m. EDT
Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on ***3/4/2013*** *at 5:00 p.m. EDT*

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

Projected Payments

Payment Calculation	Years 1-7	Years 8-30
Principal & Interest	$761.78	$761.78
Mortgage Insurance	+ 82	+ —
Estimated Escrow *Amount can increase over time*	+ 206	+ 206
Estimated Total Monthly Payment	$1,050	$968

Estimated Taxes, Insurance & Assessments
Amount can increase over time

$206 a month

This estimate includes	In escrow?
☒ Property Taxes	**YES**
☒ Homeowner's Insurance	**YES**
☐ Other:	

See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.

Costs at Closing

Estimated Closing Costs	$8,054	Includes $5,672 in Loan Costs + $2,382 in Other Costs – $0 in Lender Credits. *See page 2 for details.*
Estimated Cash to Close	$16,054	Includes Closing Costs. *See Calculating Cash to Close on page 2 for details.*

Visit **www.consumerfinance.gov/mortgage-estimate** for general information and tools.

SAMPLE

Closing Cost Details

Loan Costs

A. Origination Charges	$1,802
.25 % of Loan Amount (Points)	$405
Application Fee	$300
Underwriting Fee	$1,097

B. Services You Cannot Shop For	$672
Appraisal Fee	$405
Credit Report Fee	$30
Flood Determination Fee	$20
Flood Monitoring Fee	$32
Tax Monitoring Fee	$75
Tax Status Research Fee	$110

C. Services You Can Shop For	$3,198
Pest Inspection Fee	$135
Survey Fee	$65
Title – Insurance Binder	$700
Title – Lender's Title Policy	$535
Title – Settlement Agent Fee	$502
Title – Title Search	$1,261

D. TOTAL LOAN COSTS (A + B + C)	$5,672

Other Costs

E. Taxes and Other Government Fees	$85
Recording Fees and Other Taxes	$85
Transfer Taxes	

F. Prepaids	$867
Homeowner's Insurance Premium (6 months)	$605
Mortgage Insurance Premium (months)	
Prepaid Interest ($17.44 per day for 15 days @ 3.875%)	$262
Property Taxes (months)	

G. Initial Escrow Payment at Closing			$413
Homeowner's Insurance	$100.83 per month for 2 mo.		$202
Mortgage Insurance	per month for mo.		
Property Taxes	$105.30 per month for 2 mo.		$211

H. Other	$1,017
Title – Owner's Title Policy (optional)	$1,017

I. TOTAL OTHER COSTS (E + F + G + H)	$2,382

J. TOTAL CLOSING COSTS	$8,054
D + I	$8,054
Lender Credits	

Calculating Cash to Close

Total Closing Costs (J)	$8,054
Closing Costs Financed (Paid from your Loan Amount)	$0
Down Payment/Funds from Borrower	$18,000
Deposit	– $10,000
Funds for Borrower	$0
Seller Credits	$0
Adjustments and Other Credits	$0
Estimated Cash to Close	$16,054

SAMPLE

Additional Information About This Loan

LENDER	Ficus Bank	**MORTGAGE BROKER**	
NMLS/__ LICENSE ID		**NMLS/__ LICENSE ID**	
LOAN OFFICER	Joe Smith	**LOAN OFFICER**	
NMLS/__ LICENSE ID	12345	**NMLS/__ LICENSE ID**	
EMAIL	joesmith@ficusbank.com	**EMAIL**	
PHONE	123-456-7890	**PHONE**	

Comparisons

Use these measures to compare this loan with other loans.

In 5 Years	$56,582	Total you will have paid in principal, interest, mortgage insurance, and loan costs.
	$15,773	Principal you will have paid off.
Annual Percentage Rate (APR)	4.274%	Your costs over the loan term expressed as a rate. This is not your interest rate.
Total Interest Percentage (TIP)	69.45%	The total amount of interest that you will pay over the loan term as a percentage of your loan amount.

Other Considerations

Appraisal
We may order an appraisal to determine the property's value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost.

Assumption
If you sell or transfer this property to another person, we
☐ will allow, under certain conditions, this person to assume this loan on the original terms.
☒ will not allow assumption of this loan on the original terms.

Homeowner's Insurance
This loan requires homeowner's insurance on the property, which you may obtain from a company of your choice that we find acceptable.

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

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

Servicing
We intend
☐ to service your loan. If so, you will make your payments to us.
☒ to transfer servicing of your loan.

SAMPLE

Confirm Receipt

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

Applicant Signature _____ Date _____

Co-Applicant Signature _____ Date _____

Loan Estimate Page 1

Page 1 of the **Loan Estimate** includes:

- General information, such as the name of the applicants, the property address, and the sale price of the property.
- The **purpose** of the loan, for example, purchase, refinance, construction.
- A **description** of the loan, including whether it has a payment feature that could change.
- Any **rate lock** the lender has made available, including the date and time the rate lock ends.
- A **Loan Terms** table that discloses the initial interest rate, the monthly principal and interest, any prepayment penalty or balloon payment.
- A **Projected Payments** table calculating the entire monthly PITI obligation.
- A **Costs at Closing** table indicating the estimated closing costs and the estimated amount of cash needed to close the loan.

Loan Estimate Page 2

Page 2 of the **Loan Estimate** provides a good faith itemization of the costs of obtaining the loan. The items associated with the mortgage are broken down into two general types:

- **Loan Costs** are those costs paid by the consumer to the creditor and third-party providers of services the creditor requires to be obtained by the consumer during the origination of the loan. These costs are categorized as origination charges, services the borrower cannot shop for such as an appraisal fee or credit report fee, and services the borrower can shop for, such as fees for pest inspections and title insurance.
- **Other Costs** include taxes, governmental recording fees, and certain other payments involved in the real estate closing process, for example, initial escrow payments and prepaid fees such as insurance.

The **Calculating Cash to Close** table then shows how the amount of cash needed at closing is calculated, taking the down payment, earnest money deposit, and other credits into consideration.

Loan Estimate Page 3

The last page of the **Loan Estimate** provides additional information about the loan, as well as contact information.

The **Comparisons Table** discloses the critical **annual percentage rate** (**APR**), which expresses the full cost of obtaining the loan as a rate. This is NOT the interest rate negotiated between the borrower and lender. This table also shows the borrower how much he or she will have paid in interest and principal at the end of given years. The Comparison Table is intended to help a borrower easily compare loans terms offered by other various lenders.

Finally, any other considerations related to the loan are indicated. A borrower is NOT required to sign the Loan Disclosure, although the lender may ask for a signature as proof of receipt. Signing the Loan Disclosure does not obligate the borrower to continue with the loan process.

Availability of Terms

The estimate of the charges and terms for all settlement services must be available for at least **10 business days** from when the Loan Estimate is provided. This 10-day provision, however, does **not** apply to the interest rate, charges and terms dependent upon the interest rate—which includes the charge or credit for the interest rate chosen—the adjusted origination charges, and per diem interest. Because of this, borrowers and lenders frequently agree to a **rate lock** for a pre-determined period of time.

If any charges at settlement exceed the charges listed on the Loan Estimate by more than the permitted tolerances, the only way the loan originator can cure the tolerance violation is by reimbursing the borrower the amount by which the tolerance was exceeded, **at settlement or within thirty (30) calendar days** after settlement.

If a borrower does not express intent to continue with an application **within ten business days** after the Loan Estimate is provided the loan originator is no longer bound by the Loan Estimate.

Qualifying Standards

When lenders first meet with a potential borrower—either for pre-qualification or pre-approval—they will likely perform an analysis of the current or allowable monthly housing expense based on the borrower's income and debt. This provides the lender—and the borrower—with a realistic understanding of what mortgage payment the borrower may be able to afford. There are two qualifying standards considering in underwriting:

- Housing expense ratio
- Total debt-to-income ratio (sometimes called total expense debt ratio or total debt service ratio)

Besides income, the key element needed to determine these ratios is **PITI**, which is an acronym for *a mortgage payment that is the sum of monthly **P**rincipal, **I**nterest, **T**axes (property taxes and perhaps mandatory special assessments, if applicable), and **I**nsurance (homeowners hazard insurance and mortgage insurance, if applicable)*. When the collateral property requires **association fees** as a condition of ownership, for example as with a condominium, that monthly amount must also be added to PITI to get the complete housing expense.

Qualifying standards may vary from lender to lender, but with increased lender dependence on the national secondary market, the majority of lenders throughout the country have incorporated into their own conventional loan underwriting procedures the standards set by the major secondary market investors, specifically Fannie Mae and Freddie Mac. Of course, if the loan being contemplated is to be made in conjunction with the FHA or VA, those underwriting standards must be applied (qualifying standards for FHA and VA loans will be discussed in the next chapter).

Housing Expense Ratio

A borrower's housing expense ratio, also called the **front end ratio**, is the relationship of the borrower's total monthly housing expense to income, expressed as a percentage:

Total Housing Expense / Income = Ratio %

Stable monthly income, which is covered in more detail later, is *a borrower's monthly income that can reasonably be expected to continue in the future.* This is usually a borrower's **gross monthly income** from primary employment and any other acceptable income.

Conventional lenders consider a borrower's income adequate for a loan if the proposed total mortgage payment of PITI does not exceed **28%** of stable monthly income. For an **FHA-insured** loan, the PITI payment typically cannot exceed **31%** of stable monthly income. (A loan that is guaranteed by the Veteran's Administration does not apply a payment-to-income ratio as a qualifying component, but looks at residual income, which is covered in more detail in the next chapter.)

Case in Point

Mark has a stable monthly income of $2,900 and the house he wants to buy would have a total monthly housing expense of $700:

$2,900 Stable Monthly Income

$ 700 Proposed Housing Expenses (PITI + association fees, if required)

$700 / $2,900 = 0.24 or 24%

His housing expense ratio in this example is 24%, which is acceptable for an FHA-insured loan or a conventional loan.

Total Debt-to-Income Ratio

A borrower's total debt-to-income ratio (DTI), also known as the **back end ratio**, is the relationship of the borrower's total monthly debt obligations (including housing expenses and long-term debts) to income, expressed as a percentage.

Total Debt / Income = Ratio %

Here, alimony, child support, or any other court-ordered obligations the borrower has must count as debt against this ratio. Debts with fewer than ten payments remaining may still be counted against the borrower if payments are high (e.g., $600 car payment). If there are student loans currently in deferment, these need to be calculated as debt regardless of how soon the loans will be repaid.

Conventional lenders want to be sure the borrower's housing expenses plus debt (any installment debts with 10 or more payments left or other debt that will not be cancelled) do not exceed **36% of stable monthly income**. For an **FHA-insured** loan, the total recurring debt cannot exceed **43%** of stable monthly income. For a **VA-guaranteed** loan, the total debt including utilities cannot exceed **41%** of stable monthly income.

Case in Point

$2,900	Stable Monthly Income
$700	Proposed Housing Expenses (PITI + association fees, if required)
$225	Auto Payment (18 payments left)
+ $100	Child Support
$1,025	Total Debt

$1,025 / $2,900 = 0.35 or 35%

The borrower's total DTI ratio in this example is 35%, which is acceptable for an FHA-insured loan, a VA-guaranteed loan, or for a conventional loan.

When the underwriter considers both ratios, the borrower must generally qualify under **both**.

Qualifying Income Expense Ratios

	Payment-to-Income Ratio	Debt-to-Income Ratio
Fannie Mae/ Freddie Mac Conventional Loans	PITI Not to exceed **28%** of income	Housing + Debt (10 or more payments) Not to exceed **36%** of income
FHA-Insured Loans	PITI Not to exceed **31%** of income	Housing + Debt (10 or more payments) Not to exceed **43%** of income
VA-Guaranteed Loans	Not considered; instead, looks at residual income	Housing + ALL Debt and Utilities Not to exceed **41%** of income

Note that the qualifying standards discussed here could change. Always check for the most current information.

Broker Price Opinion (BPO)

A **broker price opinion**, or BPO, is an ***estimate of the probable selling price of a certain piece of property prepared by a real estate broker.*** At one time, lenders commonly used BPOs to determine a value on properties for which the expense and time of a formal appraisal was not necessary. A BPO typically provides a varying level of detail about the property's condition, neighborhood, and marketplace.

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, broker price opinions may no longer be used as the primary basis to determine the value of property for the purpose of originating a residential mortgage loan.

Loan Processing and Underwriting

Lenders expect the loans they make to be repaid in a timely manner without collection or foreclosure. Thus, employment stability, income potential, history of debt management, and assets are important considerations. A loan application is designed to elicit responses that detail the borrower's history, trends, and attitude as a means of trying to predict future loan repayment behavior.

Completing the Uniform Residential Loan Application

The uniform residential loan application (Fannie Mae **Form 1003** or Freddie Mac **Form 65**) is a form lenders require potential borrowers to complete that allows them to collect pertinent information about the borrower and the property. An application may either be in writing or electronically submitted, including a written record of an oral application. The borrower typically completes a loan application during the initial consultation with the mortgage loan originator. There's a great deal of information asked, including the following:

- **Property** information and purpose of the loan (a principal residence is less risky than a second home)
- **Personal** information, such as name, address, phone, Social Security number, age, schooling, marital status, number of dependents
- **Employment** information, including number of years on the job, line of work, whether or not self-employed (generally looking for 2 years)
- Monthly **income** and combined **housing expense** information (current and proposed)
- **Assets**, which are *items of value owned by the borrower*, such as cash on hand, checking or savings accounts, stocks, bonds, insurance policies, real estate, retirement funds, automobiles, and personal property
- **Liabilities**, which are *financial obligations or **debts** owed by a borrower* (debts are recurring monetary obligations that will not be canceled plus any installment debts with 10 or more payments left)
- **Net worth**, which is *determined by subtracting liabilities from total assets*, and is usually a good indicator of creditworthiness
- Details of the real estate transaction itself, including purchase price, closing costs, prepaid items (e.g., escrows for taxes, insurance), estimated closing costs, mortgage insurance, secondary financing, etc.

A borrower's ability to qualify for a real estate loan depends on many factors related to income, credit history, and assets.

Income

Before deciding if a borrower has sufficient income to qualify for a loan, the underwriter must decide what portion of the borrower's total verified earnings are acceptable as a part of the total monthly income. Borrowers can substantiate employment and income by providing **W-2 forms** for the previous **two years** and **payroll stubs** for the previous **30-day** period.

Stable monthly income, the *monthly income that can reasonably be expected to continue in the future*, is generally meant to include the **gross** base income of the borrower(s) from **primary** jobs. A **quality** source of income is one that is *reasonably reliable,* such as income from an established employer, government agency, interest-yielding investment account, etc. A **durable** source of income can be *expected to continue for a sustained period*. Remember that lenders may not discriminate on the *source* of a borrower's income.

Secondary Sources of Income

Predictable earnings from acceptable secondary sources are considered if a lender's thorough analysis determines they can be substantiated and are durable. Secondary sources of income include, but are not limited to, the following:

- Bonuses, commissions above base salary, part-time earnings (if durable)
- Overtime (2-year average)
- Disability payments (if permanent, or if expected to continue for 3 years)
- Social Security
- Pensions
- Retirement payments
- Interest-yielding investments (if sound and consistent)
- Rental income (if stable cash flow is verified)
- Alimony, child support, maintenance (if expected to continue for 3 years; usually requires copy of divorce decree)
- Unemployment and welfare (if verifiable, continuous, and ongoing)

Self-Employment Income

Self-employed borrowers need to provide personal and entity (corporation, partnership, sole proprietorship) **tax returns** (all schedules) for a **minimum of two years** to verify this income. The lender may also ask to see **financial statements,** which are *documents that show assets and liabilities for an individual or an entity, such as a company for a specific period or point in time*. Profit and loss statements and/or balance sheets may also be required.

Computing Monthly Income

After deciding which income counts, all gross monthly income from those sources is added together to arrive at a total gross monthly income figure. If a borrower earns an hourly wage, it must be converted to a monthly figure. To convert a person's hourly wages to monthly earnings:

1. Multiply the hourly wage by the number of hours worked in a week
2. Multiply by 52 (weeks in a year)
3. Divide by 12 (months in a year)

Case in Point

Our borrower makes $19.50 per hour. Assuming the borrower works 40 hours a week, to compute the monthly income:

Hourly Wage:	**$19.50**
Weekly Income:	**$19.50 x 40 hours = $780**
Annual Income:	**$780 x 52 weeks = $40,560**
Monthly Income:	**$40,560 / 12 months = $3,380**

IRS Form 4506-T

Underwriters generally require the lender to obtain a completed and signed **Form 4506-T** from all borrowers at both application and prior to closing. This form gives the lender permission to request electronic transcripts of federal tax returns from the IRS when documenting the borrower's income. Under current requirements, the lender determines if and when to submit the form to the IRS (or designee) to obtain the tax information. These transcripts are used to validate the borrower's income against their W-2s with the intention of helping to reduce instances of mortgage fraud.

Credit History

Credit history is a *record of debt repayment, detailing how a person paid credit accounts in the past as a guide to whether he or she is likely to pay accounts on time and as agreed in the future.* **Debts** are *any recurring monetary obligation that will not be cancelled.* A car lease is a debt; so is a student loan or court-ordered child support. Utilities and insurance premiums are *not* considered debts because they can be cancelled. Lenders assume you would turn off your phone before losing your house. Gray areas can include such things as doctor bills. These are not considered a debt unless you have a payment schedule (e.g., for braces). Borrowers must inform a lender of *all* debts—even things that may not show up on a credit report.

As part of the loan evaluation, the underwriter analyzes the borrower's and any co-borrower's credit history by obtaining a credit report from a national credit bureau (e.g., Experian, Equifax, and TransUnion). If the credit history shows a slow payment record or other derogatory credit information (suit, judgment, repossession, collection, foreclosure, or bankruptcy), a loan application could be declined or the borrower put into a **high-risk** (B-C credit) category.

In some cases, derogatory ratings don't prevent a borrower from obtaining a loan if the credit problems can be explained. The underwriter must be satisfied that these problems don't represent the borrower's overall attitude toward credit obligations, and the circumstances were temporary and no longer exist.

Credit Scoring

Credit scoring is an *objective means of determining creditworthiness of potential borrowers based on a number system*. A credit score is a numeric representation of the borrower's credit profile compiled by assigning specified numerical values to different aspects of the borrower. These numbers are adjusted up and down based on the strengths and weaknesses of particular qualifications. For example, a person with a large line of available credit that is hardly used would likely score higher than a person with lower credit limits but whose credit cards are all maxed out. The numbers are added from all the categories and a credit score based on these various criteria is assigned.

Credit scores also play an important role in automated underwriting since Fannie Mae and Freddie Mac have identified a strong correlation between mortgage performance and credit scores. The higher the credit score, the better credit risk a borrower is; the lower the score, the higher the risk of default.

FICO/BEACON Scores

FICO is a credit score developed by Fair, Isaac & Co. While not used by every credit reporting agency, FICO is a common term. These scores are the result of very complex calculations carried out by a computer that takes into account every aspect of the borrower's credit file. Items considered include these:

- Number of open accounts
- Total credit limit
- Types of credit (e.g., credit cards, installment loans)
- Length of credit history (e.g., when opened, latest activity)
- Total amount of debt outstanding
- Number of late payments in the past 30-60-90 days
- Presence of adverse public records (e.g., liens, judgments, or bankruptcies)
- Number of recent credit inquiries
- Re-establishment of positive credit history after past payment problems

Each of these three main credit bureau scores is calculated a little differently. For example, FICO weighs payment history as 35% of the total score, amounts owed as 30%, length of credit history as 15%, and new credit and types of credit used as 10% each. Regardless of the actual calculation, all credit bureaus produce similar credit scores, which range from about **300 to 850**. While lenders can't tell you exactly how each credit score is computed, they can tell you what cutoff scores they use in qualifying borrowers for various mortgage loan programs.

Secondary Market

The secondary market has pricing adjustments to the interest rate depending upon FICO score and LTV. Fannie Mae and Freddie Mac guidelines generally consider those with credit scores **above 720** to be an *acceptable* credit risk and therefore have little interest rate adjustment. Those with scores **between 620 and 660** are considered *marginal* and are held to a more comprehensive review. Fannie Mae and Freddie Mac do *not* accept loans with FICO scores **below 620** except for certain products and programs. Before making decisions regarding qualification, lenders are encouraged to check the accuracy of credit information.

Explaining Derogatory Credit

Most people try to meet credit obligations on time; when they don't, there's usually a reason. Job loss, hospitalization, prolonged illness, death in the family, or divorce can create financial pressures that affect debt-paying habits. If a few derogatory items appear on a credit report, it may be possible to show that the problems occurred during a specific period of time for understandable reasons, and that prior and subsequent credit ratings have been good.

If borrowers refuse to accept responsibility by explaining credit difficulties based on misunderstandings or on the creditors themselves, underwriters may not look favorably upon such explanations. Underwriters reason that a borrower's reluctance to take responsibility for prior credit problems is an indication of what can be expected in the future.

Borrowers may have questions regarding credit scores. The Fair and Accurate Credit Transactions Act requires that a **Notice to the Home Loan Applicant Credit Score Information Disclosure** be provided to borrowers. This disclosure must include the score that a credit reporting agency distributed to the lender used in connection with a home loan and the key factors affecting the credit scores. This disclosure must include contact information for any credit agency used.

Bankruptcy

Bankruptcy, as established by Title 11 of the United States Code, is a court process that cancels debt and provides some relief for creditors. There are two basic proceedings for individuals:

- **Chapter 7.** Sometimes called a straight bankruptcy, it 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. Someone wishing to file Chapter 7 must meet certain tests related to income and debt.
- **Chapter 13.** This is filed by individuals who want to pay off their debts over a period of three to five years. This is preferable to those who have non-exempt property that they want to keep. It is only an option for individuals who have predictable income and whose income is sufficient to pay their reasonable expenses with some amount left over to pay off their debts.

The **Fair Credit Reporting Act** indicates (§ 605) that consumer reporting agencies may maintain bankruptcy information on a consumer's credit report for no more than 10 years from the date of entry of the order for relief or the date of adjudication, whichever the case may be. While credit reporting agencies do keep completed Chapter 7 bankruptcies on the credit report for the maximum 10 years, they often keep Chapter 13 bankruptcies on the credit report only for seven years after discharge date. This is an incentive for a consumer to file under Chapter 13 and repay their debts.

Other Negative Information

According to FICO, in addition to Chapter 13 bankruptcies, other negative information that remains on a consumer's credit report for **seven years** includes:

- Late payments
- Foreclosures
- Collections (generally, depending on the age of the debt being collected)

Also, information that is part of the public record may show for seven years, although unpaid tax liens can remain indefinitely.

Bill Consolidation and Refinancing

Even without derogatory ratings, lenders may find other concerns in a credit report that might indicate the borrower is a marginal credit risk. If an individual's credit pattern is one of continually increasing liabilities and periodically bailing out through bill consolidation (borrowing a larger sum of money to pay off many smaller debts) and refinancing, he or she may be classified as a marginal risk. This pattern suggests a tendency to live beyond a prudent level. It is a subjective consideration likely to influence the lender's decision if a borrower is weak in other areas, such as income or net worth.

Assets

Assets are simply *items of value*. The underwriter takes the necessary steps to verify the nature and value of assets held by a borrower. If a borrower has a marginal total debt-to-income ratio, above average assets can offset this deficiency. Underwriters know that assets, especially in **liquid** form such as savings, trust funds, stocks, or bonds, can be used to pay unexpected bills or to support a borrower when there's a temporary interruption in income. Documentation of assets includes **one to two months of bank statements** (all pages) to verify available funds. A **Verification of Deposit (VOD)** form may also be used to verify bank statement balances, both current balance and average balance.

There are three aspects of a borrower's assets in which lenders and underwriters are interested: Down payment, reserves, and other assets.

Down Payment

It must be determined that the borrower has **sufficient liquid assets** to make the cash down payment and pay the closing costs and other expenses incidental to the purchase of the property. Most loan programs require the borrowers to bring at least 5% of the down payment from their own personal savings history into the transaction. There are some programs that allow a smaller down payment—mostly government programs or those geared to first time homebuyers.

The lender also wants to know the **source** of the borrower's down payment. Savings or sale of a prior home are both acceptable sources of down payment. **Borrowed funds** must be secured and the debt considered in the total debt-to-income ratio. If an applicant lacks the necessary funds to close a transaction, a **gift** of the required amount is usually acceptable to the underwriter. The gift should be confirmed by means of a **gift letter** signed by the donor. The letter should clearly state that the money represents a gift and *does not have to be repaid.*

Reserves

Reserves are *cash on deposit or other highly liquid assets a borrower will have available after the loan funds.* Lenders prefer to see enough to cover two months' PITI mortgage payments of principal, interest, taxes, and insurance (and assessments such as condominium association fees, if applicable) after the borrower makes the down payment and pays all closing costs, though in most cases this is not required.

Other Assets

Having assets in addition to cash and other liquid assets shows that the borrower is able to manage money and has resources, if needed, to handle emergencies and make mortgage payments. For example, **real estate equity** is an important asset to consider. Equity is *the difference between the market value of the property and the sum of the mortgages and other liens against the property*. Equity, less all selling expenses, is what a buyer should receive from the sale of property. If the equity from the sale of a home is the source of money for the purchase of the subject property, the underwriter might require evidence that the sale closed and the borrower received the proceeds before making the new loan. If the loan is a construction loan and the borrower owns the lot, the underwriter treats the borrower's equity in that lot as cash or its equivalent when determining the down payment needed.

Property Insurance

Providing funds to a borrower to purchase a home carries with it a great deal of financial risk for the lender, who is said to have an **insurable interest** in the property. To protect that collateral, therefore, lenders normally require insurance.

Homeowner's Hazard Insurance. A policy that covers loss or damage to the home or property in the event of fire or other disaster such as tornado, snow, and hail damage. Lenders generally:

- Require the policy to be sufficient to replace the home or reimburse the mortgage amount with the lender being named on the actual policy.
- Have the right to place insurance on the property to cover its interest (the loan value) in the event of a loss if the customer does not comply with the lender's insurance requirements.
- Require buyers to pay the first year's insurance premium in full *prior* to closing.
- Incorporate the annual insurance cost (along with current property taxes) into an **escrow account,** which is prorated over the next 12 months to determine a monthly insurance and property tax payment amount. This is added to the monthly principal and interest due for loan repayment. Upon payment each month, the insurance and taxes are deposited into the client's escrow account. When property taxes and insurance become due, the lender/servicer forwards the payment to the respective recipients on behalf of the property owner.

Flood Insurance. Homeowner's hazard insurance does **not** cover damage caused by the peril of flood. When a property is located in a federally designated special flood hazard area (SFHA), the lender for federal loans will require a flood insurance policy for the life of the loan in addition to homeowner's hazard insurance. Flood insurance must be purchased from the **National Flood Insurance Program (NFIP)** or from an insurer participating in the Write Your Own program**.** In order to buy federal flood insurance, the property must be in a community that is voluntarily participating in the NFIP.

Underwriting

There are general steps all lenders take before deciding whether or not to make a real estate loan and on what terms. First, the borrower's loan file is evaluated to make sure the minimum qualifying standards are met. Next, the property the borrower wants to use as security for the loan is evaluated. The primary concern throughout the loan underwriting process is determining the degree of **risk** a loan represents. The underwriter attempts to answer two fundamental questions:

- Is there sufficient value in the property pledged as collateral to assure recovery of the loan amount in the event of default?
- Does the borrower's overall financial situation, which is comprised of credit, income, and assets, indicate a reasonable expectation of making the proposed monthly loan payments in a timely manner?

The underwriting process can be automated, where all information is fed into an automated underwriting system (AUS), or done by an individual who works for the lender. Both processes have various qualifying standards applied to the loan information.

Automated Underwriting Systems (AUS)

Automation is used in all facets of the lending process. The purpose of automated underwriting is to reduce the cost of examining a loan application and speed up mortgage approvals. An AUS is able to provide consistent underwriting decisions using statistical computer models based on traditional underwriting factors, and never considers factors such as race, ethnicity, age, or any other characteristic prohibited by law. And with large databases of statistics and information available, the secondary market has increased efforts to manage credit risk by improving loan criteria.

The AUS makes a recommendation to accept a loan for delivery, or refers it for an underwriter for further manual review and analysis. Even with an automated approval, the underwriter still must validate the information entered into the AUS, along with the supporting documentation.

Final Underwriting

While lenders may rely on automated underwriting systems for a preliminary decision, it generally comes down to a human underwriter to make the final decision. After all conditions identified through AUS are met, a loan package is assembled for final lender approval. Loan underwriters carefully examine a loan package, and then decide to approve, reject, or approve the loan with conditions. Conditional approval usually requires additional items, such as:

- Closing statement from the sale of the buyer's previous home,
- Final inspection report, and/or
- Commitment for private mortgage insurance (often a condition for approving conventional loans with less than 20% down).

Closing and Settlement Statement Reconciliation

After the loan is approved and all "prior to doc" conditions are met, the lender issues a **clear to close** the loan and the necessary documents are prepared for closing. **Closing**, also called **funding**, completes the process of granting a loan as funds are disbursed in accordance with the settlement statement. When the transaction involves the **sale** of real property, closing also involves *transfer of ownership of real property from seller to buyer, according to the terms and conditions in the sales contract or escrow agreement.* This is the final stage in a real estate transaction, when the seller receives value for property (cash, mortgage, etc.) and the buyer receives title. You may also hear the closing process referred to as **settlement** or **loan consummation**. The **Real Estate Settlement Procedures Act (RESPA)** is the federal law dealing with real estate closings that sets forth procedures and guidelines for disclosing settlement costs using a standard settlement statement.

Closing Procedures

Generally speaking, the mechanics of closing are the responsibility of either an escrow/title agent or an attorney. This escrow agent may be the lender's in-house escrow department, an independent escrow company, or a title insurance company. The title agent gathers all necessary documents, calculates the various prorations, adjustments, and fees charged to each party, and also compares the closing costs in the Loan Estimate to the Closing Disclosure to verify the proper tolerance with disclosed fees. Each party receives a Closing Disclosure that complies with the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA).

The lender wants to ensure that there are no unforeseen problems during closing—for example, if the seller did not really have title to the property—the loan papers (e.g., promissory note, mortgage, deed, etc.) are signed, and there's one final check to be sure that everything is in order. Once the necessary documents have been recorded, loan funds may then be disbursed to the proper parties, according to the sales contract or escrow instructions.

Debits and Credits

To understand the final distribution of money involved in the transaction, real estate licensees must be familiar with the concept of **debits** and **credits**.

- **Debits** (like debts) are *sums of money owed*. A debit is charged to a particular party on a balance sheet to represent money that must be paid out. The settlement statement reflects the total costs the seller must pay and the buyer must pay. These are the debits.
- **Credits** are *sums of money received*. A credit is given to a particular party on a balance sheet to represent money that is paid by another party or that has already been paid. The settlement statement also reflects the total amounts credited to the seller and the buyer.

Debits and credits work together when **reconciling** the settlement statement. All debits owed by the buyer are totaled and added to the purchase price. Then the credits are totaled and subtracted from the total debits to determine *how much money the buyer must bring to closing*. The **mortgage** amount shows up as a **credit** to the buyer, since it is the lender who brings that money to closing. The details on a settlement statement allow a buyer to see the **acquisition cost**, which is a total of the amount of money necessary to purchase the property, since it shows the sales price as well as the charges necessary to close the loan.

A similar process occurs on the seller's side. All credits due to the seller are totaled and added to the purchase price. All debits owed are totaled and subtracted from the total money due to determine how much money the seller will receive at the closing.

Proration

Proration is *the division of expenses between buyer and seller in proportion to the actual usage of the item* represented by a particular expense as of the **day the loan is funded.** A proration is also known as an **adjustment**. In order to adjust a cost shared by both buyer and seller, it's necessary to determine whether the expense is accrued or prepaid.

Accrued Expenses

Accrued expenses are the items on a settlement statement for which *the cost has been incurred, but the expense has not yet been paid.* Examples of accrued expenses include unpaid recurring assessments, property taxes, and mortgage interest. Accrued items start from the position that nothing has been paid, so the seller's portion must be calculated so she can be debited and the buyer credited for this amount. For example, a transaction closes on May 31. The neighborhood has a special assessment for sidewalks that is due twice a year; the next assessment payment is due June 30 so the buyer would have to pay that. Since the seller lived in the house for five of the six months covered by the unpaid assessment, that portion will be prorated on the settlement statement as a debit to the seller and a credit to the buyer.

Prepaid Expenses

Prepaid expenses are the *items on a settlement statement the seller has already paid.* This is sometimes referred to as P.O.C., which means, "paid outside of closing." Homeowners insurance, association fees, utility bills, and property or special assessment taxes may be prepaid costs. Since the seller has already paid for these, he is entitled to a credit for the portion paid but that will not be used by him. For example, a transaction closes on July 31. Property taxes in New York are paid in advance, so the buyer will get a tax bill at the beginning of the year. The seller lived in the house for seven months of the year and is therefore responsible for that portion of the tax bill. At settlement, the taxes would be prorated so that the seller is credited for the remaining five months of the property taxes that he has already paid. The buyer's side will show a debit for five months of property taxes.

Shared Expenses

Buyers and sellers sometimes share the costs of items such as surveys, inspections, and lender fees. These items are easy to prorate because they are either negotiated or are calculated as a percentage of the item used and not based on days of usage.

Calculating Prorations

When performing proration calculations, it's important to know the factor on which to base the adjustment. Expenses may be prorated using:

- A 360-day year, 12 months of 30 days each (sometimes referred to as a "banker's year").
- A 365-day year, counting the exact number of days in each month (taking leap years into account).

Either way, the steps to calculate the adjustment are similar:

1. Determine if the expense is accrued or prepaid.
2. Divide the expense by the appropriate period to find a monthly/daily rate.
3. Determine how many months/days are affected by the expense.
4. Multiply the monthly/daily rate by the number of affected months/days.
5. Determine which party is credited and which is debited.

Case in Point

Example 1: ***Property taxes of $2,140 are due every six months and are paid in arrears. The transaction closes on September 15.***

(Using a 360-day year)

1. Property taxes are paid in arrears, so the buyer will be required to pay them.
2. $2,140 / 6 = $356.67 per month; $356.67 / 30 = $11.89 per day
3. July and August = 2 months; September 1 to September 14 = 14 days
4. (2 months x $356.67 = $713.34) + (15 days x $11.89 = $166.46) = $879.80
5. Buyer credit of $879.80; seller debit of $879.80

Example 2: ***Condominium fees of $275.50 were paid on the first of the month. The transaction closes on July 17.***

(Using a 365-day year)

1. Condo fees are a prepaid item that the seller paid.
2. $275.50 / 31 = $8.89 per day
3. July 17 to July 31 = 15 days
4. 15 days x $8.89 = $133.35
5. Seller credit of $133.35; buyer debit of $133.35

Proration Notes

- Generally speaking, buyers become the owners of the property they purchase *on the closing date.* In practice, the buyer or seller may be charged with that day's fees and expenses. Actual possession of the property may take place several days, weeks, or even months after closing. In these instances, the sales contract should note who is responsible for what expenses until the new owner takes possession.
- In some areas, unless specifically noted otherwise, interest, taxes, utility bills, and similar expenses are calculated using 360 days in a year and 30 days in a month. In other areas, prorations are calculated using the actual number of days in the calendar month of closing and 365 days in a year. It's important to find out which factor is used.
- In some cases, sellers are expected to pay off special assessments before the transaction can close. Special assessments are usually levied for municipal improvements such as street repairs and the installation of sidewalks and sewers, and are usually payable over several years.
- When rental property is sold, the rent is commonly prorated on the basis of the actual number of days in the month of closing. Buyers often agree to collect any unpaid rent for the current month and remit a share of it to the seller since the property was still the seller's when the rent was actually due. Tenants' security deposits are transferred by the seller to the new property owner. Even though this may be transparent to tenants, it is required by law that they be notified of the transfer of deposit.

Closing Disclosure

The **Closing Disclosure** used for RESPA and TILA compliance may be prepared by the lender or closing agent, although the lender is ultimately responsible for the accuracy and timely delivery of the document. The Closing Disclosure itemizes all charges imposed upon the borrower and the seller by the loan originator, all sales commissions—whether to be paid at settlement or outside of settlement—and any other charges which either the borrower or the seller will pay at settlement. For each separately identified settlement service in connection with the transaction, the name of the person ultimately receiving the payment must be shown together with the total amount paid to such person.

The Closing Disclosure is required for all **federally-related transactions**. Privately financed transactions and cash sales do not fall under RESPA, and so this Closing Disclosure is not required, although it may be used as a convenience.

Compatibility with the Loan Estimate

If there are changes between the Loan Estimate and the actual costs that exceed the statutory tolerances, the lender must provide a revised Loan Estimate at least four days prior to loan consummation. The final Closing Disclosure must then be made available to the borrower within three business days prior to closing the loan.

An **updated** Closing Disclosure is required if:

- The **APR** (annual percentage rate) increases by more than **1/8 of a percent for fixed-rate loans or 1/4 of a percent for adjustable loans**.
- A **prepayment penalty** is added, making it expensive to refinance or sell.
- The basic **loan product changes**, such as a switch from fixed rate to adjustable interest rate or to a loan with interest-only payments.

This would trigger another three business day waiting period.

Closing Disclosure Page 1

The data on **Page 1** of the Closing Disclosure provides details about the loan:

- **Transaction details**, such as the closing date, parties to the transaction, and loan information
- **Loan terms** as found on the **Loan Estimate**, updated as necessary
- **Projected payments** that provide a complete picture of the borrower's **total monthly obligations** over the life of the loan.
- **Closing costs**, reflecting a detailed break-down of costs and **cash to close** found on Page 2 of the Closing Disclosure.

Closing Disclosure Page 2

Page 2 of the Closing Disclosure itemizes the closing costs paid by the **borrower**, the **seller**, or by **others**. For example, in your sample Closing Disclosure we can see the fees required by the lender to make the loan, such as origination charges and escrow payments, as well as other costs necessary to conclude the transaction, such as government taxes. The columns for Borrower-Paid items and Seller-Paid items are divided into two parts:

- Items paid **at closing**. These items figure into the total costs owed by the buyer and seller on the day of closing.
- Items paid **before closing**. These items are noted here for both buyer and seller. Items the buyer paid before closing reduce the buyer's cash to close calculation on Page 3. Items paid before closing are not included in the summaries of transactions for either buyer or seller, however.

Page 2 is also where any **commission** due is itemized.

Closing Disclosure

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

Closing Information		Transaction Information		Loan Information	
Date Issued	4/14/2016	**Borrower**	Michael Jones and Mary Stone 123 Anywhere Street Anytown, ST 12345	**Loan Term**	30 years
Closing Date	4/14/2016			**Purpose**	Purchase
Disbursement Date	4/14/2016			**Product**	Fixed Rate
Settlement Agent	Epsilon Title Co.	**Seller**	Steve Cole and Amy Doe 321 Somewhere Drive Anytown, ST 12345	**Loan Type**	☒ Conventional ☐ FHA ☐ VA ☐ _____
File #	12-3456			**Loan ID #**	123456789
Property	456 Somewhere Ave Anytown, ST 12345	**Lender**	Ficus Bank	**MIC #**	000654321
Sale Price	$180,000				

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

Projected Payments

Payment Calculation	**Years 1-7**	**Years 8-30**
Principal & Interest	$761.78	$761.78
Mortgage Insurance	+ 82.35	+ —
Estimated Escrow *Amount can increase over time*	+ 206.13	+ 206.13
Estimated Total Monthly Payment	$1,050.26	$967.91

Estimated Taxes, Insurance & Assessments *Amount can increase over time* *See page 4 for details*	$356.13 a month	**This estimate includes**	**In escrow?**
		☒ Property Taxes	**YES**
		☒ Homeowner's Insurance	**YES**
		☒ Other: Homeowner's Association Dues	**NO**
		See Escrow Account on page 4 for details. You must pay for other property costs separately.	

Costs at Closing

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

Closing Cost Details

Loan Costs		Borrower-Paid At Closing	Borrower-Paid Before Closing	Seller-Paid At Closing	Seller-Paid Before Closing	Paid by Others
A. Origination Charges		**$1,802.00**				
01 0.25 % of Loan Amount (Points)		$405.00				
02 Application Fee		$300.00				
03 Underwriting Fee		$1,097.00				
04						
05						
06						
07						
08						
B. Services Borrower Did Not Shop For		**$236.55**				
01 Appraisal Fee	to John Smith Appraisers Inc.					$405.00
02 Credit Report Fee	to Information Inc.		$29.80			
03 Flood Determination Fee	to Info Co.	$20.00				
04 Flood Monitoring Fee	to Info Co.	$31.75				
05 Tax Monitoring Fee	to Info Co.	$75.00				
06 Tax Status Research Fee	to Info Co.	$80.00				
07						
08						
09						
10						
C. Services Borrower Did Shop For		**$2,655.50**				
01 Pest Inspection Fee	to Pests Co.	$120.50				
02 Survey Fee	to Surveys Co.	$85.00				
03 Title – Insurance Binder	to Epsilon Title Co.	$650.00				
04 Title – Lender's Title Insurance	to Epsilon Title Co.	$500.00				
05 Title – Settlement Agent Fee	to Epsilon Title Co.	$500.00				
06 Title – Title Search	to Epsilon Title Co.	$800.00				
07						
08						
D. TOTAL LOAN COSTS (Borrower-Paid)		**$4,694.05**				
Loan Costs Subtotals (A + B + C)		$4,664.25	$29.80			

Other Costs						
E. Taxes and Other Government Fees		**$85.00**				
01 Recording Fees	Deed: $40.00 Mortgage: $45.00	$85.00				
02 Transfer Tax	to Any State			$950.00		
F. Prepaids		**$2,120.80**				
01 Homeowner's Insurance Premium (12 mo.)	to Insurance Co.	$1,209.96				
02 Mortgage Insurance Premium (mo.)						
03 Prepaid Interest ($17.44 per day from 4/15/13 to 5/1/13)		$279.04				
04 Property Taxes (6 mo.)	to Any County USA	$631.80				
05						
G. Initial Escrow Payment at Closing		**$412.25**				
01 Homeowner's Insurance $100.83	per month for 2 mo.	$201.66				
02 Mortgage Insurance	per month for mo.					
03 Property Taxes $105.30	per month for 2 mo.	$210.60				
04						
05						
06						
07						
08 Aggregate Adjustment		– 0.01				
H. Other		**$2,400.00**				
01 HOA Capital Contribution	to HOA Acre Inc.	$500.00				
02 HOA Processing Fee	to HOA Acre Inc.	$150.00				
03 Home Inspection Fee	to Engineers Inc.	$750.00			$750.00	
04 Home Warranty Fee	to XYZ Warranty Inc.			$450.00		
05 Real Estate Commission	to Alpha Real Estate Broker			$5,700.00		
06 Real Estate Commission	to Omega Real Estate Broker			$5,700.00		
07 Title – Owner's Title Insurance (optional)	to Epsilon Title Co.	$1,000.00				
08						
I. TOTAL OTHER COSTS (Borrower-Paid)		**$5,018.05**				
Other Costs Subtotals (E + F + G + H)		$5,018.05				

J. TOTAL CLOSING COSTS (Borrower-Paid)		**$9,712.10**				
Closing Costs Subtotals (D + I)		$9,682.30	$29.80	$12,800.00	$750.00	$405.00
Lender Credits						

CLOSING DISCLOSURE PAGE 2 OF 5 • LOAN ID # 123456789

Calculating Cash to Close

Use this table to see what has changed from your Loan Estimate.

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

Summaries of Transactions

Use this table to see a summary of your transaction.

BORROWER'S TRANSACTION

K. Due from Borrower at Closing				**$189,762.30**
01	Sale Price of Property			$180,000.00
02	Sale Price of Any Personal Property Included in Sale			
03	Closing Costs Paid at Closing (J)			$9,682.30
04				
Adjustments				
05				
06				
07				
Adjustments for Items Paid by Seller in Advance				
08	City/Town Taxes		to	
09	County Taxes		to	
10	Assessments		to	
11	HOA Dues	4/14/16	to 4/30/16	$80.00
12				
13				
14				
15				
L. Paid Already by or on Behalf of Borrower at Closing				**$175,615.04**
01	Deposit			$10,000.00
02	Loan Amount			$162,000.00
03	Existing Loan(s) Assumed or Taken Subject to			
04				
05	Seller Credit			$2,500.00
Other Credits				
06	Rebate from Epsilon Title Co.			$750.00
07				
Adjustments				
08				
09				
10				
11				
Adjustments for Items Unpaid by Seller				
12	City/Town Taxes	1/1/16	to 4/14/16	$365.04
13	County Taxes		to	
14	Assessments		to	
15				
16				
17				

CALCULATION	
Total Due from Borrower at Closing (K)	$189,762.30
Total Paid Already by or on Behalf of Borrower at Closing (L)	– $175,615.04
Cash to Close ☒ From ☐ To Borrower	**$14,147.26**

SELLER'S TRANSACTION

M. Due to Seller at Closing				**$180,080.00**
01	Sale Price of Property			$180,000.00
02	Sale Price of Any Personal Property Included in Sale			
03				
04				
05				
06				
07				
08				
Adjustments for Items Paid by Seller in Advance				
09	City/Town Taxes		to	
10	County Taxes		to	
11	Assessments		to	
12	HOA Dues	4/14/16	to 4/30/16	$80.00
13				
14				
15				
16				
N. Due from Seller at Closing				**$115,665.04**
01	Excess Deposit			
02	Closing Costs Paid at Closing (J)			$12,800.00
03	Existing Loan(s) Assumed or Taken Subject to			
04	Payoff of First Mortgage Loan			$100,000.00
05	Payoff of Second Mortgage Loan			
06				
07				
08	Seller Credit			$2,500.00
09				
10				
11				
12				
13				
Adjustments for Items Unpaid by Seller				
14	City/Town Taxes	1/1/16	to 4/14/16	$365.04
15	County Taxes		to	
16	Assessments		to	
17				
18				
19				

CALCULATION	
Total Due to Seller at Closing (M)	$180,080.00
Total Due from Seller at Closing (N)	– $115,665.04
Cash ☐ From ☒ To Seller	**$64,414.96**

Additional Information About This Loan

Loan Disclosures

Assumption
If you sell or transfer this property to another person, your lender
☐ will allow, under certain conditions, this person to assume this loan on the original terms.
☒ will not allow assumption of this loan on the original terms.

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

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

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

Partial Payments
Your lender
☒ may accept payments that are less than the full amount due (partial payments) and apply them to your loan.
☐ may hold them in a separate account until you pay the rest of the payment, and then apply the full payment to your loan.
☐ does not accept any partial payments.
If this loan is sold, your new lender may have a different policy.

Security Interest
You are granting a security interest in
456 Somewhere Ave., Anytown, ST 12345

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

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

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

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

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

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

Loan Calculations

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

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

Other Disclosures

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

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

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

☒ state law may protect you from liability for the unpaid balance. If you refinance or take on any additional debt on this property, you may lose this protection and have to pay any debt remaining even after foreclosure. You may want to consult a lawyer for more information.

☐ state law does not protect you from liability for the unpaid balance.

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

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

Contact Information

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

Confirm Receipt

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

Applicant Signature Date

Co-Applicant Signature Date

Closing Disclosure Page 3

The Calculating Cash to Close Section of **Page 3** has columns to compare items from the ***Loan Estimate*** to the **Final** amount to arrive at **Cash to Close**, which is the amount the borrower must bring to closing.

In the Summaries of Transaction tables, the amounts associated with the real estate purchase transaction between the buyer and seller, together with closing costs, are itemized in order to disclose the amounts d**ue from the borrower** or **due to the seller** at closing as applicable. The borrower's debits and credits are on the left side of the page; the seller's debits and credits are on the right side of the page.

The Borrower's Transaction debits and credits and the Seller's Transaction debits and credits are reconciled, with the **final calculations** indicated at the bottom of the page.

Closing Disclosure Pages 4 and 5

Pages 4 and 5 are primarily of interest to the borrower, as they provide details about the loan itself. Characteristics of the loan are found on Page 4, for example, whether there are late fees, an acceleration or due on sale clause, the possibility for negative amortization, and whether the loan may be assumed. Page 5 includes four sections:

- **Loan Calculations.** Details about the payments made by the borrower, such as total of payments, finance charge, and the annual percentage rate.
- **Other Disclosures.** Miscellaneous disclosures to the borrower about their ongoing rights and responsibilities.
- **Contact Information.** Includes lender, mortgage broker, real estate broker(s), and settlement agent as applicable.
- **Confirm Receipt.** The signature(s) of the borrower(s).

Summary

1. **Lender's return** is the total amount a lender or broker makes on a loan. For lenders, this can come from loan fees, discount points, or, for mortgage brokers, yield spread premium. **Points** are 1% of loan amount; increase lender's yield, and are paid for many reasons. **Discount points** are used to buy down the interest rate. **Yield spread premium** is a tool mortgage brokers can use to reduce a borrower's settlement costs.
2. Borrowers can get pre-qualified or pre-approved. **Pre-qualification** is when a real estate broker or lender reviews a borrower's history to determine if they're likely to get approved for a loan, and the approximate amount. Pre-qualification is *not* binding on the lender. **Pre-approval** is when a lender uses an application to determine that potential borrowers can be financed for a certain amount for a specific property. Neither a mortgage broker nor a real estate broker can give a borrower a pre-approval; only a lender can.
3. Address and **employment** information must go back two to three years. **Income** should be stable and verifiable. Alimony/child support may be excluded as income if borrower chooses. Those who are self-employed may need personal and company tax returns and financial statements for two years. **Assets** and **liabilities** must all be disclosed, including alimony and child support, if it's an obligation. **Debts** are recurring obligations that will not be cancelled (debts with less than 10 payments left are not counted). **Liquid assets** can be quickly and easily converted to cash. **Net worth** is assets minus liabilities.
4. **Bankruptcy** is a court process that cancels debt and provides some relief for creditors. Chapter 7 bankruptcy is a liquidation proceeding where the debtor receives a discharge of all dischargeable debts. Chapter 13 bankruptcy is filed by individuals who want to pay off their debts over a period of three to five years. Chapter 13 bankruptcy usually appears on a credit report for 7 years.
5. Monthly **income** must show stability, quality, and durability. Bonuses, commission, part-time earnings, and overtime all count if shown to be a consistent part of the borrower's income for the past few years. Lenders do not usually count temporary unemployment, welfare, and other income. **Credit history** is a record of debt repayment. **Credit scoring** is an objective means of evaluating credit. Lenders verify assets and may require financial statements. The three main credit bureaus produce similar credit scores, which range from about **300 to 850.** A **gift letter** can show part of the down payment/closing costs are a non-repayable gift.
6. Conforming loans sold on the secondary market (e.g., Fannie Mae and Freddie Mac) require income ratios of **28%** for housing expense and **36%** for debt-to-income (DTI). The housing expense ratio is the relationship of the borrower's total monthly housing expense (Principal, Interest, Taxes, Insurance or PITI) to income (stable monthly income), expressed as a percentage. PITI also includes required homeowners association fees. Total debt-to-income ratio is the relationship of the borrower's total monthly debt obligations (including housing and debts that will not be cancelled and that have ten or more payments remaining) to income (stable monthly income), expressed as a percentage. A borrower must qualify under **both** ratios.
7. **Closing**, also called settlement, is the culmination of the loan process where papers are signed and funds disbursed. In a real estate sales transaction, it's also the transfer of ownership of real estate from a seller to a buyer, per terms of the sales contract. The **Closing Disclosure** is mandated by RESPA and TILA to clearly itemize all charges imposed upon the borrower and the seller by the loan originator, all sales commissions—whether to be paid at settlement or outside of settlement—and any other charges which either the borrower or the seller will pay at settlement. It also provides final details about the loan terms and characteristics, including the annual percentage rate.
8. **Debits** (like debts) are any sum of money that is owed. A debit is charged to a particular party on a balance sheet to represent money that must be paid to the other party. **Credits** are indicated as that sum of money either already paid before closing, paid by a third party, or to be reimbursed at closing, whether it is the buyer or the seller. **Proration** is the adjustment of expenses between buyer and seller in proportion to the actual use of the item represented by a particular expense. **Accrued expenses** are the items on a settlement statement for which the cost has been incurred, but the expense has not yet been paid. **Prepaid expenses** are the items on the settlement statement that the seller has already paid, but will not be used because he or she no longer owns the property. Prorations are calculated based on a 360-day year (12 months of 30 days each) or a 365-day year to account for the specific number of days in the proration period.

Quiz

1. ***Jon buys a house for $150,000. He makes a $30,000 down payment and pays three discount points. What is the total cost of the discount points?***
   a. $1,500
   b. $3,000
   c. $3,600
   d. $4,500

2. ***A gift letter***
   a. can come from a borrower's parent or guardian only.
   b. cannot be used for part of the down payment.
   c. must be signed by the donor.
   d. must state when the gift is to be repaid.

3. ***When qualifying for a conventional loan, stable monthly income could include***
   a. alimony received (that a borrower chooses to reveal).
   b. bonus received for the first time last year.
   c. erratic unemployment earnings.
   d. income from other family members.

4. ***If you use this calculation when evaluating income—"PITI divided by Gross Monthly Income"—you have just determined what?***
   a. housing expense ratio
   b. loan-to-value
   c. net income
   d. total debt-to-income

5. ***Johanna wants to get a loan to buy a house. When evaluating her credit obligations, which would LEAST LIKELY be considered as debt?***
   a. car loan payment with 15 payments left
   b. cell phone service payment
   c. child support payments
   d. credit card payments

6. ***A borrower has a stable monthly income of $3,200 and recurring monthly debts of $370. What is the maximum mortgage amount (PITI) he could get for a conforming loan?***
   a. $782
   b. $896
   c. $928
   d. $1,152

7. ***Which statement about pre-qualification of a buyer is TRUE?***
   a. Pre-qualification always requires an application fee.
   b. Pre-qualification of a buyer is not binding on the lender.
   c. Pre-qualification of a buyer is not useful to the real estate agent.
   d. Pre-qualification requires the lender to pull a credit report.

8. ***Which law mandates the use of the Closing Disclosure for the purpose of itemizing closing costs?***
   a. Equal Credit Opportunity Act
   b. Fair Credit Reporting Act
   c. Real Estate Settlement Procedures Act
   d. Truth in Lending Act

9. ***When qualifying for a conventional mortgage loan, which would be LEAST LIKELY to count as allowable income?***
   a. annual bonuses
   b. occasional overtime
   c. retirement income
   d. salary

10. ***Paula has been at her job for 10 years and typically works overtime 5 hours per week at time and a half. Her hourly rate is $15.75. What is the gross monthly income you can use to qualify Paula?***
    a. $2,614.5
    b. $2,830.22
    c. $3,170.05
    d. $3,241.88

11. ***A credit report shows the borrower's***
    a. current purchase or sale agreement.
    b. history of making payments on past debts and obligations.
    c. housing expense ratio.
    d. tax returns for the previous two years.

12. ***What factor is given the LEAST consideration when evaluating a mortgage loan application?***
    a. amount of income
    b. credit history
    c. debt
    d. source of income



23 Real Estate Finance Options

Mortgage loans come in all shapes and sizes. Even buyers with very specific needs can usually find a loan to help them achieve their property-ownership goals. Within the broad categories of conventional or government-backed, there are numerous types of mortgages available. Mortgage types can be broken down by how they are repaid, what their purpose is, what collateral is used as security for the loan, and the specific situations for which they may be used. While a real estate licensee should not give financial advice, it is helpful to have a solid understanding of the available real estate finance options. In this chapter, you will be introduced to financing instruments and the rights and duties of the parties involved. These include financing instruments, such as promissory notes, and security instruments, such as trust deeds and mortgages. We'll also discuss types and features of mortgages, as well as typical clauses found in these instruments.

You will learn:

- The difference between a financing instrument and a security instrument.
- Advantages and disadvantages of trust deeds and mortgages.
- How the foreclosure process works.
- Characteristics of a conventional loan.
- The purpose of private mortgage insurance.
- The use of different types of mortgages.
- The purpose of typical mortgage clauses.
- The elements that make up an adjustable rate mortgage.
- Basic qualifying standards for FHA-insured loans.
- Basic qualifying standards for VA-guaranteed loans.

Key Terms

Acceleration Clause
Adjustable Rate Mortgage (ARM)
Alienation Clause
Amortization
Balloon Payment
Construction Loan
Conventional Loan
Equitable Right of Redemption
Equitable Title
Fixed Rate Loan
Foreclosure
Hypothecate
Judicial Foreclosure
Jumbo Loan
Land Contract
Lease/Option
Lease/Purchase
Lis Pendens
Loan-to-Value Ratio (LTV)
Mortgage
Negative Amortization
Negotiable Instrument
Non-Judicial Foreclosure
Note Rate
Private Mortgage Insurance (PMI)
Promissory Note
Security Instrument
Short Sale
Statutory Right of Redemption
Strict Foreclosure
Subordination Agreement
Subprime Loan
Teaser Rate
Trust Deed (or Deed of Trust)

Financing Overview

Finance instruments are *legal documents that establish the rights and duties of all parties involved in a transaction.* In almost all real estate financing transactions, there are two types of real estate finance documents: A **financing instrument**, typically a promissory note, and an accompanying **security instrument**.

A security instrument requires a debtor to **hypothecate** his or her property as a condition of a loan, which means that *a debtor pledges personal or real property as security for a debt without giving up possession of it.* Security instruments are usually recorded in the public record. A security instrument such as a mortgage or trust deed serves as protection for the creditor, and motivation for the debtor, to make sure that the terms of the note are fulfilled and the note is repaid as agreed. Keep in mind, though, that a security instrument just describes collateral for a note. Even without a security instrument, the debtor is still obligated to pay the note. When the debt is repaid, the note and the security instrument become void.

Promissory Notes

Promissory notes are *financing instruments that evidence a promise to pay a specific amount of money to a specific person within a specific time frame.* Simply stated, a promissory note is a written promise to pay money. Before a lender will finance the purchase of a house, the borrower must promise to repay the funds. The *one promising to pay the money* is called the **maker** of the note, usually the borrower. The *one to whom payment is promised* is called the **payee**, usually the lender, which could also be the seller. Promissory notes are basic evidence of debt, showing who owes how much to whom. A typical promissory note includes:

- Date
- Names of the parties
- Amount of the debt, including the interest rate used to amortize the debt (note rate)
- How and when the money is to be paid
- What happens in the event of default
- Signature of the maker

Most promissory notes used in real estate are **negotiable instruments**, which means that they are *freely transferable from one party to another.* When a note is freely transferable, the lender or other creditor can obtain immediate cash by selling the note, for example, when a lender sells real estate notes to the secondary market.

Trust Deeds

Trust deeds, or deeds of trust, are instruments *placing a specific financial interest in the title to real property into the hands of a disinterested third party as security for the payment of a note*. With a trust deed, the borrower is called the **trustor**; the lender is the **beneficiary**; and the party holding the trust deed (and perhaps the note) is the **trustee**. Who is eligible to be a trustee varies from state to state; it could be an attorney, for example, or a title company that provides trustee services. With a trust deed, the borrower has possession of and **equitable title** to the property. When the loan is fully paid, the beneficiary conveys clear title to the borrower, releasing the debt obligation.

Another distinguishing characteristic of trust deeds is that the trustee may begin a **non-judicial foreclosure action** when the debtor defaults on the note or trust deed. This non-judicial action is authorized by a **power of sale clause** in the trust deed, which allows the trustee to sell the property without the time and expense involved in court proceedings. The borrower, however, has the right to stop the sale and reinstate the loan by making back payments (plus interest, trustee's fees, and attorneys' fees). Trust deeds are more common in some states than in others.

Mortgages

A **mortgage** is the *conveyance of an interest in real property to a lender as security for the payment of a note.* A mortgage is a type of security instrument where the borrower (the **mortgagor**) pledges property to the lender (the **mortgagee**) as collateral for the debt, creating a **voluntary lien** on the property.

For the lender, the main advantages of mortgages are the right to **accelerate** the entire debt in the event of default and the authority of the court for **judicial foreclosure**. The main disadvantage is the time and expense involved with judicial foreclosure. Legal fees and court costs can be several thousand dollars, which the lender may or may not recover from the sale, and the entire process can take several months, or even years, to complete. Some states allow mortgagees to conduct their own sale of foreclosed property through a **power of sale clause**. For the debtor, the advantages and disadvantages of mortgages are the opposite of the lender's. The lender's right of acceleration can mean that a borrower who misses one or two payments may have to pay off the entire debt to save the home, but the debtor may have a long time to get the money together in the event of lengthy court proceedings.

Loan Repayment

A mortgage or deed of trust, like any loan, consists of two components:

- The **principal**, which is *the amount originally borrowed.*
- The **interest**, which is *the charge a borrower pays to a lender for the use of the lender's money.*

Amortization is the *reduction of the balance of the loan by paying back some of the principal owed on a regular basis*. **Negative amortization** *occurs when a loan balance grows because payments do not cover the interest on the loan.* Loans may be amortized a number of ways.

Fully Amortizing Loans

With a **fully amortizing loan**, *regular payments are applied first to interest owed and then to the principal amount over a number of years (the term).* Initially, more of the monthly payment goes to the interest payment and less goes to principal reduction. If all payments are made on time, the loan will be paid off in full with the last scheduled payment.

An **amortization schedule** is a tool that borrowers and lenders can use to *show exactly how much of each payment of a fully amortizing loan will be applied toward principal and how much toward interest over the life of the loan.* Some amortization schedules show only a year-to-year schedule, while others show a month-to-month breakdown. All amortization schedules will show the total amount that the loan is costing the borrower over its entire term.

Straight Loans

A **straight loan** is one in which the *regular payments cover only the interest over the term of the loan.* At the end of the term, a lump sum payment of the principal is required. This is also known as an **interest only loan**, sometimes shown as an I/O loan.

Partially Amortizing Loans

A **partially amortizing loan,** sometimes known as a **balloon loan**, has *periodic payments that do not fully amortize the loan by the end of the loan term.* Therefore, the final payment is larger than the others and is known as a balloon payment.

Lien Theory and Title Theory

Some states follow what is called lien theory, others follow what is called title theory, and some states—like Illinois—follow a hybrid of the two.

In **lien theory** states, the *security instrument creates a lien against the property which must be repaid by the debtor.* The property serves as collateral that is hypothecated to the lender as security for the debt, but the borrower holds the title to the property. The lender may be required to go through a judicial foreclosure proceeding to obtain title in the event of default.

In **title theory** states, the *security instrument gives actual title to the property to the lender while the debt is outstanding, with the borrower getting only* ***equitable title*** *and possession of the land*. Once the mortgage amount has been repaid, legal title is conveyed to the owner. The lender does have restricted rights in the property, but does not have to go through a lengthy foreclosure proceeding in the event of default.

The state of Illinois is an **intermediate theory** state, which means it functions under a combination of the two lien theories. Intermediate theory is usually based on title theory law and requires a lender to foreclose to obtain legal title. Under intermediate theory:

- The borrower mortgagor is recognized as the **owner** of the mortgaged land.
- The borrower holds **legal title**.
- The lender holds a lien which is released when the debt is repaid.
- The lender is required to pursue foreclosure through a court action (judicial foreclosure) in the event the borrower (mortgagor) should default on the debt.

Lien Position

Lien position establishes the *order in which liens are paid off out of the proceeds of a foreclosure sale*. Real estate tax liens—and other liens such as mechanic's liens, depending on the jurisdiction—almost always have the highest priority and get paid first, followed by the first recorded lien. Then if there's money left, the second lien gets paid, and so on. Once the funds are exhausted, liens in a later position get nothing.

A **first mortgage** is a *security instrument with a first lien position*. As such, a first mortgage almost always has priority over all other mortgages, meaning the first mortgage holder is paid first in the event of a foreclosure sale.

A **second mortgage** is a *security instrument in a second lien position.* A second mortgage may be used to help buy the property (e.g., a small loan from the seller), or a second mortgage might be taken out later (e.g., a home equity loan) to generate additional funds from the owner's accumulated equity in the property for repairs, college tuition, or for some other purpose. Although property is still used as security, the second mortgage lender is in a riskier position because a first mortgage gets paid first out of foreclosure proceedings. If nothing is left, the second mortgage holder gets nothing.

Generally speaking, *any mortgage in a higher lien position* is said to be a **senior mortgage**, so a first mortgage is always a senior mortgage. A **junior mortgage** is *any mortgage with a lower lien position than another.* Thus, a second mortgage is a junior mortgage to a first mortgage, but a second mortgage is a senior mortgage to a third mortgage.

Subordination Agreement

In some situations, the parties may desire that a later recorded instrument have priority over an earlier recorded instrument. This is common in construction financing, for example. Because of the high-risk nature of construction loans, construction lenders frequently refuse to lend any money unless they can be assured of a first lien position. Since the developer, in many cases, has already purchased the land on some sort of deferred payment plan, there is often a security instrument (mortgage, trust deed, or land contract) that has already been recorded. For the later construction loan mortgage to take priority over the earlier recorded mortgage instrument on the land, the first lender would file a **subordination agreement** in the public record that permits the second lien holder to be in first lien position.

Conventional Loans

Today, nearly half of all residential real estate lending is completed with conventional financing programs. Conventional financing refers to real estate that is paid for or financed with a **conventional loan**—one that is usually made by a bank or institutional lender and that is *not insured or guaranteed by a government entity or agency, such as FHA or VA.* Most conventional loans are, however, written to guidelines set by government-sponsored entities (GSEs), such as Freddie Mac and Fannie Mae, so that they may be sold in the secondary market.

Conforming versus Nonconforming Loans

When a loan meets the criteria necessary to be sold in the secondary market, it is considered a **conforming loan**. **Nonconforming loans**, on the other hand, do *not* meet these standards, and therefore *cannot be sold to Fannie Mae or Freddie Mac.* There are two main reasons why a loan would be classified as nonconforming:

- **Size of the Loan.** So-called **jumbo loans** *exceed the maximum loan amount established by Fannie Mae and Freddie Mac for conforming mortgage loans.*
- **Credit Quality of Borrower.** You may see a borrower who does not meet the minimum standards established by Fannie Mae/Freddie Mac classified as a **B or C borrower**, for example, someone who has had a credit problem in the past. Until recently, such **subprime loans** were alternative financing tools to help people with questionable credit reach their goal of homeownership. Some lenders and investors were willing to make these riskier loans because they could charge much higher rates. For some borrowers, it was the only way to buy a house and re-establish credit. In the current mortgage climate, few, if any, lenders are willing to make subprime loans.

Traditional Conventional Loans

Traditional conventional loans are typically **long-term, fully amortizing, fixed rate real estate loans**. This is the type of loan with which borrowers are most familiar.

- **Long-Term.** Long-term real estate loans generally have total payments spread out over 25 to 30 years, and even 40-year terms are offered.
- **Fully Amortizing.** The *total payments over the life of a loan pay off the entire balance of principal and interest due at the end of the term.* This is also known as **self-liquidating**. The payments stay constant for the entire loan term, although the amounts applied to principal and interest are adjusted each month.
- **Fixed Rate. Fixed rate loans** have *interest rates that remain constant for the duration of the loan.* This is both good and bad for the borrower and the lender. Of course, the biggest advantage is that a borrower doesn't need to worry that rates will increase. If rates decrease enough, the borrower can refinance. From the lender's perspective, there's a guaranteed rate of return, but the rate is locked in for 30 years, which benefits the borrower when rates go up.

15-Year Mortgage Loans

Lenders will often give a borrower a better interest rate on a 15-year mortgage because the shorter term means less risk for the lender. Over the life of the mortgage, the **total interest** paid on a 15-year, fixed rate mortgage is about **one-third less** than a 30-year mortgage at the same interest rate. An added benefit is that the borrower can attain full ownership in half the time it takes to pay off a 30-year mortgage. Of course, there are *disadvantages* to 15-year mortgages:

- Payments are higher.
- Higher payments consume financial resources that might be invested other ways and earn a higher return than the interest rate paid on the mortgage.
- The borrower loses the income tax deduction more quickly because the home is paid for sooner.

Loan-to-Value Ratio

Conventional loan programs can be classified by the **percentage of down payment** that the borrower pays to get the loan. The **loan-to-value ratio** (LTV), then, refers to *the amount of money borrowed (the loan amount of a first mortgage) compared to the value of the property.* Lenders use LTV to determine how much they are willing to loan on a given property based on its value. The lender will always use the *lower* of the appraised value or the sale price in order to protect its interest. The lower the LTV, the higher the borrower's down payment, which means the loan is more secure.

For example, for years, the **80% conventional loan** was the standard conventional loan, so for a house with a sale price of $200,000, the most a borrower could borrow would be:

$200,000 x 0.8 = $160,000 loan amount

Subtracting the loan amount from the sale price indicates that the borrower would need a down payment of $40,000.

Case in Point

Bill wants to buy a house that costs $160,000. For an 80% conventional loan, he can borrow $128,000 and needs to make a 20% down payment, or $32,000. If the house appraises for less than $160,000—say $150,000—then Bill can borrow only 80% of the appraised value ($120,000). Bill has a couple of options if he still wants to buy the home: He can offer the seller the appraised value of $150,000, or he needs to come up with an additional $8,000 as part of his down payment.

Higher LTV Loans

A borrower who does not have enough money for a 20% down payment but still wants a conventional loan can try to get a 90% conventional loan with a 10% down payment, a 95% conventional loan with a 5% down payment, or even a 100% conventional loan. Loans with a LTV higher than 80% are possible because of private mortgage insurance (PMI) and secondary financing. The qualifying standards for higher LTV loans tend to be more stringent, and lenders adhere to those standards more strictly. These loans may also have a higher interest rate, call for higher loan origination fees, or impose additional conditions and standards.

Private Mortgage Insurance (PMI)

Private mortgage insurance (PMI) is *offered by private companies to insure a lender against default on a loan by a borrower.* Prior to the advent of PMI, lenders would only lend 80% of the value of a property, assuming that the 20% down payment was the incentive needed for the borrower to keep mortgage payments current. Lenders also felt comfortable that, in the event of default, a foreclosure sale would yield 80% of the original sale price (or appraised value) and recover the loan amount. PMI evolved to compensate the lender for the reduced borrower equity, thus making loans easier for borrowers and safer for lenders.

When insuring a loan, the mortgage insurance company shares the lender's risk, but only *part of the risk.* The insurer does *not* insure the entire loan amount but rather the *upper portion of the loan* that exceeds the standard 80% LTV. The amount of coverage can vary, but is typically 20% to 25% of the loan amount.

In the event of default, the insurer and the lender will negotiate how best to proceed. For example, the insurer could pay off the loan or allow the lender to foreclose. If the proceedings from the foreclosure action do not fully reimburse the lender for the principal balance, the lender may be able to make a claim against the insurer. If the insurer were to take the loan, the insurer may be able to file for a deficiency judgment against the borrower.

The traditional way that private mortgage insurance companies charge for PMI is with a one-time fee at closing when the loan is made and a recurring fee, called a renewal premium, that's added to the borrower's monthly mortgage payment.

PMI Cancellation

Once the increased risk of borrower default is gone (when the loan-to-value ratio is reduced to 80% or less), mortgage insurance has fulfilled its purpose. In the past, many lenders didn't cancel PMI even when the risk was reduced. The **Homeowners Protection Act of 1998 (HPA)** requires lenders to automatically cancel PMI when a home has been paid down to **78% of its original value**, assuming the borrower is not delinquent. The law also says that lenders must drop PMI coverage at a borrower's request when the loan has been paid down to **80% or less** of the home's value and mortgage payments are current.

Secondary Financing

Secondary financing is when *a buyer borrows money from another source to pay part of the purchase price or closing costs.* This is another way a borrower can get a conventional loan without a 20% down payment. With secondary financing, it may be the **seller** who carries the extra financing. In effect, the seller extends credit to the borrower, just as if the money had been borrowed from a finance company. When underwriting a loan that will have secondary financing, the primary lender will include that payment as part of the borrower's monthly housing expense and consider the total amount borrowed when determining the **combined loan-to-value** (CLTV). For the purpose of private mortgage insurance, however, only the **loan-to-value ratio** of the first mortgage is considered, so a borrower with a higher CLTV would not have to pay PMI if the LTV is 80% or less.

Types and Features of Mortgages

There are actually many different types of mortgages, and they all share many characteristics and have the same origins. The history of the actual word "mortgage" is very interesting. "Mort"—from the Latin—means "death," while "gage" means something deposited as a pledge of performance. So the word mortgage literally means a "dead pledge" in that the property is forfeit or dead to the borrower if the loan isn't repaid, and the pledge or conveyance is dead once the loan is repaid.

Although mortgages are primarily security devices used to collateralize real estate loans, the word mortgage is often prefaced with adjectives that describe the particular function the mortgage is serving, or the nature of the circumstances surrounding its use. For example, a construction mortgage is a mortgage used to secure a construction loan; a blanket mortgage secures a loan with two or more parcels of land as collateral, etc.



Some mortgage loans can be more than one type of mortgage loan at the same time, plus some share many different mortgage features. For example, you can have a conventional mortgage loan that is a first mortgage (and thus a senior mortgage), and this same mortgage can also be an adjustable rate mortgage that is a construction mortgage. Of course, some of the mortgage types and features are mutually exclusive—a construction mortgage cannot also be a reverse equity mortgage.

Purchase Money Mortgage

The term **purchase money mortgage** generally describes *any mortgage given by a buyer to a lender or a seller to secure part or all of the money that's borrowed to purchase property.* When a seller takes part of the purchase price as a mortgage to help the sale, it may also be known as a **soft money loan**, because the borrower receives credit toward the purchase instead of actual cash. A purchase money mortgage can be a first mortgage or a junior mortgage, depending on its lien priority.

Special Purpose Mortgages

Mortgages that are used for specific situations include the following:

Blanket Mortgage. *Covers more than one parcel of land or lot*, and is usually used to finance subdivision developments. These loans usually have a **partial release clause**, allowing the borrower to pay a certain amount to release some of the lots with the mortgage continuing to cover the remaining lots.

Bridge Mortgage. Occurs *between the termination of one mortgage and the beginning of the next.* When the next mortgage is taken out, the bridge mortgage is repaid. Bridge mortgages are designed to be temporary, and are used most commonly for construction financing or, less commonly, for someone buying a new home before selling the old one.

Package Mortgage. *Includes personal property, like appliances, in the property sale and all are financed together in one contract.* With package mortgages, the personal property also serves as collateral for the loan. A common use for this type of mortgage is to buy a furnished condominium, where the loan and mortgage documents may also recite appliances and/or furniture as part of the transaction.

Wraparound Mortgage. Describes a financing arrangement in which *an existing loan on a property is retained while the lender gives the borrower another, larger loan.* For example, this arrangement could be used in lieu of traditional refinancing where a lender makes a second loan to a borrower, leaving the first loan intact. The borrower pays the wraparound lender a single payment on the combined principal. If the wraparound lender is not the original lender, then the wraparound lender makes payments on the original mortgage to the first mortgage lender. This type of arrangement gives a borrower more favorable terms than a typical refinance, since the wraparound lender is advancing only the difference between the unpaid first mortgage and the combined principal of both loans. Less commonly, a wraparound mortgage could be used as a form of seller financing.

Mortgages for Additional Funds and Refinance

Refinance Mortgages. One *where the borrower replaces the current mortgage with a new loan*. This can be a way for a borrower to simply get better terms compared to the original mortgage, for example, to lower the interest rate, change an adjustable rate to a fixed rate, change a 30-year loan to a 15-year loan, combine multiple mortgages into one, or remove private mortgage insurance. This transaction could be a no cash-out refinance or a cash-out refinance.

Home Equity Loan, Home Equity Line of Credit. A loan *secured by a mortgage on one's principal residence.* A **home equity loan** is typically a **closed-end** loan that offers a fixed amount of money that can be repaid with regular payments over a fixed term. A **home equity line of credit** (HELOC) is a type of **open-end** loan in which a borrower is granted a specific credit limit from which he can draw and pay back principal only as it is used. Usually, these financing vehicles attach a junior mortgage to the property.

Reverse Mortgage. *Allows qualified homeowners age 62 or older to convert equity in the home into a monthly cash stream or line of credit.* The borrower must have a substantial amount of equity in the home to make this option viable. The mortgage is repaid when the home is sold, the borrower does not occupy the home for 12 consecutive months, or the borrower dies. This is also called a reverse annuity mortgage, reverse equity mortgage, or home equity conversion mortgage (HECM).

Construction Mortgages

A **construction loan** is a *temporary loan used to finance the construction of improvements and buildings on land.* Generally, an appraiser will value the property for a construction loan by evaluating the building plans and specifications, completing a "subject to" appraisal. When construction is complete, the appraiser verifies that specifications have been met and the original opinion of value is valid; then the loan is replaced by a permanent amortizing loan, called a **take out loan**. New construction can take as long as a year to complete; therefore, some contracts may include **extended rate locks**.

Construction loans can be profitable, but lenders regard them as risky. Thus, not only do they charge high interest rates and loan fees on construction loans, they also closely supervise the disbursement of funds to ensure that projects are completed. There's always the danger that a borrower will overspend and exhaust the loan funds before construction is complete. If the borrower doesn't have money to finish a project, the lender is left with a partially completed project that can't be sold easily in its existing state—with a very real possibility of foreclosure. To protect themselves against this problem, lenders use plans for **disbursing construction loan proceeds** to guard against overspending by the borrower. Three common disbursement plans are fixed disbursement plan, voucher system, and warrant system.

Disbursement

A **fixed disbursement plan** *pays a percentage of funds at a set time.* A series of predetermined disbursements, called **obligatory advances,** are paid out at various stages of construction. For example, the loan agreement may state that the lender will release only 10% of the funds when a project is 20% complete, with future draws of 20% each time construction progresses 20% more toward completion.

First Release/Draw	10% of Loan	Project 20% complete
Second Release/Draw	20% of Loan	Project 40% complete
Third Release/Draw	20% of Loan	Project 60% complete
Fourth Release/Draw	20% of Loan	Project 80% complete
Fifth Release/Draw	20% of Loan	Project 100% complete

Lenders often hold the final 10% (or more) of the loan proceeds until the lien period has expired to protect against unpaid mechanic's liens, which could affect the marketability of the property. If a valid mechanic's lien is recorded, the construction loan agreement usually allows lenders to pay it from the part of the loan not disbursed.

- **Voucher System.** The contractor or borrower must pay his or her own bills, and then submit the receipts to the lender for reimbursement.
- **Warrant System.** The lender directly pays bills presented by the various suppliers and laborers on a project.

Permanent Construction Loan

A **permanent construction loan** is a *special type of construction loan where there is only one loan and one closing, with no take out loan.* There is a fixed disbursement schedule for loan funds, and the loan automatically converts to a permanent first mortgage when construction is finished.

Payment Structures

Earlier you saw that a conventional mortgage had a fixed rate, meaning that the interest rate remains the same for the life of the loan. When the payment structure is something other than fixed, the loan is considered to be nontraditional.

Graduated Payment Mortgage (GPM)

A **graduated payment mortgage** is a specialized payment structure that *allows the borrower to make smaller payments in the early years of a mortgage*. The lower payments in the early years of a mortgage structured in the note as a GPM are not sufficient to cover the interest due on the loan, and so the unpaid interest is added to the loan balance, resulting in a scheduled period of **negative amortization**. At a predetermined point in the loan term, the payments escalate on a scheduled basis until they eventually reach the point in which they are sufficient to fully amortize the loan over the remainder of its term.

Graduated Payment Buydown

A **graduated payment buydown** is a plan for which *payment subsidies in the early years keep payments low, but payments increase each year until they're sufficient to fully amortize the loan.* Usually there's a definite structure to the loan such that the subsidy may last for only two or three years. These are two common types of graduated payment buydown plans:

- **2-1 buydown** is a graduated payment buydown with the payments subsidized for only two years—usually 2% below the interest rate in the first year and 1% the second year.
- **3-2-1 buydown** is a graduated payment buydown with the payments subsidized for three years—3% below the interest rate the first year, 2% the second year, and 1% the third year.

The subsidies for graduated payment buydowns may be a borrower's upfront escrow deposit of extra cash that earns interest, or the subsidy may be from a seller or builder trying to help a buyer with lower payments early in the loan.

Adjustable Rate Mortgages (ARMs)

Adjustable rate mortgages (ARMs) permit the lender *to periodically adjust the interest rate to reflect fluctuations in the cost of money.* ARMs are popular alternative financing tools as they may help borrowers qualify more easily for a home loan or for a more expensive home. Many lenders like ARMs because they pass the risk of fluctuating interest rates on to borrowers—if rates climb, payments can go up; if they decline, payments can go down.

Because ARMs shift the risk of interest rate fluctuations to the borrower, lenders normally charge a lower rate for an ARM than for a fixed rate loan. Although the majority of borrowers prefer the security of a fixed rate (provided the rate is not too high), ARMs have maintained a place in the market despite comparatively low mortgage rates.

The borrower's interest rate is determined initially by the cost of money at the time the loan is made. To determine a current ARM interest rate, the lender designates an **index**, which is *a statistical report that is a generally reliable indicator of the approximate cost of money,* and adds to that its **margin**, which is *the lender's profit*. Future rate adjustments for ARM loans are based on fluctuations in the index.

Current Index Value + Margin = Interest Rate

In addition to margin and index, there are several elements common to an adjustable rate mortgage.

Rate Adjustment Period. The *interval at which a borrower's interest rate changes*. It can range from a few months to many years. The most common rate adjustment periods are every six months or one year. After checking movement in the selected index, lenders notify borrowers, in writing, of any change in the rate.

Mortgage Adjustment Period. The *interval at which a borrower's mortgage payment changes*. Here, the borrower's actual principal and interest payments change. Like the rate adjustment period, the payment adjustment interval can range from a period of months up to many years, and it is possible for mortgage payment adjustments not to coincide with interest rate adjustments.

Interest Rate Cap. *Limits the number of percentage points an interest rate can be increased during the term of a loan*, helping to eliminate large and frequent mortgage payment increases. This is one way lenders limit the magnitude of payment changes that occur with interest rate adjustments.

Negative Amortization Cap. *Limits the growth of the loan balance beyond a certain point* so that the loan-to-value ratio does not exceed the tolerances established by the lender. **Negative amortization** is *when a loan balance grows because payments don't cover the accrued interest due on the loan.* While negative amortization caps do *not* stop a loan from accruing negative amortization, when the cap is reached, the note usually calls for the lender to adjust or recast the monthly payments to prevent any further negative amortization.

Ceiling. The *highest interest rate that may be charged over the term of the loan.*

Conversion Option. An option on an ARM that *allows the borrower to convert to fixed-rate*. These options typically have conditions such as higher interest rates.

Teaser Rates

When the initial rate on an ARM, also known as the **start rate**, is less than the fully indexed rate, it is considered a **discounted index rate**, sometimes referred to as a **teaser rate**. Lenders offer teaser rates to make ARMs more attractive to borrowers. The downside to a teaser rate is that it has the potential for a much higher first payment adjustment. Therefore, **interest rate caps** are used with ARMs to ***limit the number of percentage points an interest rate can be increased during the term of a loan***, helping to eliminate large fluctuations in mortgage payments.

Initially, teaser rates were offered without caps, but industry leaders, especially secondary market investors, began demanding caps on ARMs as a means of protecting borrowers from **payment shock**, and themselves from **portfolio shock**—having loans that borrowers no longer had the ability to pay. Today, more uniform ARM lending practices and a period of self-regulation have resulted in most ARMs having some kind of cap.

Hybrid ARMs

A **hybrid mortgage** is a *combination of fixed and adjustable rates,* meaning that the loan has a fixed rate for a specified number of years, and then the interest rate adjusts regularly for the remainder of the loan term, usually every six months. Hybrid mortgages may be designated by the number of years fixed and adjustable, for example, a **2/28 ARM** is a mortgage that has a fixed rate for the first two years, and then the interest rate adjusts every six months for the next 28 years.

Bi-Weekly Payment Plan

A mortgage with a **bi-weekly** payment plan is a *fixed rate mortgage set up like a standard 30-year conventional loan but payments are made every two weeks instead of every month.* This alternative financing tool can help a borrower reach a goal of paying off a mortgage earlier and saving interest, since 26 payments are made each year—equal to one extra monthly payment. Loans with bi-weekly payment structures are usually paid off in about 22.3 years, instead of 30 years.

Typical Mortgage Clauses

Various clauses are used in mortgages to give certain rights to the lender or borrower. Many of these clauses can be found in the promissory note or security instrument, and often they appear in both.

Acceleration Clause	Gives the lender the right to declare the entire loan balance due immediately because of borrower default or for violation of other contract provisions. Most promissory notes, mortgages, trust deeds, and land contracts contain an acceleration clause allowing the lender to accelerate the debt upon default as defined in the contract.
Alienation Clause or Due on Sale Clause	Gives the lender certain stated rights when there is a transfer of ownership. This is designed to limit the debtor's right to transfer the property without permission of the creditor. Upon sale, or even a transfer of significant interest in the property, lenders often have the right to accelerate the debt, change the interest rate, or charge a hefty assumption fee. FHA and VA loans cannot include an alienation clause.
Condemnation	Ensures if a property is condemned or some or all of the property is taken in an eminent domain action, the lender has the right to take all or part of the condemnation award to satisfy the loan because the lender's collateral was reduced by the condemnation.
Defeasance Clause	States that in the event a stated condition has been fulfilled, the document becomes null and void. With a mortgage, for example, once the borrower has repaid the debt, the mortgage is cancelled and the mortgagor can redeem title to the property.
Occupancy Clause	Requires the borrower to occupy the property within a certain period of time (i.e., within 60 days) and continue to occupy it for a certain period of time (i.e., one year).
Prepayment Clause	Gives lenders the right to charge borrowers a penalty for paying off the loan early or making substantial principal reductions, essentially depriving the lender of further interest income. This type of clause may be seen in a conventional loan, but it is prohibited in FHA or VA loans. A prepayment penalty is generally a certain percentage of the loan balance.
Subordination Agreement	Gives a mortgage recorded at a later date priority over an earlier recorded mortgage. Normally with mortgages, trust deeds, and other real estate contracts, the first to get recorded has lien priority. In some situations, however, the parties may desire that a later recorded instrument have priority over an earlier one. Subordination agreements are made between lienholders.

Covenants

A **covenant** is a promise made *by* the borrower *to* the lender. Here are some common covenants:

- Covenant to pay taxes – a promise to pay all property taxes and assessments
- Covenant of insurance – a promise to carry adequate hazard or property insurance on the property to protect the lender's investment
- Covenant against removal – a promise not to remove or demolish buildings without lender's approval
- Covenant of good repair – a promise to keep property in good condition and gives the lender the right to inspect the property
- Hazardous substances covenant – a promise that the borrower will not store, use, or release hazardous substances in the property

Other Forms of Financing

Next, we'll look at some other forms of creative financing in use today.

Seller Financing

Seller financing is when a seller extends credit to a buyer to finance the purchase of the property. This can be instead of or in addition to the buyer obtaining a loan from a third party, such as an institutional lender. A seller may help with financing for several reasons, for example, the buyer:

- May be unable to afford the cash necessary for the required down payment for a conventional mortgage.
- May want to take advantage of the low interest rate on the seller's existing mortgage.
- Is not able to qualify for a loan from a lender for various reasons.
- In tight money markets, sometimes the only way sellers can make a deal is to finance part of the purchase price themselves. Mortgage money from traditional lenders may be too costly in terms of interest rates or it may be simply unavailable. In any case, sellers can often enhance the salability of their properties by offering complete or partial financing.

The simplest form of seller financing is when the property being sold is **unencumbered**, meaning it is commonly considered to be free and clear of mortgages or other liens (has no real estate tax liens, for example). The buyer and seller negotiate the amount and terms of financing and have documents drawn up. Even so, seller financing should not be undertaken without checking the laws of the state in which the property is located. It may be necessary to seek legal advice, as many states have limitations as to the recourse a seller may have if the purchaser defaults, for example.

Loan Assumption

Assumption means that *one party takes over primary liability for the loan of another party, usually implying no change in loan terms.* When a buyer assumes the seller's mortgage, the seller remains secondarily liable unless the lender provides a release. Loan assumption is not always an option with loans written today as lenders try to protect their interests by being able to approve a new buyer. A new loan generally allows a lender to change interest rates, charge fees, or change loan terms for a new party. If the mortgage or note has an enforceable alienation clause, an assumption may allow the lender to demand full payment of the loan immediately.

"Subject To" Financing

Similar to an assumption is "subject to" financing. With this:

- A buyer gets a loan to purchase property "subject to" the seller's existing financing.
- The buyer acknowledges the seller's existing financing but accepts no personal liability.
- The seller remains liable.



Caution: Do not take chances when writing offers that call for assumptions of existing mortgages—it's too late after a sale to find out what a lender can or will do. Buyers and sellers should always consult the lender, an attorney, or other individual who's qualified to offer advice.

Land Contracts

Land contracts are another instrument used to finance the purchase of real estate. A **land contract** is a *real estate installment agreement where the buyer makes payments to the seller in exchange for the right to occupy and use the property, but no deed or title is transferred until all, or a specified portion, of the payments have been made.* Land contracts—also called land installment contracts, installment sales contracts, land sales contracts, real estate contracts, and other names—are much different than mortgages or trust deeds, where the debtor takes possession of the property while the creditor holds a mortgage or trust deed as a security lien against the property.

Under a land contract, the seller (**vendor**) actually holds title to the property as security, not just a mortgage lien. The buyer/debtor (**vendee**) has the right to possess and enjoy the land, but is *not* the legal owner. The seller retains legal title to the subject property, while the buyer is only an owner in fact, having possession and **equitable title**, but no actual title and no deed. Even though actual title won't be transferred until a future date, the person who holds equitable title still enjoys certain rights and privileges.

Land contracts are a popular form of seller financing in some parts of the country. This type of financing has many of the same advantages as any other form of seller financing, such as freedom from institutional loan qualifying standards and flexibility of terms. The main disadvantage is that land contracts can't be resold to Fannie Mae, although a few private secondary market investors may be willing to buy land contracts. Because the laws governing land contracts can vary by state, it is important to consult the laws in the jurisdictions where you do business.

Land contracts usually require the vendor to give the vendee a statement, at least once a year or as requested, showing the amount of payments that have been credited to principal and interest, and the balance due under the contract. Land contracts may be structured subject to an existing mortgage or structured to allow the vendee to assume the vendor's mortgage.

Advantages and Disadvantages

For the vendor, the advantage of a land contract is the right to hold title as security. This lack of ownership is, conversely, the main disadvantage for a vendee since it makes it difficult to later obtain financing based on the equity built up or for improvements, as banks are reluctant to lend to a person without actual legal title to the property. Also, a land contract provides little or no protection in the event that the land contract or other relevant document with terms of the sale is not recorded.

Because the vendor still retains title to the property, there's also some risk that he could mortgage the property for an amount greater than his interest in the property. Therefore, under most state laws, the vendor cannot mortgage the property for more than the balance due under the land contract without the vendee's consent. This protects the vendee's interest in the property.

Lease/Option

A **lease/option** is *when a seller leases property to someone for a specific term, with an option to buy the property at a predetermined price during the lease term.* The lease/option plan is comprised of two elements—a lease and an option. A **lease** is a *contract where one party pays the other rent in exchange for possession of real estate.* An **option** is a *contract giving one party the right to do something within a designated time period, without obligation to do so.* Obviously, the lease/option is *not* the equivalent of a sale, but there exists a good possibility that a sale will take place under its terms. The prospective purchaser is referred to as the **optionee**; the property owner is the **optionor**.

For the most part, the option contract is designed to assure the optionee the right to purchase the property. Usually, the optionee is interested in the property, but won't exercise the right to complete the purchase unless certain problems are resolved or questions are answered beforehand.

Lease/Purchase

A **lease/purchase** is *when a seller leases property to someone for a specific term, with the tenant agreeing to buy the property at a set price during or following the lease term*. The lease/purchase plan is comprised of two elements: A lease and a purchase contract. Both contracts must conform to all laws governing real estate contracts. The lease/purchase is the equivalent of a sale, but there are additional considerations to take into account because the sale is delayed until a later date.

The purchase agreement locks in a predetermined price for the property and sets a date for the sale transaction to be completed on or by. Here, the buyer is committing to purchasing the property, but can't buy it until certain problems are resolved or other events take place.

Equity Exchanges

An **equity exchange** is *value in one property being traded for value in another property.* This is also called a tax-deferred exchange, tax-free exchange, like-kind exchange, or Section 1031 (from the section number of IRS law). General rules for a tax-deferred equity exchange of real estate are:

- The properties must be exchanged, or qualify as delayed exchange (promise to provide a replacement—located within 45 days, closed within 180 days).
- The properties must be like-kind property (real estate for real estate).
- The properties must be held for use in a trade or business, or held by the party as an investment.

When property is exchanged as part of an equity exchange, the seller defers paying taxes until a capital gain (profit) is actually realized from the transaction. Usually, this means when the property is sold in the future. If the transaction does qualify for tax-free exchange treatment, any gain that is purely a result of the exchange is deferred. However, any property or money that does not qualify (that is, it's not like-kind property held for income, business, or investment) is treated as boot and is taxable. **Boot** is *unlike property or cash that is added to a deal to balance the value*.

Equity exchanges are often used when a buyer can't come up with sufficient cash for a sale. The difference between what the buyer has in cash and the purchase price of the property can be made up with other assets, such as land, another house, cars, boats, or any other property in which the buyer has an equity interest and that the seller would be willing to accept as part of the down payment. If the equity exchange involves real estate that meets the IRS criteria mentioned, then there are no immediate tax consequences for the seller.

A like-kind exchange is *not* available for residential property or for property held for sale by a dealer (a person who holds property for the sole purpose of reselling it).



Caution: Buyers and sellers should always consult professional tax advice and legal counsel for any deal involving equity exchanges or tax deferral.

Introduction to Government Loan Programs

The federal government plays a key role in the national real estate market, and their influence seems to grow every year. In addition to passing legislation that affects mortgage lending in general, one of the most direct ways in which the government can impact a specific borrower is through government agency loan programs that help borrowers purchase or refinance residential real estate. (Don't confuse these programs with government-sponsored enterprises such as Fannie Mae and Freddie Mac and their involvement in the secondary mortgage markets.) The two most common programs are **FHA-insured loans**, under the authority of the Department of Housing and Urban Development (HUD), and **VA-guaranteed loans**, under the authority of the Department of Veterans Affairs (VA). Other specialized loan programs exist as well, which will also be briefly discussed.

Federal Housing Administration (FHA)

To begin, let's clear up some possible misconceptions: The Federal Housing Administration (FHA) rarely provides mortgage funds directly to borrowers; the FHA does *not* build houses, nor does the FHA set interest rates. Instead, the Federal Housing Administration **insures** loans for single-family and multifamily homes made by approved lenders, which are called **Direct Endorsers**. Another common misconception about FHA loans is that they are targeted to lower-income borrowers or first-time homebuyers only, but this is not the case. The Federal Housing Administration does *not* have income limits to determine who is eligible for FHA loans. Anyone who is a U.S. citizen, permanent resident, or non-permanent resident with a qualifying work visa, and who meets the lending guidelines can obtain a loan.

Property Requirements

The FHA does impose stringent requirements for approved property.

- **Property Eligibility.** Eligible one- to four-family dwellings include detached or semi-detached dwellings (with additional requirements for dwellings that are not detached), row houses, multiplex dwellings, individual condominium units (approved), and some manufactured housing.
- **Occupancy.** Borrowers with FHA loans are required to establish bona fide occupancy of the property as their principal residence **within 60 days** of signing a security instrument (e.g., mortgage, trust deed). Furthermore, they are required to live in the house for **at least one year**. Generally, a borrower may have only one FHA loan at a time, although some exceptions may be made.
- **Property Conditions.** At a minimum, the site conditions of a property must be free of health and safety hazards. FHA Handbooks provide minimum property standards for new construction and minimum property requirements for existing properties.
- **Maximum Mortgage Amount.** Although there are no income limits with FHA loans, HUD limits the maximum loan amount—sometimes called a **loan ceiling** or **base**—that may be insured in a given community. When determining limits, boundaries may be based on county, zip code, or metropolitan statistical area (MSA). The loan amounts are reviewed every three years.

FHA Provisions

Other important provisions on FHA loans are summarized here.

- **Qualifying Standards.** FHA considers a borrower's income adequate for a loan if the proposed total mortgage payment (PITI) does not exceed **31%** of gross stable monthly income. A borrower's **total debt-to-income ratio** should not exceed **43%** of monthly income.
- **Required Minimum Investment.** A borrower seeking an FHA loan must make a minimum required investment of at least **3.5%** of the home's purchase price or appraised value, *whichever is less* (i.e., maximum LTV of 96.5%) from an acceptable source. The entire required minimum investment can be a non-repayable **gift** from a relative, an employer or labor union, a charitable organization, or a close friend with a clearly defined and documented interest in the borrower.
- **Prepayment Penalties.** HUD regulations prohibit prepayment penalties in FHA loans.
- **Mortgage Insurance Premium.** A **mortgage insurance premium** (MIP)—not to be confused with PMI for conventional loans—is required for all FHA loans, regardless of the down payment. There is an initial premium—called the **upfront mortgage insurance premium** (UFMIP)—and an **annual premium**, which is based on the annual average outstanding loan balance divided into 12 monthly payments.
- **Loan Assumption.** For FHA loans endorsed on or after December 15, 1989, the lender will require a creditworthiness review of the new borrower as well as a fee. Assumptions without credit approval may be grounds for acceleration of the mortgage. Therefore, any offers involving mortgage assumptions must be investigated thoroughly with the lender, who must supply a specific release of liability, and perhaps even with legal counsel.

VA-Guaranteed Loans

VA-guaranteed loans are *guaranteed by the federal government through the Veterans Benefits Administration*, which is part of the **Department of Veterans Affairs**. The VA's main purpose in guaranteeing loans is to help meet the housing needs of eligible veterans who have served or are currently serving on active duty in the U.S. Armed Forces, which includes: Army, Navy, Air Force, Marine Corps, Coast Guard, Reserves, or National Guard. VA loans are available to eligible veterans for the purchase of owner-occupied single-family homes and for multifamily dwellings up to four units if the veteran intends to occupy one of the units as the primary residence.

The VA rarely loans money directly to borrowers. It may do so in isolated rural areas where financing isn't readily available, but usually a veteran must borrow money from a VA-approved lender.

Eligibility

Lenders may not process or close a VA loan without verifying the eligibility of the borrower with a **Certificate of Eligibility** (COE) issued by the VA. To be eligible for a VA-guaranteed loan, the borrower must have completed a minimum number of days of active duty—generally more than 180 days in peacetime or at least 90 days in wartime—and must not have been dishonorably discharged. Most commonly, this is evidenced by a Certificate of Release or Discharge from Active Duty, or **DD-214**, issued by the Department of Defense. The DD-214 identifies the character of service and reason for discharge (honorable, dishonorable, etc,).

Property Requirements

The VA also imposes requirements for approved property.

- **Certificate of Reasonable Value.** Every appraisal made for VA purposes must be reviewed either by the lender's VA-authorized staff appraisal reviewer or a VA staff appraiser, who then issues a **Notice of Value** (NOV) or a **Certificate of Reasonable Value** (CRV).
- **Maximum Loan Amount.** The VA doesn't limit the price a veteran can pay for a house (as long as the house will appraise for the loan amount), but the VA does limit the amount it will guarantee in case of default to **25%** of the purchase price or the established reasonable value, whichever is less. A veteran's maximum guaranty amount, known as **entitlement**, represents the portion of the loan that the VA guarantees in the event of default by the borrowing veteran. Therefore, veterans can generally purchase a home priced up to **four times** the amount of their entitlement, which is documented in the Certificate of Eligibility, with no down payment.
- **Occupancy.** A veteran obtaining a VA-guaranteed loan must certify that he or she intends to personally occupy the property as a principal residence. As of the date of certification, the veteran must either personally live in the property as his or her home, or intend, upon completion of the loan and acquisition of the dwelling, to personally move into the property and use it as his or her home within a reasonable time, which generally means **within 60 days** after the loan closing.

VA Provisions

Other important provisions on VA loans are summarized here.

- **Qualifying Standards.** VA considers a borrower's income adequate for a loan if borrower's **total debt-to-income ratio** does not exceed **41%** of monthly income. In addition, an underwriter must ensure that an eligible borrower has the appropriate balance of cash flow remaining for family support. This is determined by looking at **residual income**, which is *the amount of income remaining after subtracting taxes, housing expenses, and all recurring debts and obligations.*
- **Variable Funding Fee.** While there is no upfront or monthly mortgage insurance premiums required for VA loans, borrowers must pay a one-time **variable funding fee** at closing for guaranteeing the loan. The variable funding fee is waived for disabled veterans and surviving spouses of veterans who died in service or from service-connected disabilities.
- **Loan Assumption.** For VA loans committed and closed on or after March 1, 1988, VA loan assumptions are *not* allowed unless the veteran first has the assumption **approved** by the Department of Veterans Affairs or its authorized agent (i.e., the loan holder).
- **Prepayment Penalties.** The VA does not allow clauses for prepayment penalties to be included in VA loans.
- **FHA/VA Purchase Agreement Addendum.** When a buyer intends to apply for an FHA-insured loan or VA-guaranteed loan, it is necessary to include an FHA/VA Purchase Agreement Addendum to the purchase agreement. This addendum includes an amendatory clause that allows the buyer to back out of the contract without penalty if the FHA or VA does not provide a written statement setting that value of the property at or above the sales prices stated in the purchase agreement.

USDA Rural Development Programs

In 1994, the U.S. Department of Agriculture (USDA) was reorganized to create **USDA Rural Development** in order to administer farm financial programs for rural housing, community facilities, water and waste disposal, and rural businesses. Although one mission of Rural Development is to provide financial support to low-income homebuyers in rural communities, the definition of "rural" may be broader than one might think. It can include small towns up to 20,000 people, even those in areas that may be in close proximity to larger metropolitan areas. In addition, the USDA could determine that particular areas are temporarily eligible for their programs in response to certain conditions or natural disasters such as a flood or hurricane.

The USDA Section 502 loan program either **guarantees loans** made by approved private lenders or **makes direct loans** if no local lender is available. Section 502 loans can be used to:

- Purchase an existing home.
- Construct a new home.
- Renovate or repair an existing home.
- Relocate an existing home.
- Purchase and prepare a site for a home, including sewage and water facilities.

Applicants for Section 502 loans—guaranteed and direct—must meet certain income requirements based on the **area median income** (AMI). Assuming that the applicant meets the income eligibility and the house is in an approved area, the borrower may receive **100% financing**, based on the appraised value or acquisition cost, whichever is less. Unlike FHA loans, these USDA loans do **not** require mortgage insurance of any kind.

Borrowers must personally occupy the dwelling following the purchase. Dwellings must be structurally sound, functionally adequate, and in good condition.

Homebuyer Assistance Programs

Homebuyer assistance programs can be down payment assistance programs (sometimes referred to collectively as DAP programs), subsidized mortgage interest rates, help with closing costs, or a combination. These programs may be offered by government or non-profit organizations to promote home ownership, or by lenders as part of their obligation under the federal Community Reinvestment Act.

Some programs allow people to buy homes with lower down payments than conventional loans, often 3% or less. This may be offered by cities, counties, or the state, and the money may be targeted to specific neighborhoods. Often a portion or all of the required down payment is paid on behalf of the buyer. Money for these programs is usually limited and administered on a first-come, first-served basis. Various bond issues or levies may replenish the funding for the program, but it is hard to predict when money will become available. Some non-profit organizations also provide grants, gifts, or otherwise arrange money for down payment assistance.

Interest rate subsidies may also be obtained from a variety of sources. Bond money is available from time to time, whereby the state issues bonds and uses the funds to subsidize the interest rate paid on mortgages by low-income families. Underwriting requirements may be the same as for FHA loans, but the interest rate is lower than an FHA loan because of the subsidy. Some such programs may even offer both down payment assistance and interest rate subsidies through various agencies.

First Time Homebuyer Loans or **Community Homebuyer Programs** are some of the generic names for the various programs that lenders have created in response to the Community Reinvestment Act, which requires lenders to offer more flexible financing than that for conforming loans with regard to credit, income, and down payment as a means of supporting the community. The law does not require lenders to make high-risk loans, but loans in the community should be made whenever possible while maintaining the safety of the institution. Borrowers with poor credit may have to complete a course on financial responsibility to qualify for a loan.

All of these government and private sector programs have numerous rules that must be followed for borrowers to qualify for the assistance programs. Nevertheless, the maze of regulations and paperwork can offer hope to some who might not otherwise be able to buy a home on their own. Supporters of these programs applaud the fact that they help more people buy homes; detractors worry about high potential default rates for people with little money to put down on a home or spend on upkeep.

Illinois Homebuyer Assistance

www.ihda.org

The **Illinois Housing Development Authority** (IHDA) has numerous programs to promote homeownership among eligible buyers, including down payment and closing assistance. You can learn more about the IHDA SmartMove Mortgage Products from their website.

Foreclosure and Short Sales

When a borrower fails to repay the debt according to the terms of the agreement, he is considered to be in **default**. The lender's remedy for borrower default, in most cases, is some type of **foreclosure** proceeding, which can differ depending on the laws of each state:

- **Judicial Foreclosure.** This is handled through the court and can be a lengthy process. Generally speaking, when a borrower is in default, the court allows the lender to sell the property to satisfy the debt. This is the most prevalent type of foreclosure.
- **Strict Foreclosure.** This also requires a court proceeding, but is less involved than a judicial foreclosure. Under strict foreclosure, the court establishes a date by which the borrower must pay the balance in full. If the deadline passes, the lender is simply awarded title to the property. No sale is held. The mortgagor loses all equity in the property and usually has no course of redemption or reinstatement. The lender, however, loses the right to seek any deficiency judgment. This method is *not* commonly used.
- **Non-Judicial Foreclosure.** In states that allow non-judicial foreclosure (sometimes referred to as non-statutory foreclosure), the creditor is authorized by a **power of sale clause** in the mortgage or deed of trust to sell the property after proper notice to the defaulting borrower but without court supervision. Non-judicial foreclosure is not permitted in Illinois.

Alternatively, a lender may decide that it's more advantageous to get as much as it can out of the property without a lengthy foreclosure procedure and could, therefore, agree to a **short sale**.

Judicial Foreclosure

Generally speaking, when a debtor is in default, the lender accelerates the due date of the debt to the present and gives the debtor a **notice of foreclosure**, demanding that the debtor pay off the entire **outstanding balance** of the loan at once. The notice of foreclosure is recorded in the municipality or county where the property is located, giving constructive notice of pending court action (**lis pendens**).

If the debtor fails to satisfy the debt within the timeframe stated in the notice of foreclosure, the lender files a lawsuit, called a **foreclosure action**, in a court of jurisdiction where the land is located. The court will determine whether the lender is rightfully owed the money and the debtor is in default. If the court finds in favor of the lender, the judge will issue **summary judgment of foreclosure**, after which a foreclosure sale may be scheduled.

The public is notified of the place and date of the sale via advertising that runs for a specified number of weeks in a newspaper circulated in the county. On the sale date, a **public auction**, sometimes called a sheriff's sale or a judgment sale, is held where anyone can bid on the property. The minimum bid is generally a set percentage of the appraised value as determined by a number of disinterested appraisers. The property is sold to the highest bidder, and a document called a **confirmation of sale** is filed to finalize the sale. The officer of the court makes out a **sheriff's deed** to the purchaser of the property. This deed—which does **not** include any warranties—is executed, acknowledged, and recorded just like any other deed.

Proceeds from the sale are used to first pay **reasonable expenses associated with the sale** and then to pay off the mortgage(s) and any other liens, generally in the order in which they were filed. Any **overages** (surplus) remaining after all debts, liens, expenses, and costs related to the property are paid may go to the debtor. If the sale of the collateral property through foreclosure sale (or short sale) does not raise enough to cover the entire loan amount, accrued interest, and other costs, the creditor may be able to obtain a **deficiency judgment** against the property owner. This is *a court-ordered personal judgment against the debtor that creates a general, involuntary lien against all real and personal property.* Note that in Illinois, homestead rights, which offer some protection from creditors, are forfeited in the event of a foreclosure action.

If the property does *not* sell, the lender legally repossesses the property and it goes on their books as a **real estate owned** (REO) asset.

Redemption and Reinstatement

Some states allow debtors to redeem (save) the property from foreclosure from the time a notice of foreclosure is filed until the foreclosure sale takes place. This is done by paying the amount that is in default, as well as applicable court costs and attorneys' fees. This right to *redeem the property prior to the sale* is called the **equitable right of redemption**. In Illinois, a borrower has the equitable right to redeem the property for **seven months after service of the notice of foreclosure** or **three months after the summary judgment of foreclosure**, whichever is later (735 ILCS 5/15-1603). A foreclosure sale may not take place until the timeframe for redemption has passed.

Some states allow what is called a **statutory right of redemption** through which debtors may *redeem the property after the foreclosure sale.* Once the redemption is made, the court will set aside the sale, pay the parties, and the debtor regains title to the property. Illinois does *not* recognize this right.

Illinois does recognize the **statutory right of reinstatement**, which is a way for borrowers to cure the default by bringing the mortgage current—including all accumulated costs and fees—within **90 days** after the time they receive a notice of foreclosure or the notice was recorded. The lender cannot proceed with the foreclosure action until the reinstatement timeframe has passed. The right of reinstatement is available to a borrower once every five years (735 ILCS 5/15-1602).

In Illinois, if homeowner waives his or her right of redemption and/or reinstatement once a foreclosure proceeding has commenced and expressly consents in writing to the entry of foreclosure judgment, the creditor, in turn, consents and agrees to **waive any and all rights to a deficiency judgment** (735 ILCS 5/15-1601).

Possession

In Illinois, a homeowner is allowed to remain in the home during the judicial foreclosure proceeding and for **up to 30 days** after the foreclosure sale is confirmed. On day 31, if the homeowner has not vacated the property, the new owner may initiate eviction proceedings (735 ILCS 5/15-1701). A tenant who was in possession of the property prior to foreclosure proceedings has the right to remain on the property after a confirmation of sale through the terms of the lease.

Short Sales

When a homeowner owes more on the mortgage than the property is worth, he is said to be **underwater**. Several factors can contribute to this:

- Financial hardship, such as a serious illness or job loss
- Falling home values based on the sale prices of comparable homes
- Repayment issues related to subprime or predatory lending
- Negative amortization resulting from a rise in interest rates associated with loan options such as adjustable rate mortgages (ARMs) or interest only loans

A **short sale**, or short payoff, is when *a lender agrees to accept less than the loan balance when real property is sold.* Many lenders require that the homeowner be several months behind in mortgage payments before considering a short sale, but others are willing to make a short sale to offset a potential loan default.

One of the most frustrating aspects of a short sale is the time it takes to close. Every stakeholder—the lender(s), loan servicer, lien holders, mortgage insurers, securities investors, and possibly others—must decide whether or not to approve the short sale. With a short sale, the title to the property must be clear of all liens and encumbrances (except for items that will run with the land, for example, easements, real estate taxes, etc.). Since **all lien holders must agree to payoffs and then release the liens**, an unreleased lien could cause a delay of the sale or might become a deal breaker. Often, offers will expire before the all interested parties respond to the short sale agreement. As a result of time delays, many buyers simply walk away. Still, a short sale may be quicker and less expensive than judicial foreclosure.

If a short sale is the best option, the seller must contact the lender and ask for someone with authority in the **loss mitigation department**. The seller should explain the situation and ask for the lender's short sale policy. A **letter of authorization** from the seller to the lender is required in order for the seller's agent or representative to contact the lender on the seller's behalf. To qualify for a short sale, the seller must prove to the lender that he is suffering a financial hardship. This is typically done with a **hardship letter** in which the seller documents the specific reason for the hardship.

Broker's Role

There are a number of things a broker can do to help a seller achieve a short sale, for example:

- Determine how much is currently owed to the mortgagee(s) and to other lien holders. Make a note of who all creditors/lien holders are and how to contact them. Get copies of documents as proof of the seller's financial situation.
- Generate a **comparative market analysis** to help the seller determine a possible listing price.
- Prepare the listing agreement and include a statement to the effect that the agreement should state that the "**seller's acceptance of any offers is subject to third-party approval**." This protects the seller in case the lender doesn't approve the sale. The listing agreement should also contain language that permits the seller to back out of the deal if the lender chooses to foreclosure on the property.
- List the property. When listing a short sale property on the multiple listing service (MLS), follow its guidelines. Typical listings for short sale properties contain phrases like "subject to bank approval" or "subject to lien holder approval" or "subject to third-party review" or simply "short sale."

Short Sale Package

Once the seller has an offer from a qualified buyer, a short sale package can be submitted to the lender's loss mitigation department. In most cases, the listing agent is charged with taking care of this. Each lender has its own requirements, but a short sale package typically includes the following items:

- Cover letter summarizing the seller's hardship situation, amount owed on the home, the offer, and the amount the lender can expect to net from the sale
- Hardship letter with supporting documentation
- Employment pay stubs from the past two months
- Bank statements from the past two months
- Income tax returns from the past two years (including W-2s and/or 1099s)
- Financial statements and monthly budget
- Comparative market analysis (CMA)
- Preliminary settlement statement showing zero profit to the seller
- Report of any property damage or needed repairs, including photos and cost estimates
- Market conditions and history reports
- Listing agreement
- Purchase contract
- Written proof of the buyer's ability to purchase
- Short sale application

The loss mitigator will review the short sale package and, if complete, determine the best plan of action to remedy the borrower's situation with the least amount of loss to the lender.

Rejecting a Short Sale

There are several viable reasons why the lender may reject a short sale:

- **Seller does not qualify.** A seller would likely be ineligible if the hardship is due to careless money management or if the settlement statement shows a profit for the seller.
- **Buyer does not qualify.** A buyer who cannot provide a loan pre-approval letter may end up not being qualified when the loss mitigator checks the loan approval status.
- **Offer price is too low.** If the offer price is lower than the appraised value of the property, the lender may reject the offer in hopes of obtaining a higher offer or selling price through foreclosure. The loss mitigator is not likely to reveal the price that's acceptable so as to get the highest possible offer.
- **Lender sold the loan.** If the lender is simply servicing the loan and does not own the loan, it does not have the authority to approve the sale.

If the loss mitigator rejects the first offer, the buyer can submit a counteroffer or reject the deal and walk away. As long as the home is listed on the MLS, there could potentially be other interested buyers. Negotiations may go several rounds before coming to an agreement.

Alternatives to Foreclosure and Short Sales

There are a number of alternative solutions to foreclosure or short sale. Having an attorney review any agreement and explain the terms is essential so that homeowners are aware of their options and financial obligations.

Loan Modification. The lender agrees to modify the loan terms by reducing the monthly payment amounts or interest rate, extending the term of the loan, or some other agreed-upon change.

Repayment Plan. The lender and the homeowner reach an agreement in which an additional predetermined amount is added to the mortgage payment for several months until the delinquent amount is paid in full, bringing the account current. Borrowers can then focus on rebuilding their credit.

Forbearance Agreement. The lender agrees to temporarily reduce, postpone, or suspend the mortgage payment and not proceed with foreclosure as long as the borrower brings the loan current within the specified time. If the homeowner fails to meet the obligations under the forbearance agreement, he cannot contest any actions taken by creditors to collect.

Refinancing the Home. The homeowner may be able refinance the mortgage loan at a lower interest rate or extend the loan over a longer period of time. To refinance, there must be adequate equity in the home and the homeowner must have a good credit score.

Renting the Home. If the homeowner is able to find alternate housing, he may want to consider renting the home until his financial situation improves or the real estate market recovers. There are, obviously, many responsibilities that go along with being a landlord.

Selling the Home. The homeowner can proceed with a typical home sale, as opposed to a short sale, if the homeowner can cash in assets or borrow money to pay off the mortgage note, pay the real estate commission, and closing costs. If the homeowner cannot afford to pay off the mortgage loan and other costs, a typical home sale is not an option.

Deed in Lieu of Foreclosure. The homeowner voluntarily **conveys ownership of the property to the lender** by signing over the deed, which could be a quit claim deed, grant deed, or warranty deed, depending on the state or jurisdiction where the property is located. Once the deed is signed over to the lender, the property can then be sold to recoup all or part of the lender's losses.

Mortgage Assumption. A buyer assumes the current loan at the original loan interest rate. To assume the loan, the buyer must apply for a new loan and be approved by the lender. Most conventional lenders do not permit loan assumptions. FHA and VA lenders allow loan assumptions with proper approval and release.

Bankruptcy. The borrower may want to consider filing for bankruptcy; however, it negatively affects one's credit score more than any other alternative. Chapter 7 and Chapter 13 of the Bankruptcy Code are the two most common options that an individual facing foreclosure would consider.

Summary

1. **Finance instruments** are written documents establishing rights and duties of the parties involved in a transaction. **Promissory notes** are written promises to pay money. They are negotiable instruments and are freely transferable so creditors can sell them for cash. A **mortgage** is a type of security instrument where the borrower (called the **mortgagor**) pledges property to the lender (called the **mortgagee**) as collateral for the debt, a concept known as **hypothecation**. **Trust deeds** (or deeds of trust) place some financial interest in the property into the hands of a third party as security for the payment of a note; they allow for non-judicial foreclosure in the event of default.
2. **Conventional loans** are not insured or guaranteed by a government entity. Traditional conventional loans are long term, fully amortizing, and have a fixed rate. A 15-year loan retires sooner and saves interest, but requires higher payments and, sometimes, a higher down payment. An 80% conventional loan means the **loan-to-value ratio** (**LTV**) is 80% of the appraised value or sale price of property, whichever is less, and the buyer makes a 20% down payment.
3. **Conforming** loans meet Fannie Mae/Freddie Mac standards and can be sold on the secondary market. Qualifying standards are **28%** and **36%**. **Nonconforming** loans do not meet these standards and cannot be sold to Fannie Mae/Freddie Mac. Nonconforming can be due to credit quality (**subprime** loans) or loan size (**jumbo** loans exceed Fannie Mae/Freddie Mac maximum loan amount).
4. **Private mortgage insurance (PMI)** is private insurance for lenders against borrower default and is typically required for conventional loans with an LTV greater than 80%. PMI compensates lenders for lower borrower equity, and shares partial risk (of the upper part) with the lender. Federal law says that loans after July 1999 must drop PMI when LTV is 78% of original property value, or if the borrower requests it and the appraisal is 80% of the original property value.
5. Mortgages are often prefaced by words describing its type or function. **Purchase money** mortgage—seller or lender takes mortgage for part of purchase price. **Bridge** mortgage—temporary mortgage between two others and repaid with a later mortgage. **Package** mortgage—includes personal property. **Blanket** mortgage—for more than one land parcel. **Construction** mortgage—temporary loan to finance building. **Reverse** mortgage—provide monthly income, a lump sum of cash, or a line of credit to borrowers aged 62 or older, based on the equity in their homes.
6. **Adjustable rate mortgages** (ARMs) let lenders adjust interest rates. Borrowers select an **index** (statistical report reflecting cost of money). At predetermined intervals, the index is added to the **margin** (the agree-upon spread) in order to find **interest rate** due on the loan for that period.
7. Many clauses are common in real estate contracts. An **acceleration** clause lets the lender call the loan balance due if in default. A **prepayment** clause lets lenders charge a penalty for paying off a loan early. An **alienation** clause gives lenders some stated rights if the property is transferred (also called due on sale clause). A **defeasance** clause cancels a mortgage when it has been repaid. **Subordination** lets a later-recorded mortgage take priority over an earlier one.
8. Alternative financing options may include: 1. A **land contract** is a real estate installment agreement. Buyer (vendee) makes payments to seller (vendor) for right to occupy land, but no title is transferred until all, or part of, payments are made. Buyer has **equitable title** under a land contract. 2. A **lease/option** has the seller (optionee) lease to a tenant (optionor) who has the right (but not the obligation) to buy the property at a set price within a certain time. 3. A **lease/purchase** combines a lease with a purchase contract. 4. An **equity exchange** (tax-deferred exchange, like-kind exchange, Section 1031) is commercial or investment property traded for value in other property.
9. **FHA-insured** loans are for owner-occupied single-family and multifamily dwellings of 4 or fewer units, made by approved lenders. FHA loans require lower down payments and less stringent qualifying standards than conventional loans. The FHA sets a maximum mortgage amount, depending on the geographic area. FHA loans have a required minimum investment of **3.5%** of lesser of purchase price or appraised value and require an upfront mortgage insurance premium and a monthly MIP.

10. **VA-guaranteed** loans help eligible veterans buy homes often with no down payment. Veteran must occupy the home. VA doesn't limit home price, but limits guaranty amount that the lender can recover for default to 25% of maximum loan limit in county where property is located. Borrowers need **DD-214** (discharge papers) and **COE** (Certificate of Eligibility). The VA issues **Notice of Value** (NOV) or **Certificate of Reasonable Value** (CRV) based on appraisal; if price exceeds estimate of reasonable value, veteran must make up difference with down payment/equity. VA loans require a variable **funding fee**—paid in cash or financed (waived for disabled veterans).
11. **Rural Development** is an agency under the U.S. Department of Agriculture (USDA) that offers various assistance programs for both businesses and homebuyers in rural communities. USDA's **Section 502** loans for single-family homes either **guarantees** loans made by private lenders or makes **direct loans** if no local lender is available. Eligible borrowers can get **100% financing** without any mortgage insurance.
12. **Homebuyer assistance programs** can be down payment assistance programs (DAP), subsidized mortgage interest rates, help with closing costs, or combination. Programs can be offered by federal, state, and local government; non-profit groups; or by lenders as obligated under the Community Reinvestment Act.
13. If in default of a mortgage loan, **judicial foreclosure** ensues: Notice of default; foreclosure action filed; summary judgment issued by court; notice of pending sale publicized; public auction held; confirmation of sale filed; sheriff's deed issued. In Illinois, debtor has **equitable right of redemption** to regain property for 7 months after notice of foreclosure/3 months after judgment, whichever is later. Debtor has **right of reinstatement** for 90 days after notice of foreclosure. After the costs of the sale are paid out of the proceeds, liens are generally paid in the order filed. If sale does not cover debt, a **deficiency judgment** against all property may be sought (unless the debtor waives the right of redemption and/or reinstatement). A **short sale** is when a lender agrees to accept less than the loan balance owed when real property is sold. It requires homeowner to show financial distress.

Quiz

1. ***A loan that is repaid with periodic payments of both principal and interest so that the entire loan amount is paid in full at the end of the loan term is a(n)***
   a. annualized loan.
   b. fully amortizing loan.
   c. partially amortizing loan.
   d. straight loan.

2. ***Which document is evidence of debt, showing who owes what to whom?***
   a. deed
   b. mortgage
   c. promissory note
   d. purchase agreement

3. ***Barbara would like to get a conventional loan on a house appraised at $164,000 with the purchase price of $160,000. She states she does not want to pay PMI on the loan. In that case, what is the maximum loan amount she can receive?***
   a. $32,000
   b. $128,000
   c. $131,200
   d. $154,400

4. ***The type of mortgage that may provide the borrower with a monthly check instead of the borrower paying a monthly payment is known as a(n)***
   a. blanket mortgage.
   b. graduated payment mortgage.
   c. interest only mortgage.
   d. reverse mortgage.

5. ***Which term describes the process by which a borrower pledges property as security for a loan without giving up possession of it?***
   a. defeasance
   b. hypothecation
   c. redemption
   d. subordination

6. ***Which statement about FHA-insured loans is FALSE?***
   a. FHA loans are intended for low-income first-time homebuyers.
   b. FHA loans have less stringent qualifying standards.
   c. FHA loans require low down payments.
   d. FHA offers an adjustable rate mortgage.

7. ***A mortgage clause that permits the lender to call the outstanding balance due and payable should the property be sold by the borrower is a(n)***
   a. acceleration clause.
   b. alienation clause.
   c. balloon payment clause.
   d. exculpatory clause.

8. ***A veteran's entitlement for a VA loans is specified in what document?***
   a. COE
   b. CRV
   c. DD-214
   d. NOV

9. ***With an ARM, the index is added to the _____ to determine the _____ .***
   a. APR / cost of funds
   b. home value / amount borrowed
   c. margin / interest rate charged
   d. qualifying ratio / maximum monthly mortgage payment

10. ***Conforming loans follow guidelines of***
    a. ECOA.
    b. Fannie Mae and Freddie Mac.
    c. the FHA.
    d. RESPA.

11. ***The borrower who pledges property to a lender as collateral is referred to as the***
    a. beneficiary.
    b. mortgagee.
    c. mortgagor.
    d. trustee.

12. ***In the event of a default, which debt is normally paid first from the proceeds of the foreclosure sale?***
    a. costs of the sale
    b. junior lien
    c. mortgage lien
    d. real estate taxes



UNIT 8

Introduction to Commercial Real Estate

Chapter 24 – Commercial Property Overview

Chapter 25 – Retail and Office Properties

Chapter 26 – Commerical Valuation Basics



24 Commercial Property Overview

Commercial real estate is a challenging and exciting specialty within the real estate field. Of the total number of licensed real estate professionals in the United States, numerous studies have indicated that only about two of every ten agents practice commercial real estate. More agents may explore commercial real estate further if they had some basic information to get started. In this chapter, you will see how commercial real estate can be defined and take a first step toward understanding the language of commercial real estate.

You will learn:

- License requirements for commercial real estate.
- The scope of commercial real estate opportunities.
- How commercial leases may be structured.
- How commissions may be earned on commercial transactions.

Key Terms

Amenity Purchaser
Commercial Broker's Lien
Common Area Maintenance (CAM)
Escalation Clause
Graduated Lease
Gross Lease
Land Lease
Net Lease
Pass-Through
Sale and Leaseback
Setback
Subdivision

Working in Commercial Real Estate

Just what is "commercial" real estate? How is that different from "investment" real estate? For all intents and purposes, both terms refer to the same thing: Property that is used for investment purpose. If a single-family home is going to be used for investment purposes, then it, in effect, becomes commercial real estate. Multi-family properties, office, retail, industrial, land—it doesn't really matter what the property is or how it is zoned. If someone intends to use that property as an investment, it all falls into the category of commercial real estate.

License Requirements

Contrary to what many people assume, practicing commercial real estate does **not** require a special license. The Illinois real estate broker's license is all-encompassing, which means the license permits an agent to conduct business in the brokerage of all forms of real estate. The basic provisions of agency law, contract law, real property law, and license law are almost identical in commercial real estate and residential real estate. Also, licensees working in commercial real estate must understand that federal, state, and local laws related to civil rights and fair housing also apply to commercial properties.

Remember: Although a broker license is not required for residential leasing, someone who leases commercial real estate must be licensed as a broker.

All In a Day's Work

Working with commercial clients and customers usually means working the hours they work, often nine to five and rarely on the weekend. There are exceptions to this rule, however, as in smaller markets or with those who deal in both residential and commercial properties. And like any real estate professional, it's up to the licensee to generate business. So, while they may not be working directly with clients after typical working hours, or on the weekends, they may be busy generating marketing material, making phone calls, and engaging in other business-building activities.

Learning the Language of Commercial Sales

What many agents find attractive about commercial real estate is the creativity required to put transactions together. Because of this, negotiations are often more time consuming and sophisticated. Commercial transactions are often riskier and more complicated than typical residential transactions. Commercial real estate investments usually require specialized knowledge and expertise different from residential transactions.

By necessity, the commercial real estate industry has developed its own language to describe the market and properties for sale. Therefore, many of the concepts and the vocabulary used by developers and investors have been adopted into the commercial real estate lexicon. The language of commercial real estate may contain some unfamiliar real estate terms, but most of it should be familiar.

Agency Disclosure Obligations

Licensees in Illinois are **not** exempted from the statutory obligation of **agency disclosure** when working in commercial real estate. Since agency deals with the rights of the consumer, it is very important for licensees to be able to explain the concept to prospective clients and customers. Agency disclosure *ensures that all parties know who an agent works for and the obligations of the agent in a transaction*, depending on the agency relationship.

Licensees have a legal obligation to explain the concept of agency and disclose the statutory obligations of an agent, including:

- The types of agency allowed by the state.
- The types of agency that are practiced by their brokerage.
- The role that each type of agent plays in a real estate transaction.

In Illinois, disclosure of the agency relationship may be accomplished with a separate disclosure form or it may be incorporated into a brokerage agreement. Records of agency disclosure must be maintained by the sponsoring broker either electronically or in hard copy format for **five years**.

Parties to Commercial Transactions

Every party to a commercial transaction has unique needs and motivations, but that does not mean that these parties have to be adversaries.

- **Developers** of income properties carefully evaluate the risks and probabilities of success, based on their knowledge of the costs and a desired rate of return, before beginning development.
- **Subdividers** of vacant land analyze the best method of use for the land taking into account zoning, market condition, investor demands, and topography.
- **Buyers** carefully estimate return on investment, using all known information, before deciding to purchase properties, whether it's for their own use or lease to tenants. Their motivation is to realize the highest return possible on their investment.
- **Owners** make decisions to sell or lease based on calculations of anticipated future profit and continued risk levels, before taking action.
- **Tenants** want to get the most out of their rental dollars and are more concerned with the usefulness of the property for their business.
- **Landlords** want as much income as possible.

Types of Investment Property

Commercial investment real estate often brings to mind large buildings such as skyscrapers, shopping centers, or large apartment complexes with hundreds of tenants. These properties certainly do exist within the commercial market; however, the vast majority of commercial investment real estate transactions are of a much smaller scale. Commercial investments run the full spectrum from single-family homes to small single-user retail or office buildings to large industrial properties and/or multi-family residential complexes. One thing to keep in mind is that regardless of the type of property, the investor's goals remain the same: To maximize **return on investment** and to **minimize the risk** in any transaction.

Unimproved Land

There are many things to consider when analyzing a parcel of land. As with most categories of real estate, location is usually the first item considered. There is a long list of site considerations to evaluate as well, including zoning, environmental requirements, and characteristics of the land itself, such as topography, to determine how much of the land is *usable*. All of these can impact the investor's decision whether to purchase the property and at what price.

When the property is analyzed, it usually is surveyed and perhaps receives an engineering or environmental report. Then potential investors generally evaluate the property's **highest and best use**, which is *the legal use of that property that will yield its highest present value* (greatest net return) so long as the use is:

- Physically possible.
- Financially feasible.
- Legally permissible.
- Maximally productive (most profitable).

Other Considerations

These are some of the other considerations that will impact the development on unimproved land:

Setbacks. The distance that a building (or the building area including parking) must be placed from a street, a property line, or an adjacent property. These lines create invisible boundaries that define the maximum footprint of the improvement.

Floor Area Ratio (FAR). The total maximum size of a building permitted on a development; typically stated as a percentage of the total square footage of the parcel.

Access Roads and Curb Cuts. The value and its subsequent utility of commercial real estate is strongly impacted by its accessibility from a public thoroughfare. While engineers may evaluate traffic patterns to determine where best to locate curb cuts, ultimately, placement of curb cuts is generally governed by local code.

Utilities and Sanitation Services. Accessibility to water, electricity, gas, sewers, and waste removal is critical. If utilities have not been brought to the site, how far away are they and how much will it add to the cost of development?

Green Space. Any vegetated land or water within or adjoining an urban area; it may include vacant land, rivers, playgrounds, bike trails, etc. Local subdivision regulations define the percentage of green space that must be established as a part of land development.

Sidewalks. Many communities are requiring developers to install sidewalks that extend across the entire frontage of a land site. The widths and materials used can vary from area to area.

Community Improvements. Municipalities frequently will require the developer to set aside land for a community improvement such as sidewalks and parks. In addition, a subdivider/developer may have to agree to provide a certain percentage of the development designated to specific use categories.

Residential Property

An investor in a residential property typically does not intend to live at the property but instead chooses to rent it out to tenants for the production of income. Investors have an array of residential property from which to choose, from single-family homes to large multi-family apartment buildings. Each has its own set of considerations.

Single-Family Residences

Many real estate professionals start their commercial careers selling single-family investment property. And many beginning investors own one or more single-family investment residences. Some of the perceived advantages to single-family properties include comparatively smaller management requirements, the stability of the market for rental homes, and the fact that it's a more liquid commodity than other types of investment property. However, the market value of single-family investment property tends to be influenced by general market conditions instead of generally accepted methods of determining investment values. Often, single-family homes may not be able to produce sufficient rental income to justify the price an investor would have to pay to own them. Another consideration: A single-family residential property is either 100% occupied or 100% vacant.

Small Multi-Family Residences

Small apartment buildings—consisting of two to four units—are still relatively affordable and attractive in the marketplace. An advantage to this property type over single-family homes is that the risk of a full vacancy is somewhat diminished. In a building with two units, if one tenant moves out, it is still 50% occupied and consequently still bringing in some income. Some factors to consider with these properties that are not present with single-family homes include utility metering, maintenance of common areas, tenant privacy and compatibility, soundproofing between units, and accessibility issues.

Large Multi-Family Properties

As the number of units in an apartment property increases, so do the management considerations and complexity of investment analysis. While the basic principles do not change, many additional criteria must be analyzed. Typical investors are often larger companies adept at acquiring and managing these properties. Considerations when analyzing large multi-family properties include market conditions and rent levels, overall condition of the property, amenities and services available to tenants, parking, maintenance and security of common areas, rent control laws, insurability, and liability issues.

Office Buildings

An office building is simply a building that contains office space. Office properties range from former single-family homes converted into commercial space, to small buildings with a few office suites, to large buildings in research office parks, to skyscrapers. The determination of when an office building is called a high-rise or skyscraper is usually dependent on the specific locality. As you'll see, commercial office building space is generally classified as A, B, C, or D quality, with A representing a highly desirable building with high-end amenities and D being a more basic utilitarian building. The difference between a letter classification is primarily a point of individual perception.

Retail Property

Retail properties are diverse and unique when compared to other types of real estate investments, with a wide range of property types available to investors. In the retail market, the ability of a property to produce an acceptable income stream depends on a number of factors, some of which are unique to retail space. The location and its demographics of the customer base are critical, as are these factors: Market appeal, access to public transportation, traffic flow, parking (the ratio of parking spaces per square footage is a function of local zoning ordinance), visibility and signage, competition, tenant mix, and anchor tenants.

Industrial and Manufacturing Properties

Industrial real estate is a very broad category and includes properties considered as distribution, manufacturing, and research facilities. Unlike office space, this type of property is often purchased by an investor who will also *use* the property since it often has highly specialized features. Therefore, industrial properties must be assessed individually based upon the intended use and perhaps the overall adaptability. Industrial properties are typically handled by an industrial specialist or an industrial broker who specializes exclusively in industrial properties. Institutional investors, including pension funds, life insurance companies, and real estate investment trusts, often purchase industrial property, which can be categorized based on use or property type, for example:

- Warehouse
- Service center
- Wholesale trade
- Distribution/transit warehouse
- Research and development center
- Factory (light or heavy assembly, high tech)

Structural and Site Considerations

There are a number of features to consider in almost all industrial properties:

- **Floor load capacity**, which is how many *pounds per square foot the floor can support*
- **Ceiling height**, which determines what processes or equipment can be used in the space
- **Clear span**, which is the *open distance between inside faces of support members,* and is especially important for distribution warehouses or manufacturing processes that require wide open spaces for large machinery, assembly lines, or conveyor belt systems
- **Loading docks** for shipping and receiving areas
- Accessibility and proximity to **transportation** such as highways, railroads, airports, and shipping
- **Mechanical** systems, including type and adequacy
- **Environmental** concerns, almost always requiring an environmental impact statement (EIS)

Another consideration related to industrial properties is community opposition. There may be resistance to certain types of industrial businesses that fall into the "NIMBY" category, that is, "Not in my back yard!"

Mixed-Use Buildings

Mixed-use buildings are those that do not fall into a single-use category. A mixed-use building could, for example, combine retail and office space on the first floor with residential on the floors above, or combine industrial, office, and retail. The possibilities and combinations are numerous and depend largely on local zoning laws and ordinances.

A common example of a mixed-use building is a loft. **Loft** buildings are characterized by the fact that *most of the building's interior is left unfinished, or minimally finished*. A loft building or loft space can also refer to an open space design of the tenant's usable area. Traditionally, loft space was used for lower cost or budget manufacturing or distribution operations. Today, however, lofts are often seen in older multi-story buildings that have been converted into multiple creative use designs for retail, restaurant, office, and residential areas. Because the space is unfinished, the rental rate for a loft lease is often lower than for finished space.

Buying vs. Leasing

When a business venture is seeking new or additional operating space, one of the factors that a commercial practitioner needs to address is analyzing whether to purchase or lease the new space. Practically every aspect of a business operation can affect the own versus lease decision process. Brokers and their clients need to analyze the proposed acquisition to assess the relative merits of the investment value. The ultimate goal is to make the client comfortable with the available alternatives that best satisfy the requirements of his business, which may be something other than a straight lease or purchase.

Owning Property

Fee simple ownership is the fullest freehold interest in property. It includes all the bundle of rights (possession, quiet enjoyment, disposition, exclusion, and control). This means that a fee simple estate is inheritable and transferable. These are among the *advantages* of owning:

- Tax advantages, including the deductibility of mortgage interest, property taxes, and depreciation
- Income
- Appreciation
- Control of the property

Of course, there are potential *disadvantages* to owning property, such as these:

- Initial capital outlay
- Financing
- Liability
- Management requirements
- Legal compliance
- Inflexibility

Amenity Purchasers

When working with commercial buyers, the term "amenity purchaser" is sometimes used. Although there is some overlap between an amenity purchaser and investor, they will not find the same value in the same property:

- The **amenity purchaser** is most likely an owner/user who is *motivated to find a location from which to house and operate a business.* This buyer values a property based on its ability to fulfill his specific business needs and may be more concerned about factors such as space, location, potential for expansion, etc.
- The **investor** *desires to place money where it will earn more money.* Investors value a property based primarily on its investment return and are more concerned with vacancy rates, income stream, creating a tax shelter, etc.

Real Success

You know that residential transactions often require the services of other professionals, such as home inspectors and attorneys. Commercial real estate deals are typically more complex than residential property transactions. As such, a real estate agent working on a commercial transaction is likely to be working with many other parties as well, such as attorneys, structural engineers, environmental specialists, and accountants. Early on in the transaction, look for the opportunity to form that team.

For example, when working with a client, an agent has a fiduciary obligation to provide reasonable care. You know that you should never give legal advice to a client unless you're also an attorney. But one thing that you should do is to make sure that your client's **attorney** is well-versed in commercial real estate transactions. Ask permission to talk to your client's attorney and take the time to establish a good working relationship.

Another key person in a commercial real estate transaction is your client's **accountant**. An accountant would likely be advising his or her client on issues such as:

- Whether or not the property would meet the client's investment objectives.
- Potential property and income tax issues related to the investment property.
- Lease terms.
- Possibilities for taking advantage of 1031 Exchanges.

Leasing Property

The alternative to acquiring fee simple ownership is obtaining a leasehold interest in property. Leasing is the means of acquiring occupancy rights, physical and partial economic use of property for a specific period. Some of the *advantages* of leasing include:

- Flexibility.
- Lower up-front cash requirement.
- Some tax relief (property taxes, rent, and other expenses are deductible).
- Lower risk of obsolescence.
- Stability of costs.
- Mobility.
- Fewer management distractions.
- Better return on inventory turnover as opposed to tying up capital in ownership.

And some of the possible *disadvantages* to leasing include:

- Inability to take advantage of appreciation.
- Inability to take advantage of tax deductible advantages, such as interest on mortgage loans and recognition of building depreciation.
- Lack of control over property.
- Lack of operational control and changes.
- Limited tax relief.
- Contractual penalties.
- Actual total cost of leasing is often more expensive per square foot than ownership.

Sale and Leaseback

A **sale and leaseback** arrangement exists when a company holds title to property, constructs a building that suits its needs, then sells the property to an investor (who becomes the landlord), and executes a lease back to itself from the buyer. This arrangement essentially turns the company's freehold estate into a leasehold estate. Frequently, if done correctly, this strategy provides seller/occupants with a profitable return on their initial investments, as well as the right to occupy the building under specified lease terms favorable to their business objective. A sale and leaseback allows the tenant company to have more liquid assets to invest in product or other resources, rather than having all assets tied up in the real estate. There are also tax advantages for both the company lessee and the investor lessor.

Long-Term Lease on Land

Ground leases, also referred to as a **land leases**, enable tenants to lease only unimproved land. Tenants are then able to construct an improvement to meet their business objectives. This type of lease is structured to separate the ownership of the land from the ownership of the buildings and improvements on the land. The ground lease is very popular in commercial property development. Very often, tenants plan to make substantial improvements to the parcel and the rental value reflects only a base rental amount for the land alone.

A good long-term ground lease enables tenants to have physical control over the parcel, and then finance improvements over the term of the ground lease. Most land leases are in the form of a triple net lease, whereby the landlord does not pay any of the expenses normally associated with ownership of land, rather the tenant does just as if he owned the property. As we have learned, triple net expenses generally include property taxes, insurance, repairs, and maintenance (and all other operating expenses).

It should be noted when a tenant builds a building upon leased ground, that tenant (and perhaps his lender) would want a long-term ground lease to enable him to amortize and/or depreciate the improvements. Often the lease term for a ground lease is in the form of an initial term with several options to renew.

Consider this example: An initial lease term could be 10 years with four 5-year options. This would enable the tenant to control the property for an extended period—at least 30 years. This is extremely important because upon expiration of the ground lease, the land, *and the building erected upon it*, reverts to the landowner—not the lessee.

Commercial Lease Basics

Leases are *binding contracts that set forth the terms and conditions under which a space can be occupied by a tenant.* Common lease terms include rental payment, permitted uses of the space by the tenant, who is responsible for maintenance and utilities, and how much, if any, rent will increase over the term. Because there are frequent tenant improvements required—payable by either the tenant or the landlord, dependent upon negotiation—commercial leases are for extended periods of time, unlike residential leases. Long-term leases allow the party paying for the improvements to be able to capitalize the improvement for tax purposes.

The commercial lease spectrum is simply the wide range of possibilities that exist for constructing rental payment arrangements and cost recovery in different types of income properties. A triple net lease is at one extreme of the spectrum, and a gross lease, or full service lease, is at the other end. In between the two extremes is where most rental negotiations take place.

Considerations for Lessors and Lessees

Landlords (lessors) and tenants (lessees) have different perspectives when considering a lease. From a **landlord's** point of view, there are several important aspects to leasing, which include having the ability to:

- Determine if the tenant has the ability to pay the rent.
- Set forth specific permissible uses for the property.
- Require the tenant to maintain the property.
- Increase rent when necessary to protect income from inflation and provide increased revenues.

From the **tenant's** point of view, a commercial rental arrangement should be structured to allow the tenant to occupy space where:

- The permitted use of the premises is sufficient and flexible to allow adaptation to changing market conditions.
- There is regular maintenance and upkeep of the premises.
- The obligation to pay rent is limited to a clearly defined formula.

Gross Leases

A **gross lease** is a *straightforward exchange of rent for occupancy.* With a gross lease, also called a **full service lease**, the tenant pays a fixed rent, while the owner or landlord pays all ownership expenses, such as property taxes, repairs, janitorial services, insurance, and sometimes utilities.

In a **modified gross lease** arrangement, tenants may be responsible for utilities, trash removal, and cleaning. The landlord pays the taxes and obtains damage and liability insurance and also maintains heating, ventilation, and air conditioning (HVAC) systems as well as security for the building.

Net Leases

A **net lease** is a lease for which *the tenant pays some or all of the costs of ownership, except mortgage interest and principal, in addition to the agreed upon rent.* With net leases, the property owner or landlord has shifted much of the risk for increased property costs to the tenants, who get the additional tax benefit of the business expense. Additionally, shifting the expenses attendant may have a direct impact on the overall value of the property when utilizing the "income approach to value." A net lease means lower rent for the tenant, but higher costs. Net leases may be categorized by the extent of the tenant's responsibility for paying these ownership costs:

- Taxes
- Insurance
- Common area maintenance (CAM) such as cleaning, landscaping, exterior lighting, snow removal, signage, security, trash removal, etc.

If the lease requires the tenant to pay *one* of these expenses, it's called a **single net lease**. If the tenant is required to pay *any two* of these expenses, it's a net-net lease, or a **double net** lease. A **triple net**, or net-net-net, lease requires the tenant to pay *all three* of these expenses. A triple net lease is also sometimes referred to as an **absolute net lease**.

Commercial Lease Agreement

This Commercial Lease Agreement (Lease) is entered into on this ____ day of _____, 20__, by and between _____ (Landlord) and _____ (Tenant). Landlord is the owner of land and improvements whose address is: _____. Landlord makes available for lease a portion of the Building designated as _____(Leased Premises).

Landlord desires to lease the Leased Premises to Tenant, and Tenant desires to lease the Leased Premises from Landlord for the term, at the rental and upon the provisions set forth herein.

THEREFORE, in consideration of the mutual promises contained herein, and for other good and valuable consideration, it is agreed:

Term.

The Initial Term of the Lease shall begin on the _____ day of _____, 20__, and end on the _____ day of _____, 20__. Landlord shall use its best efforts to put Tenant in possession of the Leased Premises on the beginning of the Lease term. If Landlord is unable to timely provide the Leased Premises, rent shall abate for the period of delay. Tenant shall make no other claim against Landlord for any such delay.

Tenant may renew the Lease for one extended term of _____. Tenant shall exercise such renewal option, if at all, by providing written notice to Landlord not less than ninety (90) days prior to the expiration of the Initial Term. The renewal term shall be at the rental set forth below and otherwise upon the same covenants, conditions and provisions as contained in this Lease.

Rent.

Tenant shall pay to Landlord during the Initial Term rent of _____ Dollars ($) per year, payable in installments of _____ Dollars ($) per month. Each installment payment shall be due in advance on the first day of each calendar month during the lease term to Landlord at the following address:

The rental payment amount for any partial calendar months included in the lease term shall be prorated on a daily basis.

Tenant shall also pay to Landlord a "Security Deposit" in the amount of _____ Dollars ($).

The rental for any renewal lease term, if created as permitted under this Lease, shall be _____ Dollars ($) per year payable in installments of _____ Dollars ($) per month.

Prohibited Uses.

Notwithstanding the forgoing, Tenant shall not use the Leased Premises for the purposes of storing, manufacturing or selling any explosives, flammables or other inherently dangerous substance, chemical, thing or device.

Sublease and Assignment.

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Tenant shall have the right without Landlord's consent, to assign this Lease to a business with which Tenant may merge or consolidate, to any subsidiary of Tenant, to any corporation under common control with Tenant, or to a purchaser of substantially all of Tenant's assets.

Except as set forth above, Tenant shall not sublease all or any part of the Leased Premises, or assign this Lease in whole or in part without Landlord's consent, such consent not to be unreasonably withheld or delayed.

Repairs.

During the Lease term, Tenant shall make, at Tenant's expense, all necessary repairs to the Leased Premises. Repairs shall include such items as routine repairs of floors, walls, ceilings, and other parts of the Leased Premises damaged or worn through normal occupancy, except for major mechanical systems or the roof, subject to the obligations of the parties otherwise set forth in this Lease.

Alterations and Improvements.

Tenant, at Tenant's expense, shall have the right, upon obtaining Landlord's consent, to remodel, redecorate, and make additions, improvements and replacements of and to all or any part of the Leased Premises from time to time as Tenant may deem desirable, provided the same are made in a workmanlike manner and utilizing good quality materials. Tenant shall have the right to place and install personal property, trade fixtures, equipment and other temporary installations in and upon the Leased Premises, and fasten the same to the premises. All personal property, equipment, machinery, trade fixtures and temporary installations, whether acquired by Tenant at the commencement of the Lease term or placed or installed on the Leased Premises by Tenant thereafter, shall remain Tenant's property free and clear of any claim by Landlord. Tenant shall have the right to remove the same at any time during the term of this Lease provided that Tenant shall repair, at Tenant's expense, all damage to the Leased Premises caused by such removal.

Property Taxes.

Landlord shall pay, prior to delinquency, all general real estate taxes and installments of special assessments coming due during the Lease term on the Leased Premises, and all personal property taxes with respect to Landlord's personal property, if any, on the Leased Premises. Tenant shall be responsible for paying all personal property taxes with respect to Tenant's personal property at the Leased Premises.

Insurance.

If the Leased Premises or any other part of the Building is damaged by fire or other casualty resulting from any act of negligence by Tenant or by any of Tenant's agents, employees or invitees, rent shall not be diminished or abated while such damages are under repair, and Tenant shall be responsible for the costs of repair not covered by insurance.

Landlord shall maintain fire and extended coverage insurance on the Building and the Leased Premises in such amount as Landlord shall deem appropriate. Tenant shall be responsible, at its expense, for fire and extended coverage insurance on all of its personal property, including removable trade fixtures, located in the Leased Premises.

Tenant and Landlord shall, each at its own expense, maintain a policy or policies of comprehensive general liability insurance with respect to the particular activities of each in the Building with the premiums thereon fully paid on or before due date. Such insurance policy shall be issued by and binding upon an insurance company approved by Landlord, and shall afford minimum protection of not less than $1,000,000 combined single limit coverage of bodily injury, property damage or combination thereof. Tenant shall provide Landlord with current Certificates of Insurance evidencing Tenant's compliance with this Paragraph.

Utilities.

Tenant shall pay all charges for water, sewer, gas, electricity, telephone and other services and utilities used by Tenant on the Leased Premises during the term of this Lease unless otherwise expressly agreed in

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writing by Landlord. In the event that any utility or service provided to the Leased Premises is not separately metered, Landlord shall pay the amount due and separately invoice Tenant for Tenant's pro rata share of the charges.

Tenant shall pay such all such utility charges prior to the due date. Tenant acknowledges that the Leased Premises are designed to provide standard office use electrical facilities and standard office lighting. Tenant shall not use any equipment or devices that utilizes excessive electrical energy or which may, in Landlord's reasonable opinion, over load the wiring or interfere with electrical services to other tenants.

Signs.

Following Landlord's consent, Tenant shall have the right to place on the Leased Premises, at locations selected by Tenant, any signs which are permitted by applicable zoning ordinances and private restrictions. Landlord may refuse consent to any proposed signage that is in Landlord's opinion too large, deceptive, unattractive or otherwise inconsistent with or inappropriate to the Leased Premises or use of any other tenant. Landlord shall assist and cooperate with Tenant in obtaining any necessary permission from governmental authorities or adjoining owners and occupants for Tenant to place or construct the foregoing signs. Tenant shall repair all damage to the Leased Premises resulting from the removal of signs installed by Tenant.

Entry.

Landlord shall have the right to enter upon the Leased Premises at reasonable hours to inspect the same, provided Landlord shall not thereby unreasonably interfere with Tenant's business on the Leased Premises.

Parking.

During the term of this Lease, Tenant shall have the non-exclusive use in common with Landlord, other tenants of the Building, their guests and invitees, of the non-reserved common automobile parking areas, driveways, and footways, subject to rules and regulations for the use thereof as prescribed from time to time by Landlord. Landlord reserves the right to designate parking areas for Tenant and Tenant's agents and employees. Tenant shall provide Landlord with a list of all license numbers for the cars owned by Tenant, its agents and employees.

Building Rules.

Tenant will comply with the rules of the Building adopted and altered by Landlord from time to time and will cause all of its agents, employees, invitees and visitors to do so; all changes to such rules will be sent by Landlord to Tenant in writing. The initial rules for the Building are attached hereto as Exhibit "A" and incorporated herein for all purposes.

Damage and Destruction.

If the Leased Premises or any part thereof or any appurtenance thereto is so damaged by fire, casualty or structural defects, such damage or defects not being the result of any act of negligence by Tenant or by any of Tenant's agents, employees or invitees, that the same cannot be used for Tenant's purposes, then Tenant shall have the right within ninety (90) days following damage to elect by notice to Landlord to terminate this Lease as of the date of such damage. In the event of minor damage to any part of the Leased Premises, and if such damage does not render the Leased Premises unusable for Tenant's purposes, Landlord shall promptly repair such damage at the cost of the Landlord. In making the repairs called for in this paragraph, Landlord shall not be liable for any delays resulting from strikes, governmental restrictions, inability to obtain necessary materials or labor or other matters which are beyond the reasonable control of Landlord. Tenant shall be relieved from paying rent and other charges during any portion of the Lease term that the Leased Premises are inoperable or unfit for occupancy, or use, in whole or in part, for Tenant's purposes. Rentals and other charges paid in advance for any such periods shall be credited on the next ensuing payments, if any, but if no further payments are to be made, any such advance payments shall be refunded to Tenant. The provisions of this paragraph extend not only to the matters aforesaid, but also to any occurrence which is beyond Tenant's reasonable control and which renders the Leased Premises, or any appurtenance thereto, inoperable or unfit for occupancy or use, in whole or in part, for Tenant's purposes.

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Default.

In the event of a default made by Tenant in the payment of rent when due to Landlord, Tenant shall have fifteen (15) days after receipt of written notice thereof to cure such default. In the event of a default made by Tenant in any of the other covenants or conditions to be kept, observed and performed by Tenant, Tenant shall have thirty (30) days after receipt of written notice thereof to cure such default. In the event that the Tenant shall fail to cure any default within the time allowed under this paragraph, Landlord may declare the term of this Lease ended and terminated by giving Tenant written notice of such intention, and if possession of the Leased Premises is not surrendered, Landlord may reenter said premises. Landlord shall have, in addition to the remedy above provided, any other right or remedy available to Landlord on account of any Tenant default, either in law or equity. Landlord shall use reasonable efforts to mitigate its damages.

Quiet Possession.

Landlord covenants and warrants that upon performance by Tenant of its obligations hereunder, Landlord will keep and maintain Tenant in exclusive, quiet, peaceable and undisturbed and uninterrupted possession of the Leased Premises during the term of this Lease.

Condemnation.

If any legally, constituted authority condemns the Building or such part thereof which shall make the Leased Premises unsuitable for leasing, this Lease shall cease when the public authority takes possession, and Landlord and Tenant shall account for rental as of that date. Such termination shall be without prejudice to the rights of either party to recover compensation from the condemning authority for any loss or damage caused by the condemnation. Neither party shall have any rights in or to any award made to the other by the condemning authority.

Subordination.

Tenant accepts this Lease subject and subordinate to any mortgage, deed of trust or other lien presently existing or hereafter arising upon the Leased Premises, or upon the Building and to any renewals, refinancing and extensions thereof, but Tenant agrees that any such mortgagee shall have the right at any time to subordinate such mortgage, deed of trust or other lien to this Lease on such terms and subject to such conditions as such mortgagee may deem appropriate in its discretion. Landlord is hereby irrevocably vested with full power and authority to subordinate this Lease to any mortgage, deed of trust or other lien now existing or hereafter placed upon the Leased Premises of the Building. Tenant agrees that it will from time to time upon request by Landlord execute and deliver to such persons as Landlord shall request a statement in recordable form certifying that this Lease is unmodified and in full force and effect (or if there have been modifications, that the same is in full force and effect as so modified), stating the dates to which rent and other charges payable under this Lease have been paid, stating that Landlord is not in default hereunder (or if Tenant alleges a default stating the nature of such alleged default) and further stating such other matters as Landlord shall reasonably require.

Security Deposit.

Landlord shall hold the Security Deposit without liability for interest and as security for the performance by Tenant of Tenant's covenants and obligations under this Lease, it being expressly understood that Tenant shall not consider the Security Deposit an advance payment of rent or a measure of Landlord's damages in case of default. Unless otherwise provided by law or regulation, Landlord may commingle the Security Deposit with Landlord' s other funds. Landlord may, from time to time, without prejudice to any other remedy, use the Security Deposit to the extent necessary to make good any arrearages of rent or to satisfy any other covenant or obligation of Tenant hereunder. Following any such application of the Security Deposit, Tenant shall pay to Landlord on demand the amount so applied in order to restore the Security Deposit to its original amount. If Tenant is not in default at the termination of this Lease, Landlord shall return the balance of the Security Deposit remaining after any such application to Tenant.

Notice.

Any notice required or permitted under this Lease shall be deemed sufficiently given or served if sent by United States certified mail, return receipt requested, addressed as follows:

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Landlord:

Tenant:

Landlord and Tenant shall each have the right from time to time to change the place notice is to be given under this paragraph by written notice thereof to the other party.

Brokers.

Tenant represents that Tenant was not shown the Premises by any real estate broker or agent and that Tenant has not otherwise engaged in, any activity which could form the basis for a claim for real estate commission, brokerage fee, finder's fee or other similar charge, in connection with this Lease.

Waiver.

No waiver of any default of Landlord or Tenant hereunder shall be implied from any omission to take any action on account of such default if such default persists or is repeated, and no express waiver shall affect any default other than the default specified in the express waiver and that only for the time and to the extent therein stated. One or more waivers by Landlord or Tenant shall not be construed as a waiver of a subsequent breach of the same covenant, term or condition.

Memorandum of Lease.

The parties hereto contemplate that this Lease should not and shall not be filed for record, but in lieu thereof, at the request of either party, Landlord and Tenant shall execute a Memorandum of Lease to be recorded for the purpose of giving record notice of the appropriate provisions of this Lease.

Headings.

The headings used in this Lease are for convenience of the parties only and shall not be considered in interpreting the meaning of any provision of this Lease.

Successors.

The provisions of this Lease shall extend to and be binding upon Landlord and Tenant and their respective legal representatives, successors and assigns.

Consent.

Landlord shall not unreasonably withhold or delay its consent with respect to any matter for which Landlord's consent is required or desirable under this Lease.

Performance.

If there is a default with respect to any of Landlord's covenants, warranties or representations under this Lease, and if the default continues more than fifteen (15) days after notice in writing from Tenant to Landlord specifying the default, Tenant may, at its option and without affecting any other remedy hereunder, cure such default and deduct the cost thereof from the next accruing installment or installments of rent payable hereunder until Tenant shall have been fully reimbursed for such expenditures, together with interest thereon at a rate equal to the lesser of _____ percent (%) per annum or the then highest lawful rate. If this Lease terminates prior to Tenant's receiving full reimbursement, Landlord shall pay the un-reimbursed balance plus accrued interest to Tenant on demand.

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Compliance with Law.

Tenant and Landlord each shall comply with all laws, orders, ordinances and other public requirements now or hereafter affecting the Leased Premises.

Final Agreement.

This Agreement terminates and supersedes all prior understandings or agreements on the subject matter hereof. This Agreement may be modified only by a further writing that is duly executed by both parties.

IN WITNESS WHEREOF, the parties have executed this Lease as of the day and year first above written.

_____ _____

Landlord Tenant

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Warehouses and Industrial Building Leases

Triple net leases are common for industrial commercial space where single tenants lease entire warehouses. The tenant takes responsibility for all expenses related to maintenance, repair, utilities, taxes, and sometimes even the roof and structure of the building, as well as the parking lots and grounds upkeep.

Of course, the rental payment to the landlord is much smaller on a per-square-foot basis, but the income to the landlord is usually dependable, without the vagaries of bills and unexpected costs. Lease terms for warehouses and other general-purpose industrial properties can be as short as a few months for multi-tenant buildings or as long as several decades for single tenant facilities.

Real Success

Of course, the terms of a lease are negotiable; therefore, there is a myriad of commercial property lease arrangements to suit individual circumstances. Frequently, leases on larger commercial units are customized by one of the attorneys for the parties in order to define the specific needs of both landlord and tenant. For example, the lease may be a modified net lease arrangement whereby the landlord is responsible for some of the property expenses such as maintaining the building's exterior walls and foundation, as well as any common areas, such as parking lots and main signage. The tenant, then, is usually responsible for other property expenses such as utility payments and trash removal, plus a pro-rata share of the property taxes and common area maintenance (CAM) charges. Because every element of a lease is negotiable, you should always read the entire lease carefully to examine its specific terms.

Lease Clauses

Each and every clause of a lease is a negotiating point between a landlord and a tenant. The following lease clauses, although not all-inclusive, represent some of the most common.

Use Clause

The **use clause** *specifically defines what type of business or use can be conducted by the tenant on the premises.* For example, a commercial lease for a space in an office building might state the leased premises will be used "only for general business office purposes, and for no other use or purpose," or contain words of similar import or intent. This clause is commonly seen in leases for retail or commercial space. Often mall leases may even state what type of products may or may not be sold by the tenant in that space.

Tenants usually want use clauses to be as flexible as possible so they can add other goods and services. Landlords, on the other hand, want to ensure tenants do not compete with each other, so they want use clauses to be specific. If the lease does not have a use clause or does not state a specified purpose, the tenant may use the space for any lawful use.

Attornment

An **attornment clause** *establishes tenancy with a new owner and defends current tenants against claims for rent from the former property owner.* This clause provides that, in the event of foreclosure or termination, for example, the lease shall continue, in force, as if the new owner or mortgagee were the landlord for a term equal to the unexpired term of the lease, and upon the same terms and provisions.

Estoppel

An **estoppel certificate** is a legal instrument that *prevents a person from taking a position, denying a fact, or asserting a fact inconsistent with previous conduct or statements*. Most standard commercial leases contain a clause whereby all tenants agree to comply with the request to complete an estoppel document upon request of the landlord. For example, an investor who purchases rental property may have current tenants sign an estoppel certificate acknowledging their obligation to pay the agreed upon rent and to confirm the terms of their existing leases.

Subordination and Nondisturbance

When someone is purchasing commercial property, the lender may not be willing to accept the property as security for the loan if it is burdened by an existing leasehold interest with a higher claim against the real estate. A **subordination** agreement *makes the existing lease junior to that of the new mortgage on the leased property.* For example, when a subordination clause is in the lease, the tenant will grant a waiver of his priority in favor of the new lender in the event of foreclosure of the landlord's loan. Those rights of recovery and protection in a leasehold would be subordinate to the rights of the lender, which means the lender could cancel the lease when taking over the tenant's building.

The tenant's protection to a subordination request is a **nondisturbance** agreement from the landlord's lender. This clause requires lenders to sign a document agreeing to honor and not terminate the tenancies of lessees who are current with their rent and who are complying with all provisions and obligations of their leases.

Right of First Refusal Clause

Tenants who think they may wish to buy the building or the property in the future may negotiate to have a **right of first refusal** clause placed in the lease. This clause, also called a right of preemption:

- Gives the tenant the right to have the *first opportunity* to buy or lease property *if* the owner decides to put it up for sale or lease.
- Cannot be exercised until the owner gets a bona fide offer from a third party. The owner must then make the property available to the person holding the right at the same terms as the bona fide offer.

Note that a right of first refusal is an inheritable interest and it also creates a **cloud on the title** and should be recorded in the public record.

Utility Clauses

Utility expenses are often addressed by specific lease clauses. This may, of course, depend on whether the lease is a full service lease or a triple net lease. However, even in a full service lease, utilities may be treated as a separate category. The monitoring of utility usage may be determined by:

- **Direct metering** by the utility company, where each tenant is separately metered and pays the utility company.
- **Sub-metering** by the landlord, who pays the utility bill and monitors individual private meters, billing the tenants.
- **Pro-rata** based on percentage of space occupied.

Sometimes utility expense responsibility is determined by the actual usage or type of usage of the space by the tenant, recognizing that certain categories of tenants may require a higher consumption of a specific utility, such as higher water and sewer usage for certain types of manufacturing processes.

Escalation Clauses

Leases often contain an **escalation clause** that *allows landlords to raise rent at an agreed upon time during the term of a lease.* These clauses, sometimes called **escalators**, protect a property owner's profit margin and, in some cases, may prevent the erosion of their expected return due to inflation.

Base Year

Escalators typically kick in after the **base year** that is identified in the lease. The base year, often the first year of the lease, establishes the operating expenses and taxes. If there is no historical data that supports specific figures for these costs, the indicated base year might not be the first year of the lease. For example, a tenant in a new development has a five-year lease. Since there is no historical data in a new development, the base year indicated in the lease might be year two, so the rent increases will begin in year three.

Pro-Rata Share

Much commercial property includes common space and amenities shared by all the tenants, who are expected to pay for their share of the property's expenses. Some leases determine that share of common expenses on a **pro-rata share** or *proportional basis* of the building's total area.

Tenant's Usable Area / Building's Total Usable Area = Pro-Rata Share

For example, if a tenant occupies 10,000 square feet of a 40,000 square foot building, the tenant is expected to pay a pro-rata share of 25% of the building's expenses:

10,000 sq. ft. / 40,000 = .25, or 25%

By evaluating costs occurring in each comparison year with the cost of the same expenses during the base year, increases or decreases in those expenses can be calculated. The determination of the base year and its actual operating costs is necessary to calculate the tenant's pro-rata share. The statement of the base year, operating costs, and the proportionate share should always be clearly defined in a lease to avoid misunderstandings between tenants and landlords.

Pass-Throughs

Many leases allow landlords to *pass along unexpected increases in operating costs to tenants*. These charges are referred to as **pass-throughs**. For example, a lease may contain a provision where the landlord agrees to operating costs up to a maximum rate per square foot or a maximum dollar amount of certain operating expenses with the remainder being passed through to the tenants.

In theory, tenants may be subject to an unlimited number of added expenses that could be passed through by their landlords. Therefore, tenants often negotiate a lease clause that places a maximum on their expense liabilities, which is referred to as an **expense cap** or **expense ceiling**.

Insurance and Property Tax Payments

Insurance and ad valorem property taxes are often handled in the same manner as other operating expenses. A separate clause in a lease may be included to refer to a negotiated amount at which the owner's contribution to property taxes stops. For example, if property taxes were $4 per square foot and the owner had a stop of $3 per square foot, the owner would pay $3 per square foot and tenants would pay $1 per square foot.

Lease Structure

Commercial leases are often structured in such a way that the lessor and the lessee share the risk—and the profits—associated with the property.

Step Increases

With a negotiated contractual **step or bump increase**, *base rent is scheduled to step up or bump up at a predetermined negotiated percentage or pre-established dollar amount* (no matter what happens to actual operating expenses). This is also known as a **graduated lease**.

Such fixed percentage adjustments are commonly effective on each anniversary of the lease or at the beginning of each calendar year. Often, landlords find that lenders are more willing to finance buildings with the income certainty of step increases, as opposed to the fluctuations of other indexed increase methods.

Percentage Leases

A **percentage lease** is a gross or net lease in which *the tenant pays a fixed monthly base rent as well as a percentage of gross sales achieved by the tenant over and above a predetermined level of sales known as the "breakpoint."* This type of lease, most commonly used for **retail tenants** with seasonal sales cycles, allows the landlord to share in the tenant's success and may include a clause that allows the owner to reclaim the premises if gross sales fall below a specified point. Base rent for retail is usually:

- Figured on an annual basis.
- Paid on a monthly basis.
- Quoted on a per-square-foot basis.

Index Leases

An adjustment mechanism frequently used in the commercial rental market is to link escalation clauses to a readily available **index** based on changes in the marketplace.

Consumer Price Index

The most commonly used index is the **Consumer Price Index (CPI)**. The CPI is an index published monthly by the United States Bureau of Labor Standards (BLS) and is considered *by many to be the basic indicator of inflation in the U.S.* CPI calculations exist for the U.S. as a whole and for regions, states, and even individual markets. By basing rental increases on the increase (or decrease) in the CPI, landlords and tenants can be reasonably sure the amount of rent being paid at the beginning of the lease retains its effective purchasing power no matter what happens to the value of the U.S. dollar due to inflation.

Porter's Wage Escalation Formula

The **Porter's Wage Escalation Formula** ties the rent escalation to the wages of the building's cleaning and building maintenance personnel (called "porters"). The formula *provides that tenants' rent will increase a specific amount per square foot for a specified increase in the porters' hourly wages*.

Disposal of Leased Space

The commercial real estate leasing market is influenced by various economical cycles and is usually most noticeable when the economy experiences a downturn. Tenants may experience these shifts in their own businesses, and their space needs may change accordingly. For instance, a tenant who faces the need to downsize or eliminate a local office will likely need to dispose of the leased space. There are four options available to do this, depending upon the terms of the lease:

Close Down. Tenants may elect to close down the operation but continue to pay the obligated rental payment until the end of the current term and not exercise their renewal option. By doing this, tenants eliminate paying additional operating expenses. This option is viable only if a nominal amount of time is left on the lease term; if the lease still has several years, the tenant may wish to explore another option.

Buyout. Tenants may elect to approach the landlord with a buyout proposal, in the form of a lump sum paid to terminate the existing lease early. For instance, consider a tenant who is at the end of the second year of a five-year lease and wants to close his business. The current lease obligates him to pay $50,000 per year, or $4,167 per month, in rent. The tenant may offer to pay the landlord a lump sum of one year's rent, or $50,000, in exchange for being released from the remaining three years of his obligation.

Sublease. Tenants may sublease their space to another tenant, if the lease permits it. A sublease exists when a tenant leases his leasehold interest, in whole or in part, to another party. The original tenant remains liable and is entirely responsible for lease payments and all other obligations.

Assignment. Tenants may assign their lease if they no longer wish to occupy the property. When tenants assign a lease, they transfer leasehold interest, rights, and obligations to another party. Tenants holding a leasehold interest can sell their interest or give it away freely, provided the original lease provisions allow assignment. Upon transferring leasehold interest, original tenants no longer make lease payments, but may still be liable for rent and other obligations in the event the assignee defaults.

Good-Guy Clause

Leases often contain a rider known as a "**good-guy clause**" that limits the liability of the personal guarantor for a tenant when a lease is terminated early. So if a tenant defaults on the lease but is current on rent payments and surrenders the property in good condition, the landlord will not seek payment from the guarantor. A good-guy clause could take the form of a simple paragraph or could be a multiple-page addendum.

Commercial Commissions

The commission rate that will be paid on the sale or lease of commercial property is **negotiated** between the client and the broker at the time a listing agreement is made. Although a sponsoring broker may have a standard commission rate that he or she, as a company policy, wants to charge, it's up to the sponsoring broker to determine how much he or she is willing to negotiate with a client. Any attempt or effort by a group of real estate practitioners to create a standard commission schedule would be construed as a violation of antitrust laws.

In commercial real estate, fees may be paid when the transaction closes or in installments, as with a long-term lease. The type and amount of compensation and the payment schedule are always negotiable.

Sales

Licensees may calculate commissions for the sale of commercial real estate in several ways, including using one of these four methods:

Fixed Percentage. The negotiated commission rate is based on the actual sale price of the property: Sale Price x Commission Rate = Commission.

Graduated Percentage. The commission rate is adjusted to the property sale price, for example, 7% on the first $500,000, 6% on the next $500,000, and 5% on anything over $1 million.

Fixed Fee. A fixed dollar amount is paid for the performance of specific real estate services. To be paid, the fee arrangement generally requires the successful completion of the transaction.

Retainer or Hourly Fee. A retainer (in advance) or a fee based on hours worked to perform specified tasks may be paid even when transactions do not close. Licensees working under this type of compensation arrangement are expected and required to keep very strict and specific accounting records of the time spent and actions taken on behalf of the client. This fee arrangement could be a percentage basis or a fixed dollar amount.

Leases

As with all commission agreements, the commission paid for procuring leases is based on the schedule and arrangement between the participating parties. Leasing commissions are generally established based upon one or more of the following:

Lump Sum. Commission is paid either at the time of execution of the lease (signing of the lease by both the landlord and the tenant) or upon the tenant taking occupancy of the leased premises. This commission is often based on a percentage of the *total rental value of the lease*, known as the **aggregate lease amount**.

While commissions are not paid on the additional percentage paid on a retail percentage lease, there may be opportunity to earn additional commission on an aggregate lease. For example, it's not uncommon to include a provision in the listing agreement that commission is also due on all expansions of space and exercised options. So if a tenant goes into five-year lease with three five-year options, commission would be due and payable upon exercise of each of those options.

Per Square Foot Fee. Commission is based on a dollar amount per square foot of leased space.

Flat Fee. Commission is based on a fixed dollar amount for leasing the space regardless of square footage.

Procurement Fee. A fee typically paid for finding space for a tenant. Procurement fees are often fixed fees but could be percentage based.

Timing of Commercial Commissions

Another consideration regarding commissions in commercial transactions is the time frame in which they are paid. Most often when there is a sale transaction, just as in the residential arena, payment occurs at closing. However, occasionally in commercial leasing situations, there may be a periodic commission payment arrangement.

Depending on local markets, some large commissions may be paid in **installments** over the period of lease terms (either monthly or annually). Although this arrangement is not as desirable for many practitioners, sometimes the situation, competitive environment, and market conditions dictate it. The agreement may be that commission is paid as the landlord receives each rental payment.

An assumption agreement, you may recall, allows a tenant to assign the lease to another party, who is then responsible for carrying out the terms of the lease. By the same token, if the property is purchased by someone else, the new seller could assign all current leases to the new owner. So, even if the lease has been assigned to someone else—either tenant or landlord—the property owner would still be obligated to pay commissions for renewals as indicated in the lease agreement.

A word of caution: If the commission is paid in scheduled installments and the building is sold prior to a scheduled payment, the new owner of the building may not have an obligation to meet the unpaid commission installments unless the sales contract recognizes the commission due.

Illinois Commercial Broker's Lien

770 ILCS 15/10

In Illinois, a sponsoring broker has the right to file a **lien** on commercial real estate, or any interest in that commercial real estate, in the amount of commission the broker is due under a written agreement with either the:

- Owner of the property, or
- Prospective buyer or tenant.

A broker would have to record a notice of a lien in the Recorder's Office or the Office of the Registrar of Titles in the county in which the commercial real estate is located **prior** to the actual conveyance of the deed for the commercial real estate against which the broker is claiming a lien. In addition, the broker must provide the owner of the property with a copy of the lien **document within 10 calendar days** of filing.

The lien attaches to the commercial real estate as of the date it was recorded, not the date of the written agreement. An exception to this is if the payments are made in installments, in which case the broker could record a lien for payments due after the transfer of the real estate and prior to the due date. In that case, the lien would be effective only against the outstanding balance due, not the entire amount indicated in the written agreement. In the case of a lease, the claim for lien must generally be recorded within 90 days after the tenant takes possession.

A broker may bring suit to enforce a lien in the Circuit Court in the county where the property is located **within two years.**

Real Success

It's very important to maintain relationships with your clients and customers. You know that from a residential standpoint. It's even more important from a commercial standpoint because most commercial transactions, particularly leases, tend to be for a limited term. It might be for three years or five years. What does that mean? It means in three to five years, something is going to happen with these tenants. They're either going to renew, so that's an opportunity for a ***new*** commission; or they're going to look for a larger space, an opportunity for a ***bigger*** commission; or they're going to have to downsize and go into something else, a opportunity for ***additional*** commission.

Summary

1. The terms "commercial" real estate and "investment" real estate refer to the same thing: Property that is used for investment purpose. Nearly any type of property could be considered commercial property: Unimproved land, residential property, office buildings, retail, industrial, manufacturing, and mixed-use buildings.
2. Practicing commercial real estate does **not** require a special license or special course work. The basic provisions of agency law, contract law, real property law, license law, and civil rights and fair housing laws are almost identical in commercial real estate and residential real estate.
3. When business owners are deciding whether to buy or to rent commercial property, they must evaluate the relative merits of owning versus leasing. Advantages to owning include tax savings, appreciation, and control. Advantages of leasing include flexibility, lower costs, and less risk.
4. An **amenity purchaser** is most likely an owner/user who is motivated to find a location from which to house and operate a business. This buyer values a property based on its ability to fulfill his specific business needs and may be more concerned about factors such as space, location, potential for expansion, etc. An **investor** desires to place money where it will earn more money. Investors value a property based primarily on its investment return and are more concerned with vacancy rates, income stream, etc.
5. Commercial leases reflect a wide range of possibilities for constructing rental payment arrangements and cost recovery. A **gross lease**, also called a **full service lease**, is a straightforward exchange of rent for occupancy. A **net lease** is a lease for which the tenant pays the agreed upon rent and one or more of these ownership costs: Taxes, insurance, or common area maintenance (CAM). A **single net lease** covers one of these expenses; **double net**, or net-net, covers any two; **triple net**, or net-net-net, covers all three of these expenses. A triple net lease, sometimes referred to as an **absolute net lease**, is typical with industrial property.

6. A **percentage lease** is a gross or net lease in which the tenant pays a fixed monthly base rent as well as a percentage of gross sales achieved by the tenant over and above a predetermined level of sales known as the "breakpoint." This type of lease, most commonly used for **retail tenants**, allows the landlord to share in the tenant's success and may include a clause that allows the owner to reclaim the premises if gross sales fall below a specified point.

7. **Ground leases**, also referred to as **land leases**, enable tenants to lease only the land (often an unimproved parcel of land), not any structures or improvements on the land. This type of lease is structured to separate the ownership of the land from the ownership of the buildings and improvements on the land. Rent, therefore, reflects only a base rental amount for the land alone. A **sale and leaseback** allows a company to sell property and lease it back to itself, turning a freehold estate into a leasehold estate, but freeing up capital for the company to invest back into the business.

8. Common lease clauses include: **Use** clause (defines use of the leased space), **attornment** (establishes tenancy with a new owner and defends current tenants against claims for rent from a former property owner), **estoppel** (affirms tenants' obligations to lease terms), **sublease** and **assignment** (used when tenants need to dispose of their leased space), **subordination** and **nondisturbance** (places the existing lease in an order junior to that of the new mortgage on leased property), and **electric service** (direct metering, sub-metering, or pro-rata).

9. Rent is often increased when a lease is renewed or extended. If a lease includes an **escalation clause**, rent may be adjusted, or escalated, during the lease term to add value to the property and/or cover increased costs of operating the building. Escalators typically kick in after the **base year** that is identified in the lease.

10. Some leases determine the share of common expenses on a **pro-rata share,** or proportional basis of the building's total area. Many leases allow landlords to pass along unexpected increases in operating costs to tenants, referred to as **pass-throughs**. Tenants may negotiate a lease clause that limits their expense liabilities, referred to as an **expense cap** or **expense ceiling.** A **graduated lease** is where the base rent is scheduled to step up or bump up at a predetermined negotiated percentage or pre-established dollar amount (no matter what happens to actual operating expenses). An **index lease** links rent escalation to a readily available index based on changes in the marketplace, such as the Consumer Price Index (CPI) or the Porter's Wage Escalation Formula.

11. Commission on commercial transactions can be figured in several ways. On commercial sales: Fixed percentage, graduated percentage, fixed fee, or retainer/hourly fee. On commercial leases: Lump sum percentage of the aggregate lease amount, per square foot fee, flat fee, or procurement fee. Commission may be paid at closing or paid periodically on a long-term lease.

Quiz

1. ***When does practicing commercial real estate require a special license?***
   a. always
   b. never
   c. when the property has more than one million square feet
   d. when the property value is greater than $5 million

2. ***Mac wants to ensure that retail tenant Jim's Gems never sells anything but jewelry from his store. What kind of clause would he put in the lease?***
   a. assignment
   b. escalation
   c. estoppel
   d. use

3. ***Craig owns a warehouse and his property taxes were recently raised. In turn, Craig charged the tenant currently occupying the building additional operating expenses. This is an example of***
   a. loss factor.
   b. a pass-through.
   c. Porter's wage escalation formula.
   d. pro-rata share.

4. ***Which statement about commercial real estate is TRUE?***
   a. Commercial and residential real estate share the same basic provisions for contract and real property law.
   b. Commercial properties have more potential buyers in comparison with residential.
   c. Commercial real estate transactions do not require agency disclosure.
   d. Single-family residential properties are never considered commercial property.

5. ***Which lease would likely have the lowest base rent?***
   a. gross
   b. net
   c. net-net
   d. net-net-net

6. ***Lucy has two years left on a lease, but her business is losing money every month. Which option for disposing of the space would you NOT recommend?***
   a. assign the lease to another vendor
   b. buy out the remainder of the lease
   c. close down the operation
   d. sublease the space

7. ***Mike listed a warehouse for sale. He negotiated 5% commission on the first $200,000, 4% commission on the next $300,000, and 6% commission on any amount over half a million dollars. The warehouse sold for $600,000. What is Mike's commission?***
   a. $26,600
   b. $28,000
   c. $30,000
   d. $32,000

8. ***An advantage for businesses to do a sale and leaseback is to***
   a. free up liquid assets to invest in other product or resources.
   b. increase the number and the variety of assets tied into real estate.
   c. leverage other people's money.
   d. qualify for more government assistance.

9. ***The type of investor who typically prefers investing in single-family residential properties is one who desires***
   a. a higher rate of return on investment.
   b. fewer management requirements.
   c. less risk of vacancy/loss.
   d. to occupy the property rather than rent it out.

10. ***Barb's lease obligates her to pay utilities, CAM, and insurance. Her landlord picks up the property tax bill. What kind of lease does she most likely have?***
    a. gross
    b. net
    c. net-net
    d. net-net-net

11. ***Of these, which type of property is LEAST likely to have a triple net lease?***
    a. multi-family residence
    b. retail storefront
    c. office
    d. warehouse

12. ***Which option would NOT offer protection to a landlord from an increase in costs of owning and maintaining property?***
    a. escalation clause
    b. index lease
    c. percentage lease
    d. triple net lease

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Retail and Office Properties

When you drive through any city or town, you can see for yourself that there are many types and styles of office and retail properties. Some are large high-rise office buildings or massive mega malls, while others may be single one-story residences that have been converted to office space or small strip malls or stand-alone shops. While the type of property may differ greatly, they share in common the fact that investors in office and retail property are looking to make a return on their investment. In this unit, you will be introduced to different types of office space and retail space and discuss the types of tenants attracted by particular properties. We will take a brief look at leases, review how rents for office and retail space are determined, and discuss some of the issues involved in tenant relations.

You will learn:

- Class categories of office buildings.
- Types of retail centers.
- How rent is calculated on office and retail property.
- Considerations for leasing office and retail property.

Key Terms

Accessibility (Ingress/Egress)
Accordion Clause
Anchor Tenant
Base Rent
Breakpoint
Building Efficiency
Class A, B, C, and D
Demographics
Loss Factor
Overage Rent
Regional Mall
Rentable Square Feet
Strip Center
Useable Square Feet

Office Buildings

An office building is simply a building that contains office space. Selling or leasing a small suite in an office building can be the first real departure from the residential real estate practitioner's experience. Office property can be highly specialized, and tenants often have very specific needs for this type of space. Some considerations that affect the value of office property include the following:

- Location
- Compliance with the American with Disabilities Act (ADA)
- Accessibility: Ingress (entrance) and egress (exit)
- Visibility (building and signage)
- Adequacy of parking
- General market conditions and rent levels
- Common areas and facilities
- Tenant profile
- Ease of tenant improvements
- Type and adequacy of mechanical systems
- Special maintenance requirements
- Security and lighting in common areas
- Staffing and management requirements
- Appearance and market appeal
- Ancillary services, such as vending, on-site cafeteria, or child care
- Technology issues, such as cable lines, satellite, or fiber optics

Classes of Office Property

In many markets, office buildings are often rated or categorized by the building's **class**, which is usually based on a combination of building characteristics, such as age, lease rates, architectural design, occupancy, location, tenant profiles, management, and building amenities and services. There are four primary classes of office buildings in most markets: **A, B, C**, and **D**. What might be a Class A building in one market might only be a Class B building in another.

This designation is also determined by whether the office building is an urban design or a suburban design. Generally, there are five size/design categories of office buildings:

- Skyscrapers
- High-rise
- Mid-rise
- Low-rise
- Garden, or subterranean

There is no set benchmark for the exact height determination across all markets for each of these categories; rather, it is determined by local and regional standards.

Class A Buildings

Class A buildings are usually the newest and most desirable buildings in a particular market with the best design, superior construction, amenities, and features. These buildings command the highest rental rates, attract the highest quality tenant, and set the standard for the rest of the local market. Typical tenants include corporate headquarters for banks, insurance companies, law firms, and Fortune 500 companies.

Class B Buildings

Class B buildings have good location, appearance, amenities, and are still desirable, but not quite the top of the market, primarily due to age. Class B buildings may have been Class A at one time, but age is taking its toll.

It may happen when a new Class A building becomes available nearby that a formerly Class A building may drop to be considered a Class B space. Depending upon the general growth of an area, a building may change from Class A to Class B in five years or ten years.

Class B buildings are still excellent commercial space but tend to appeal to a different type of tenant. The type of tenant who desires Class B space will include companies who desire a show place but may not be quite as prestigious a company as those who seek Class A space. Usually Class B buildings will also appeal to certain medical businesses.

Class C Buildings

Class C properties are older and still functionally viable, but not as favorably located or maintained. Some newer buildings are *purposely* built as Class C buildings. They are designed to be highly functional, yielding the maximum percentage of usable office space. Although new Class C buildings look functional, they tend to lack the image, amenities, or architectural statement. These "new" Class C buildings rent for considerably less than other classes and service the needs of commercial tenants who do not need image. The vast majority of office buildings are Class C. Tenants are typically price-driven.

Class D Buildings

Class D buildings are the balance of the older, functionally obsolete buildings needing extensive renovation. These are prime candidates for rehabilitation projects or demolition.

Office Leases

Having a full service lease for an office building means the tenant's rent includes his pro-rata, or proportional, share of operating costs. This is based on the percentage of square feet of the entire building the tenant occupies. A typical lease states an estimate for annual operating costs, and the rental payment is a monthly proration of that figure. At the end of the year, the landlord totals the actual costs, and if the actual costs are less than what the tenant paid, the tenant will receive a credit throughout the coming year. If the actual annual costs are more than the estimated costs, the tenant will most likely receive a bill from the landlord for the unpaid excess costs.

Lease terms for office buildings are typically from one to ten years but can, for a major tenant in some markets, be as long as 40 years, with options to extend the term further. In addition to options to extend the term, tenants occasionally negotiate provisions referred to as **accordion clauses**, which *give the tenant the flexibility to expand and contract the amount of space occupied.*

There are two major categories of rental income: Base rent and rent for additional items such as CAM (common area maintenance) and a variety of **pass-throughs**, for example:

- Tax escalations
- Utility escalations
- Contract prices
- Insurance on building

Determining Base Rent

In most markets, annual **base rent** is typically calculated as "per square foot." For example, if the rent is quoted as "$8 per square foot," a space with 6,000 square feet would result in $4,000 per month in rent:

$8 x 6,000 Sq. Ft. = $48,000 Annual Rent

$48,000 / 12 = $4,000 Monthly Rent

Understanding space measurement, therefore, is exceptionally important when considering commercial real estate.

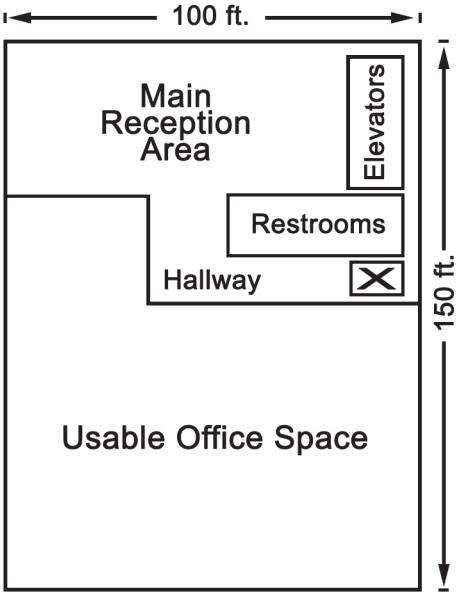
Caution: In different markets, the quoted "rent per square foot" may be either the **annual** rent or the **monthly** rent. Make sure you're clear on the terms.

Rentable Square Footage

Understanding space measurement, therefore, is exceptionally important when considering commercial real estate.

Rentable square footage is generally considered to be the *total floor area of a building*. This measurement, also called **gross square footage**, takes into account all tenant space as well as common areas or service areas such as the lobby, corridors, elevators, restrooms, and stairwells, which are used by two or more tenants and/or third parties and are not under the control of any one tenant.

Rentable square footage is the calculation usually used to determine a **lease payment** for office property. The tenant pays for a specific space and a pro-rata share of the identified common areas.



An easy way to remember that rent payments are based on the gross (rentable) square footage is to envision the word "gross" as GRO$$. $$ is paid for GRO$$ square footage.

Usable Square Footage

The **usable square footage**—also referred to as **net square footage** or **carpetable square footage**—is the *amount of actual space within the perimeter of the tenant's premises.* This figure is critical so that tenants can determine if the space will meet their specific needs for furniture, equipment, and personnel.

According to the Building and Office Manager's Association (BOMA), measurement of usable square footage is **from the interior finish of a permanent exterior wall or the interior of an exterior window** (if the window is at least 50% of the exterior wall) to the office side of corridors and to the middle of an interior partition wall between tenants. No allowances are made for columns or projections necessary to the building. This is in accordance with the theory the landlord is responsible for the roof, walls, and foundation of a building and the tenant is responsible for the interior.

But by measuring to the middle of an interior wall, the tenants on either side of the wall actually pay for the floor space on which the wall sits. In a large multi-tenant office building, that means the landlord will collect considerably more rent. Landlords who do not pay close attention to the details of usable and rentable square footage may be letting money slip through their fingers. Conversely, tenants who do not understand these concepts may pay more for rent than they should.

Real Success

Be aware that there are a number of methods for calculating rentable and usable square footage. For example, some property owners or markets may consider the common areas used by tenants, such as lobby and restrooms, as part of the rentable square footage, but ***not*** consider space taken up by critical structural elements such as fire stairs and elevators. Another property owner may consider the entire gross square footage as rentable square footage for the purpose of rent calculations. Is space measured to the middle of an interior wall, or just to the wall surface?

Make sure you understand the elements of the calculation for each specific property.

Loss Factor

To adequately cover a property owner's loss of rent for common areas that are *not* part of the usable square footage, for example, lobbies, elevator shafts, stairwells, common restrooms, etc., it is necessary to calculate the **loss factor**, sometimes called the **load**. Loss factor is *a ratio of rentable space to usable space.*

(Rentable Sq. Ft. – Usable Sq. Ft.) / Rentable Sq. Ft. = Loss Factor

For example, a building has 10,000 square feet, of which 8,000 square feet are usable:

(10,000 Sq. Ft. – 8,000 Sq. Ft.) / 10,000 = .20, or 20% Loss Factor

When a tenant's rent is calculated, that loss factor—in this example, 20%--is *added on* to the usable space to account for the tenant's share of the common areas. So, if a tenant is leasing 2,000 usable square feet of that 10,000 square foot building, the rent per square foot calculation would be:

2,000 Usable Sq. Ft. x .20 Loss Factor = 400 Sq. Ft. Common Area

2,000 Usable Sq. Ft. + 400 Sq. Ft. = 2,400 Rentable Sq. Ft.

If the landlord charged $22.50 per square foot, then the tenant's annual rent would be:

$22.50 x 2,400 Sq. Ft. = $54,000

Building Efficiency

The flip side of the loss factor is **building efficiency**, which is the *ratio of usable square footage to rentable square footage.* So, that office building with 10,000 rentable square feet and 8,000 usable square feet has a building efficiency of 80%.

Usable Sq. Ft. / Rentable Sq. Ft. = Building Efficiency

8,000 Sq. Ft. / 10,000 Sq. Ft. = 0.80 or 80% Building Efficiency

Real Success

It is critical to know and understand the language of real estate. Commercial real estate, in particular, requires that you be very specific about how you discuss things:

- When you have a new client who asks you about square footage, don't assume that he knows the difference between net square footage and gross square footage.
- Make it clear that when you quote a price per square foot the prospective tenant knows that it's based on the gross or rentable square footage, and whether that's per month or annually.
- Explain that when you say "net-net-net" you're discussing the terms of a lease where he will be responsible for paying insurance, property taxes, and common area maintenance.

Office Tenant Relations Considerations

There are particular requirements of office tenants, and it is important that you are able to ask prospective tenants the right questions about their needs so that you can provide them with appropriate options.

Parking

Typical zoning regulations for office buildings require parking for **five or six cars per 1,000 square feet of space.** This may be referred to as a 5:1 or 6:1 parking ratio. While this is generally adequate, more is certainly better. In large buildings, some common questions will be:

- How far away from the building will one have to park and walk?
- How many spaces will be available for customers (particularly for Class A and B buildings)?
- How many parking spaces are assigned to each tenant for their employees?
- What type of parking is available (interior, underground, or tiered parking garages can increase the value of the building to both the tenant and potential buyers)?
- Is there any security for parking areas?

Utilities

In most large office buildings, landlords usually pay the utilities. If that's the case, they may either:

- Add a specific utilities charge to the tenant's rent, for example, the base rent is $20 per square foot with a $2.25 utility charge.
- Bundle the utilities into the gross amount per square foot.

Hours of Operation

Not all buildings are accessible 24 hours a day, seven days a week. In today's world of international business and the 24/7 Internet, however, certain customers require round-the-clock access to their offices. Of course, this can create some issues, especially if the landlord is paying for building services such as lights, heat, etc. It's not uncommon for an office building to be a Monday through Friday building with lights and thermostats operated on a timer. If one tenant in the office building needs 24/7 access, the process of adjusting rents to cover common building amenities for a tenant who uses just some of the space becomes more challenging.

Ancillary Services

Learning what services are available in the building can be a good selling point in convincing a tenant to lease the space. Important services can include:

- On-site cafeteria,
- Health club,
- Child care facilities,
- Overnight carrier drop box, and
- Vending machines.

From a buyer's point of view, some of these services may also represent additional sources of income for the building.

Technology

Many tenants today want what are referred to as "smart" buildings, which is office space that has in place all the necessary technology a tenant requires, such as the following:

- Phone lines
- Digital computer lines (ISDN)
- High speed transmission cable lines
- Wi-Fi wireless Internet access
- Fiber optics
- Satellite hookups

While licensees do not need to become information technology gurus, they do need to have a basic understanding of the technology available in the building and, more importantly, be able to ask the prospective tenant or buyer the right questions. Some technology issues are absolute requirements for some tenants, while others may be "nice to have."

Tenant Improvements

Sometimes, a new occupant can utilize the previous occupant's space just the way it is. This is called **"as built."** When listing an existing property, it should be possible to obtain a floor plan showing the space as built from the property owner. Otherwise, it may be necessary to take out a tape measure and, some graph paper and create one.

While some tenants may be able to use a particular office space as built, it is highly unusual to find a tenant who is going to use office space exactly as built. For example, a tenant needs only 2,000 square feet and the space as built is 3,200 square feet. That does not mean that the space won't meet the tenant's needs, however. In most office buildings today, space is somewhat configurable: Knock a wall down here, put another one up there, take out individual offices and put in cubicles—whatever it takes to get the tenant the needed space.

When reconstruction—also known as a **build out**—is required, the terms are negotiated and then usually described in a **work letter**, which is then made an amendment to the lease.

Build to Suit

When office space is listed, particularly if it is new space, the property owner will often agree to a **build-to-suit** provision. In this case, the property owner will specify a specific dollar amount per square foot—known as a **tenant improvement allowance** or a **construction allowance**—that he is willing to contribute to preparing the space for the tenant in exchange for a lease commitment.

Like any construction project, a re-build of office space may involve architects, interior designers, electricians, plumbers, drywall hangers, carpet layers, and on and on. There will likely be building permits and certificates of occupancy, zoning regulations, planning board meetings, and on and on.

Retail Investment Property

Retail properties are diverse and unique when compared to other types of real estate investments. The investor in retail property is primarily interested in the income stream that can be achieved from renting out space to tenants. The investor considering the purchase of a retail property will have similar concerns and tend to ask the same questions as tenants interested in leasing space in that property. Because percentage-type leases are commonly used, the owner has a vested interest in the success of the retail tenant who is leasing the space.

Types of Retail Property

Retail investment property ranges from freestanding stores to enormous shopping malls. An **anchor tenant** is *a magnet store strategically located in shopping centers to generate traffic for smaller stores.* Retail property may be classified by purpose and size as follows:

- **Strip centers** typically contain a minimum of three stores with a total gross leasable area of up to 30,000 square feet. A wide range of tenants occupy strip centers and provide goods such as groceries and services such as dry cleaning.
- **Neighborhood centers** are typically built around a supermarket anchor tenant and range in size from 30,000 to more than 100,000 square feet.
- **Community shopping centers** have multiple anchor tenants providing a much wider range of goods and services and range from 100,000 to 300,000 square feet.
- **Regional malls** provide a broad range of general merchandise, apparel, home furnishings, appliances, and electronics, as well as an array of services, restaurants, and recreational facilities. Enclosed or not, regional malls range in size from 250,000 to more than 900,000 square feet.

- **Super regional** or **mega malls** are often built around three or more full line department stores as well as many smaller stores offering every good and service imaginable. They range in size from 500,000 square feet to well over 1.5 million square feet.
- **Specialty shopping centers** are characterized by the lack of a traditional anchor tenant, and have a group of tenants clustered together to fill the role of the anchor, for example festival centers, which are a mixed-use blend of specialty retail with a wide variety of restaurants and food vendors, a strong entertainment component, and even hotel, convention, and meeting facilities.
- **Power centers** take on the unique appearance of a cluster of very large "big box" retailers on the same property with few or no small stores.
- **Outlet centers** consist of several smaller stores that are either attached, detached, or a combination of both styles. The stores are usually restricted to major name retailers and manufacturers selling merchandise that is considered "seconds," "irregulars," or discontinued lines at a discount.

Calculating Rent on Retail Property

Unlike rent on office or warehouse space, rents for retail tenants also take into consideration the **amount of sales** a tenant is expected to generate or actually does generate. Most retail tenants who have percentage rent arrangements calculate the amount of pro-rata percentage rent due and pay it on a monthly basis, adjusting for any discrepancies at year-end when audited records are available.

With a **percentage lease** on retail space, the landlord shares in the tenant's success and is rewarded for owning a building in a great location and attracting a mix of compatible tenants. Therefore, a retail tenant pays a base rent, and then a percentage of gross sales over and above a **breakpoint.** The breakpoint *is the sales volume above which a retailer makes a profit.* Most retail tenants who have percentage rent arrangements calculate the amount of percentage rent due and pay it on a monthly basis, adjusting for any discrepancies at year-end when audited records are available.

The breakpoint may be an **arbitrary** number or a **percentage** of base rent, known as the **natural** breakpoint.

Arbitrary Breakpoint

For example, Lori, the owner of ABC Shoes, pays the landlord a base rent of $40,000 per year as determined by the gross square footage. She also agrees to pay 6% of any gross sales over the arbitrarily chosen number of $200,000.

If the shoe store did not sell $200,000 worth of shoes, she would owe no more additional rent. But if the store made $240,000, Lori would have pay $2,400 more in rent (40,000 x .06). This additional rent is **percentage rent** or **overage rent**.

Natural Breakpoint

A **natural breakpoint** is determined by dividing the base rent by an agreed upon overage percentage. For example:

A jewelry store owner agrees to a base rent of $80,000 per year, payable monthly, plus extras (such as common area maintenance charges, security, marketing, etc.). Furthermore, the owner agrees to pay 8% overage. The breakpoint can be determined by dividing the annual base rent by the agreed upon overage percentage. In this example, the breakpoint would be:

$80,000 base rent / .08 overage = $1 million breakpoint

If the jewelry store's annual sales exceed $1 million, then each dollar in sales over the breakpoint would cost the tenant another 8% in overage rent. For example, if the store had annual gross sales of $1.1 million, the **overage rent** would be payable on the $100,000 above the breakpoint. Overage rent would therefore be $8,000 ($100,000. x .08).

Retail Investment Property Considerations

In the retail market, the ability of a property to produce an acceptable income stream depends on a number of factors unique to retail sales. In the retail market segment, business and storeowners are captive to the property, which means they must wait for customers to come to them, which can sometimes be a detriment. The acquisition of retail investment property requires many of the same considerations from the investor as it does from the retail tenant.

Location

First and foremost among the considerations related to retail property is location. Both the owner (landlord) and the tenant want to know about the location and will talk along the same lines when looking for a suitable property. A "prime" location will be a different place for different tenants depending on the type of business the tenant is involved with. Many factors contribute to determining whether a particular location will meet the needs of the prospective tenant.

Parking

Another important consideration is parking. Both the investor and the tenant will be concerned about the amount of parking available. The standard parking ratio for retail is typically 3 to 1—which would mean three cars for every 1,000 square feet of space—although this will likely be dictated by local zoning codes.

Depending upon the type of retail space, there may be on-street parking, small or large parking lots, or parking garages. Here are some other questions to ask when considering parking:

- How close is the parking to the retail location (walking distance)?
- Are there an adequate number of parking spaces available to each tenant?
- Is there reserved parking for each tenant if the lot is small?
- Is handicapped parking available?
- Is there a charge to park (meters, parking garage)?
- Do neighboring businesses put high demands on parking during certain hours of the day or seasons of the year?

Signage

Since the goal of a retail business is to attract customers, both the investor and the tenant will be interested in the type of signage available to them for a retail property. Depending upon the type of retail space, each business typically will have its own individual building sign. In large retail locations, there may be a common sign that promotes different businesses within a shopping center or mall. Sign ordinances for the area will often dictate the type, design and size of the signage that a retail business in a particular location can have. The cost of the signage and its maintenance will be another consideration.

Traffic Counts

Traffic counts refer to *the amount of cars that pass by the retail business*. Depending on the type of retail business, this consideration will have an impact on the selection of a location for a particular tenant. In addition to the number of cars that pass by, there will be interest in:

- Amount and times of traffic congestion.
- Major intersections nearby.
- Traffic controls (lights, medians, turns).
- Where people using this route are on their way to and from.
- Whether the business is on the morning or evening side of a commute.

Accessibility

Along with traffic counts, both the tenant and landlord will be interested in the **accessibility** of retail property, also known as **ingress** (entrance) and **egress** (exit). Sometimes the space is in a great location but various factors can impact a customer's ability to gain access, including:

- Traffic patterns,
- Congestion,
- One-way streets, and
- Position or direction of entrances and exits to interstate ramps and parking lots.

For a retailer, ingress and egress to the property may be tantamount to the success of the business.

Demographics

Another important consideration for both owners and tenants of retail properties are the demographics. **Demographics** help the retailer understand *the customer base of the area surrounding the property*. Depending on the type of business, the principals will be interested in data within 3, 5, 10, or 20 miles of the location. Demographics are collected by government agencies and marketing groups and may be obtained from many different sources, such as the U.S. Census Bureau, the U.S. Bureau of Labor Statistics, or even local Chambers of Commerce. Information that is considered part of demographics includes, but is not limited to the following:

- Population
- Age levels
- Gender
- Income levels
- Home ownership
- Expenditures
- Education
- Internet access/usage

Competition

Both the investor and the tenant are going to be interested in the competition that is nearby the location of the retail property. Having a number of similar-type businesses within the area can be an advantage and/or a disadvantage, depending upon the type of retail business. Some businesses prefer to be unique ("the only choice") in an area while others may prefer to market themselves as a competitor in the market, an "alternative choice." Local business regulations may come into play, as planning commissions may dictate how many of a certain type of business will be allowed in a particular area.

Summary

1. Office buildings are often rated by the building's **class**, usually based on a combination of building characteristics such as age, lease rates, architectural design, occupancy, location, tenant profiles, management, and building amenities and services. The four primary classes of office buildings in most markets are **A, B, C**, and **D**. The categorization of these classes is determined by local and regional standards.
2. Lease terms for office buildings are typically from one to ten years but can, for a major tenant in some markets, be as long as 40 years, with options to extend the term further. In addition to options to extend the term, tenants occasionally negotiate provisions referred to as **accordion clauses**, which give the tenant the flexibility to expand and contract the amount of space occupied.
3. Annual **base rent** for office space is typically calculated as "per rentable square foot." **Rentable square footage**, also called **gross square footage**, is the total floor area of a building including all tenant space as well as common areas or service areas. The **usable square footage**, also referred to as **net square footage** or **carpetable square footage**, is the amount of actual space within the perimeter of the tenant's premises. Usable square footage allows a tenant to determine if the space will meet the needs. **Loss factor**, sometimes called the **load**, is a ratio of rentable space to usable space. When a tenant's rent is calculated, that loss factor is added on to the usable space to account for the tenant's share of the common areas. **Building efficiency** is the ratio of usable square footage to rentable square footage.
4. Typical zoning regulations for office buildings may require parking for **five or six cars per 1,000 square feet of space.** This is generally referred to as a 5:1 or 6:1 parking ratio. Other considerations include: Hours of operation, utilities, ancillary services such as cafeteria, and technology. **"As built"** is when a new occupant can utilize the previous occupant's space just the way it is. When a **build out** reconstruction is required, the terms are negotiated and described in a **work letter** lease amendment.
5. Retail investment property ranges from freestanding stores to enormous shopping malls. An **anchor tenant** is a magnet store strategically located in shopping centers to generate traffic for smaller stores. Retail property may be classified by total gross leaseable area: Strip centers (30,000 sq. ft.), neighborhood centers (30,000-100,000 sq. ft.), community shopping centers (100,000 – 300,000 sq. ft.), regional malls (250,000-900,000 sq. ft.), super regional/mega malls (500,000-1.5 million sq. ft.). Retail property may also be classified by purpose, for example, specialty shopping centers, power centers, outlet centers.
6. Most retail tenants have a **percentage lease** where the tenant pays a **base rent,** and then a percentage of gross sales over and above a **breakpoint**, the sales volume above which a retailer makes a profit. The breakpoint may be arbitrary or, more commonly, a **natural** breakpoint, which is determined by dividing the base rent by an agreed upon overage percentage.
7. A typical parking ratio for retail may be 3:1. Other considerations for retail space include: Location, signage, traffic counts, accessibility (ingress and egress), demographics, and competition.

Quiz

1. ***TED Resources rents space for a call center in a new office park. They had to sign a five-year lease to get the price they wanted, but they're hoping that they'll be able to expand their staff in a year or two. What clause in the lease will help them with this?***
   a. accordion clause
   b. escalation clause
   c. expansion clause
   d. subordination clause

2. ***GEM Inc. is the largest of 10 tenants in a 10,000 square foot office building. GEM pays annual base rent of $5 a square foot for each of its 2,000 square feet and a pro-rata share of the $10,000 annual maintenance. What is GEM's monthly rent?***
   a. $1,000
   b. $1,200
   c. $10,200
   d. $12,000

3. ***An office building which has 48,000 rentable square feet includes 36,000 of usable square feet. What is the building's efficiency?***
   a. 25%
   b. 33%
   c. 66%
   d. 75%

4. ***A new building that was built to be functional and inexpensive may be considered***
   a. Class A office space.
   b. Class B office space.
   c. Class C office space.
   d. Class D office space.

5. ***Which tenant would most likely be an example of a Class A tenant?***
   a. architectural firm
   b. credit card processing office
   c. real estate appraisal office
   d. telemarketing office

6. ***The difference between rentable square footage and usable square footage is known as***
   a. equity.
   b. gross square footage.
   c. load.
   d. net square footage.

7. ***An advantage of having an anchor tenant is that it***
   a. may attract customers to smaller stores.
   b. may force smaller stores out of business.
   c. may provide common area maintenance for other tenants.
   d. will usually stand on its own.

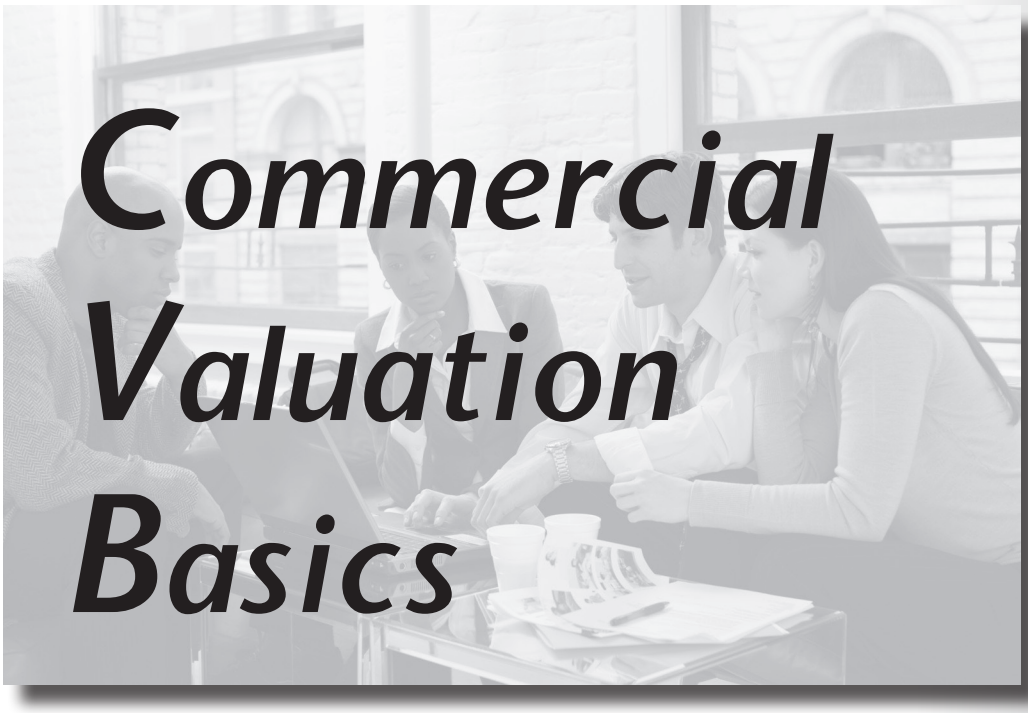
8. ***Ingress/egress refers to***
   a. accessibility of a retail property.
   b. adequacy of mechanical systems.
   c. common area maintenance.
   d. escape clause in a percentage type lease.

9. ***The type of retail property that usually contains a minimum of three stores and has a total gross leasable area of up to 30,000 square feet is most likely a***
   a. factory outlet center.
   b. free-standing store front.
   c. regional mall.
   d. strip center.

10. ***Which piece of data would most likely be considered part of the demographics for a retail business?***
    a. gross square footage of the space
    b. community income levels for the area
    c. hours the security company patrols the parking lot
    d. traffic lights and controls at the entrance

11. ***The owner of Oliver's Bakery leases space in a recently renovated building in an up-and-coming neighborhood. His lease calls for a base rent of $3,500 per month plus a 6% overage percentage. If Oliver has $720,000 in gross sales last year, what is his total rent?***
    a. $40,680
    b. $42,000
    c. $42,520
    d. $43,200

12. ***Kim pays an annual base rent of $12,000 for her little bookstore as well as an overage percentage of 7.5%. If Kim has gross sales of $120,000, what is her total rent?***
    a. $11,100
    b. $11,250
    c. $12,000
    d. $12,900



26 Commercial Valuation Basics

"Commercial" property and "investment" property are synonymous terms. So in this chapter, we'll focus on that word "investment." We'll discuss the motivations of real estate investors. Then we'll see how they can evaluate whether or not their property is meeting their investment requirements. Finally, we'll look at a property's performance from the buyer's point of view to see how much they might be willing to pay for a commercial property.

You will learn:

- Motivations of a property investor.
- Risks associated with real estate investing.
- The components of the cash flow model and how it is applied to most investment opportunities.
- How to evaluate the income potential of an investment property and determine its value to an investor.

Key Terms

1031 Exchange
Capital Gain
Capitalization Rate
Cash Flow
Cash-on-Cash Return
Debt Service
Depreciation
Economic Rent
Effective Gross Income
IRV Formula
Leverage
Liquidity
Net Operating Income (NOI)
Operating Statement
Potential Gross Income
Pro Forma
Reserve for Replacements
Return on Investment
Risk

Investment Basics

There is no shortage of investment opportunities in the marketplace, such as savings accounts, stocks and bonds, certificates of deposit, money market accounts, precious metals, fine art and collectibles, commodities futures, and, of course, real estate. No matter what the investment, investors select the opportunities they believe most closely meet their financial goals.

Of course, a primary goal of any investor is the **preservation** of the capital invested; in other words, the investor wants some assurance that there will be a return ***of*** the initial investment. Another attraction of investing in real estate, however, is its capability of producing or earning an acceptable return ***on*** his investment while it is at risk or "tied up" in the property. When a purchaser invests in real estate, he is trading a lump sum of capital in the present for the expectation of one or more of the following:

- Receiving a **continuing stream of income**
- Creating a **tax shelter**, which *gives owners certain income tax advantages*, such as deductions for property taxes, mortgage interest, and depreciation
- Building **equity** in the investment through leverage and appreciation
- Earning a **return on the investment** when the property is sold

Since a return of the total investment is often not realized until the real estate is sold, it is necessary to analyze the investment for the entire ownership period. There are a number of fundamental investment characteristics that affect how an investor views any investment opportunity. Three important characteristics to consider are risk, liquidity, and leverage.

Risk

Actual events in the market may differ from what investors anticipated at the time property was purchased and so impact an investor's actual rate of return. For example, vacancy rates may be higher than anticipated, or market rental rates at the time of lease renewals may be lower than predicted.

We can view **risk** as *the degree of probability the actual rate of return earned will differ from the return expected when the investment was made.* The amount of expected profit is directly related to the risk inherent in the investment. Low-risk investments are expected to generate low profits; high-risk investments are expected to generate high profits.

Because investors have many outlets for investing their money, real estate must compete with alternative investments; further, the expected returns from real estate must be comparable to returns from other investments with similar risk. An investor's tolerance for risk will have a great impact on his or her willingness to invest in real estate, because an acceptable level of risk means different things to different investors. Knowing the sources of risk that can affect a particular investment is the first step in risk analysis.

Space Market Risk. The risk that the *demand for space will affect rents, vacancy rates, and net operating income* (NOI). This can result from either a change in the demand for space by users or changes in the supply of space from new and existing construction.

Capital Market Risk. The risk that c*hanges in the market for capital will affect the value of real estate.* Note that this differs from changes in the market for space. Capital market risk is affected by changes in the level of interest rates, changes in the availability of mortgage and equity capital, and changes in the rate of return for alternative investment opportunities.

Financial Risk. Results when *debt is used to finance an investment.* An investor's return on equity increases if the leverage or the use of credit to enhance speculative capacity increases. Investors expect leverage to be positive when they purchase and finance property. Due to unexpected changes in market conditions, however, the leverage may be negative. The use of debt also increases the risk of default on a mortgage. The degree of financial risk increases with the amount of debt.

Inflation Risk. The risk that unexpected inflation will affect future income and purchasing power, owing to the probability that actual inflation will differ from the amount of inflation expected when the investment was made. In a weak market, building owners may not be able to raise rents to match inflation, and property values may not keep up with replacement costs. This is especially true when vacancy rates are high and new construction is not feasible.

Other types of risk can factor into an investment decision, for example **environmental** risk that the value of a property will be influenced by factors that affect the owner's ability to develop or lease the space; **legislative** risk that changes in laws and regulations will affect the market value of the property; **management** risk that property management can affect the performance of a property; or **technological** risk due to the fact that ever-changing technology creates obsolescence among businesses.

Liquidity

Liquidity is *the ability to convert an asset into cash quickly without the loss of principal.* Similar to liquidity is **marketability**, which is *the ability to quickly convert a commodity to cash at any price.*

Some investments, such as publicly traded stocks, are highly marketable and therefore relatively liquid. Real estate, on the other hand, may require extended periods to sell and is affected by an unpredictable market. So, the full value of a real estate investment property is usually *not* immediately convertible to cash without some loss of total value. This characteristic of real estate makes it one of the more non-liquid, or illiquid, of the various investment alternatives.

Leverage

Leverage is *the effect borrowed funds have on investment returns.* Leverage may increase or decrease an investor's return that would otherwise have been received had she purchased property on an all-cash basis. Usually, investors borrow money for a purchase with the expectation that the investment's financial return will increase to such an extent they will realize a profit not only ***of their*** own invested funds (typically the down payment), but will also make a profit ***on*** the borrowed funds. This use of leverage, also called the use of "**other people's money**" (OPM), is one of the biggest draws for real estate investors.

The use of OPM allows investors to compound their own buying power, thus enabling them to purchase a much larger property or perhaps more property than they otherwise could if they had to use only their own funds for the entire purchase. Leverage can be positive or negative:

- **Positive leverage** is when borrowed funds are invested at a rate of return higher than the cost of those funds to the borrower, resulting in a profit on the borrowed funds.
- **Negative leverage** occurs when borrowed funds are invested at a rate of return lower than the cost of those funds to the borrower; for example, the interest rate charged by the lender for the borrowed funds is greater than the rate of return the investment is generating on those borrowed funds. In this instance, investors incur a loss on the borrowed funds.

Case in Point

Here is a very simple example of positive leverage. Will buys a rental property for $150,000. He puts $40,000 down and mortgages the remaining $110,000 at 6%. A year later, he's earned $12,000 income from the rent. Without taking into account any tax advantages he may have gained by owning the property, after subtracting the interest paid on the loan—let's say $6,000—his net profit is $6,000, for a 15% return on investment:

$6,000 / $40,000 = .15 or 15%

If Will had ***not*** financed the purchase of the property:

$12,000 / $150,000 = .08 or 8%

That's the beauty of leverage: Using other people's money to make money.

Financing

Financing commercial real estate, from an investor's point of view, not only allows the investor to mortgage property so that he can make the purchase, but it allows the investor to **leverage** other people's money into his own income stream. Financing sources for commercial real estate include mortgage banking firms, savings and loan institutions, regional banks, insurance companies, and private investors. While the source of funds may be similar, financing of commercial real estate purchase is very different from financing residential property, however.

Residential lenders look at things such as a property's appraised value to determine the loan-to-value ratio, the borrower's ability to make mortgage payments by looking at the debt-to-income ratio, etc. While commercial lenders are certainly interested in the value of the property, they must also be concerned about the property's ability to generate income or appreciate in value. Therefore, commercial lenders also want to know the **future** value of a property. To do that, they will look at factors such as these:

- Anticipated use of the property
- Anticipated returns from the property
- Geography
- Type of real estate
- Perceived risk to lender
- Market conditions

For example, a lender would look at an office complex with 50% vacancy and a lower appraised value quite differently from an office complex that's 90% occupied, even if the properties were virtually identical in every other way.

Lenders

While some lenders specialize in specific types of commercial ventures, such as office space, retail operations, or apartment complexes, others provide across-the-board financing to a wide variety of commercial ventures. Despite the many types of financing and types of commercial real estate, lenders remain primarily concerned with the level of risk they'll be taking. Therefore, a buyer must be prepared to provide certain documentation, such as these:

- Operating statements and/or cash flow statements that demonstrate the income stream
- Financial statements on every owner, if a partnership, or principals in a corporation
- Appraisal on the property
- Plans for any improvements to the property
- Business plans, or pro formas, that define exactly how the property will be used and the anticipated income under certain circumstances

Evaluating an Investment Property

Investors are typically not emotional about their buying decisions, and like to have objective means to compare properties. Therefore, it's necessary to have a "yardstick" by which to measure the property. One such yardstick is called the **cash flow model**.

An investor uses this model to prepare a **pro forma**, also called **annual property operating data (APOD)**, to show the *hypothetical projection of income and expenses for this first full year of ownership.* Preparing a pro forma requires investors to first compile a great deal of financial information. The typical investor's thought process when making a buying decision includes weighing:

- Historical information and trends.
- Current supply and demand.
- Factors affecting such trends.
- Anticipated events such as competition from other developments under construction.

Most investors start by requesting a copy of the present owner's recent tax returns and/or their **operating statements**, which are *used by property owners to illustrate total revenues generated and expenses for a given period as a means of evaluating the property's performance.*

Operating Statement Example

An **operating statement**, also referred to as an income and expense statement or a profit and loss statement, consists of both income and expense items associated with operating the property.

While there are many similarities between the present owner's operating statement and the investor's pro forma, there are also many important differences to understand. To compare the two, below is a very simply example of a previous year's operating statement for a small apartment complex. This complex has a total of 17 units: 9 one-bedroom units and 8 two-bedroom units. One of the two-bedroom units was empty for six months:

Operating Statement	
Monthly Rent Roll	
9 Apts. @ $520.00/Month	$56,160.00
8 Apts. @ $610.00/Month	+ $58,560.00
Annual Rent Roll	$114,720.00
Vacancy Loss ($610 x 6 months)	- $3,660.00
Gross Annual Revenue	$111,060.00
Other Income (Laundry)	+ $2,400.00
Total Operating Income	**$113,460.00**
Expenses	
Owner's Salary	$20,000.00
Mortgage Interest	$25,806.00
Owner's Health Insurance	$4,850.00
Travel and Entertainment	$2,025.00
Repairs/Maintenance	$4,237.00
Accounting/Legal	$1,100.00
Advertising	$593.00
Electric	$1,585.00
Water Fees	$546.00
Snow Removal	$1,250.00
Lawn Care	$825.00
Heating Oil	$2,344.00
Trash Removal	$1,775.00
Property Taxes	$21,430.00
Pest Control	$1,200.00
Property Insurance	$4,450.00
Miscellaneous	$500.00
Depreciation	$14,546.00
Total Expenses	**$109,062.00**
Earnings Before Taxes (EBT)	**$4,398.00**

Adjusting for a Pro Forma

By reviewing the operating statement, the investor can develop a good understanding of the financial requirements of owning the property, but should not rely solely on the data provided. When the investor prepares a pro forma using the cash flow model, he will:

- Add new line items that pertain solely to the financial needs of the investor/buyer.
- Make use of some of the line items, but will adjust the financial data.

An investor will also omit line items that pertain only to the present owner and are irrelevant to an investor/buyer, for example:

- Owner's salary
- Personal insurance and retirement (medical, 401(k), etc.)
- Travel and entertainment
- Car and related expenses
- Debt service
- Depreciation

Components of the Cash Flow Model

	GROSS POTENTIAL INCOME
-	<Vacancy/Credit Loss>
+	Other Income (Misc.)
=	EFFECTIVE GROSS INCOME
-	<Total Expenses>
=	NET OPERATING INCOME (NOI)
-	<Annual Debt Service>
=	CASH FLOW BEFORE TAXES

Gross Potential Income

Gross potential income is the *total income, both cash and non-cash, received from an investment or business before any expenses are paid or losses accounted for.* This may also be referred to as **gross revenue**.

A property owner is always challenged to charge market-appropriate rents while maintaining an acceptable occupancy level. If the occupancy level is consistently 95 percent, the rent might be too low, for example. The gross income line on an owner's operating statement will reflect the current rent roll, called the **contract rent**.

A potential buyer would be more interested in determining the **economic rent**, also called the **market rent**, which is the *rent that would be possible to charge if adjusted to appropriate market levels.*

If the market rent is different from the contract rent, an adjustment may be made on the pro forma. However, if the tenants in the property have **long-term leases**, the pro forma should project the current rent roll. Market rent should *not* be used to project gross potential income if the landlord is not in a position to raise the rent.

Vacancy and Collection Losses

Gross potential income also assumes that every space in the building is leased all year with ***no vacancies***. Furthermore, it assumes that everyone is not only paying rent, but also paying on time. Unfortunately, ideal gross income conditions are not always attainable. Every landlord, at some time or another, will experience some period of vacancy during the year and occasionally some tenants will fail to pay.

The **cash flow model** makes provisions for an allowance for vacancy and collection losses on a pro forma. It is a generally accepted accounting practice that some vacancy losses are expected to be shown here, even if minor, because no property is expected to always be 100 percent occupied. This may be adjusted up or down based on circumstances and perceived risk. Data for anticipating vacancy losses can come from:

- Historical data from existing operating statements.
- Projections based on current market conditions in the area, such as unemployment, etc.
- A market analysis to determine the vacancy losses of comparable properties.

Since the vacancy loss figures so importantly into the equation for finding the net operating income, a conservative investor would want to err on the side of caution when creating a pro forma.

Miscellaneous Income

Some commercial properties generate income for their owners other than rent, such as the change collected at an apartment complex's coin-operated laundry or the vending machines in an office building's break room. Parking income, storage space fees, rooftop antennas, and other income sources are also categorized as miscellaneous income. Any money earned other than rent and rent-related items, such as tenant reimbursements for taxes or utilities, should be itemized and added in as miscellaneous income.

Effective Gross Income

The **effective gross income** is the *estimated rental income the owner anticipates collecting and that will be available to pay the expenses of owning the property.* To calculate the effective gross income, subtract the allowance for vacancy and collection losses, and add the miscellaneous income from the gross potential income.

Expenses

Owning and managing income-earning property costs money. Expenses may be broadly classified as fixed or variable:

Fixed Expenses. Expenses that *occur on a regular basis, have regular payment amounts—such as property taxes and insurance, landscaping, and other service contracts—and generally do not vary in response to changing levels of occupancy*. These expenses occur whether the property is vacant or fully leased.

Variable Expenses. Expenses that are *necessary to maintain the income stream of the property and provide services to the tenants*. Variable expenses tend to be tenant driven. They occur regularly, but may vary based on occupancy levels as well as amounts. For instance, expenses for maintenance, repairs, advertising, pool inspections, city business licenses, and utilities may occur regularly but vary in amount. Variable expenses generally depend on a number of issues including the type, size, age, and condition of the property.

Expenses: Payroll and Resident Managers

Generally speaking, salaries are included on an operating statement only for employees who have been hired by the owner to care for the building. In addition to salary, this category may also include Social Security and unemployment taxes and workers' compensation. Any "salary" that an owner draws from his investment is ***not*** considered an expense.

What about a resident property manager who gets free or reduced rent? If that is the case:

- The market rent that the resident manager's unit could make is counted as gross income.
- The reduction in that potential rent amount (all or some) is indicated as an expense.

Reserve for Replacements

Reserve for replacements is *money that a property owner sets aside regularly in anticipation of needing to fund capital improvement projects or to pay for extraordinary repairs.* An investor evaluating a property for possible purchase should not neglect this as an expense category on a pro forma.

Reserve for replacements is to the pro forma what **depreciation** represents to the operating statement. A property owner does not actually pay depreciation as an expense, and so there's not necessarily an absolute correlation between the depreciation and the amount an investor might want to consider as reserve for replacements. The depreciation, however, does provide a reasonable figure to use in a pro forma when evaluating an investment property.

Net Operating Income (NOI)

Net operating income (NOI) is the *annual income from a property or business that remains after annual operating costs are paid.* The NOI is calculated by deducting operating expenses from effective gross income. Because property has value independent of any financing an investor might obtain to acquire it, the net operating income (NOI) does ***not*** take into consideration any expenses associated with the financing of property.

The NOI is one of the first indicators of the real value or worth of an investment and is the most important component in valuing income-producing properties. The NOI measures the ability of an investment property to produce an income stream or cash flow from its operations. Once an investor determines the NOI, he can use it to determine how much he would be willing to pay for the property.

Valuing Commercial Properties

Commercial properties purchased to provide an income for the owner are most often valued by appraisers using the **income approach**, which derives its value from the net operating income stream generated by the investment. One way to perform the income approach is to determine the **capitalization rate.** This discussion will focus on a simplified income capitalization rate formula used by investors to *estimate the present value of future income.* This rate is essentially equal to the **rate of return** an investor would expect to earn in a real estate investment. The primary factor that a potential investor needs in order to estimate the value of a real estate investment is the **net operating income**.

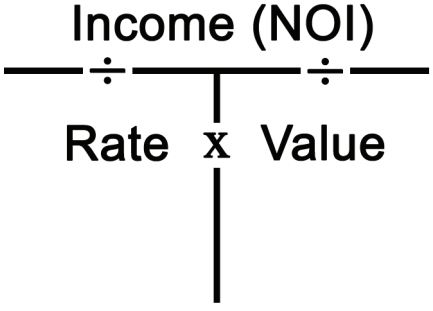
Calculating the Cap Rate

The capitalization rate formula, called the **IRV formula**, relies on three variables: **I**ncome, **R**ate, and **V**alue.

I = Income, the property's annual **net operating income** (NOI), may be based on the prior income the property produced or on the projected income demonstrated in a pro forma.

R = Rate, the **capitalization rate**, represents the *amount of return the investor expects to earn from the investment.* Investors determine what rate of return is acceptable. For example, one investor may be looking for a 10% return, while another would be content with an 8% return.

V = Value, the **value of the property**, is the *amount an investor would be willing to pay for the property.*



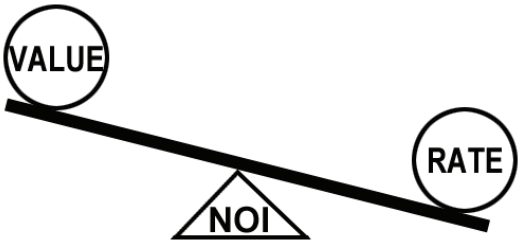
When any two factors are known, it is possible to calculate the third, for example:

Income (NOI) / Rate = Value

Income (NOI) / Value = Rate

Value x Rate = Income (NOI)

Given the same level of NOI, as the desired rate of return (cap rate) increases, the value decreases. Or, as the price of the property (value) rises, the cap rate decreases. This illustrates one of the basic rules affecting cap rates. Referred to as an **inverse relationship**, the value and cap rates move in opposite directions.

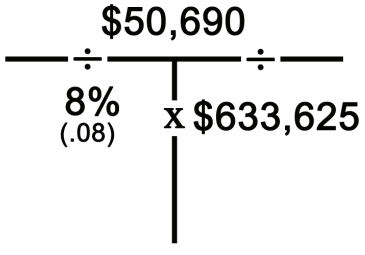


Picture a seesaw. As one end of the board goes up, the other end must go down. "Rate" and "Value" are the children on the seesaw. When "Value" goes up, "Rate" must come down. When "Rate" goes up, "Value" must come down.

Capitalization Rate Example

When creating the pro forma, the investor revised the numbers from the operating statement by raising rent and adjusting expenses to arrive at a net operating income of $50,690. If he wants to see an 8% cap rate, he would theoretically be willing to pay $633,625 to purchase the property.

What would he be willing to pay if he accepts a 7% cap rate? How much if he needed to see a 10% cap rate?



Using Cap Rates to Find the Asking Price

The IRV formula can also be used when working with a *seller* to determine the asking price of the property. Instead of considering individual investor goals, it's more common for an agent to evaluate the market and determine what an appropriate cap rate would be by looking at other comparable properties that have sold in the area. If the selling price of a property is known and the NOI can be found, it's possible to determine a reasonable cap rate for that property. Other factors to consider include:

- The location of the property
- The economic situation of the area
- The current prime interest rate

Pro Forma Example

Investors play a "what if" game when preparing a pro forma: "What if I finance at 6%? What if I put $150,000 down? What if I cut expenses? What if I increase rent rolls?" A savvy investor knows not only what questions to ask, but how to reasonably make the adjustments on the pro forma so that there are no unpleasant surprises when he reviews the actual numbers on his first year operating statement.

This simple pro forma example was prepared using the sample operating statement and adjusted with additional market-driven data. Note the differences from the operating statement.

Annual Property Operating Data - Pro Forma	
Property Address:	100 Main Street Anywhere, IL
Market Rent Projection	
9 Apts. @ $575.00 Month	$62,100.00
8 Apts. @ $660.00 Month	$63,360.00
Gross Potential Income	$125,460.00
Vacancy/Credit Loss @ 3%	($3,764.00)
Other Income (Laundry)	$2,400.00
Effective Gross Income (EGI)	**$124,096.00**
Expenses	
Repairs/Maintenance	$6,000.00
Accounting/Legal	$1,100.00
Advertising	$600.00
Electric	$1,775.00
Water Fees	$546.00
Snow Removal	$1,250,00
Lawn Care	$825.00
Heating Oil	$3,425.00
Trash Removal	$1,910.00
Property Taxes	$23,025.00
Pest Control	$1,200.00
Property Insurance	$5,100.00
Reserve for Replacement	$15,000.00
Miscellaneous	$500.00
Management @ 10% of EGI	$12,400.00
Total Expenses	**$73,406.00**
Net Operating Income	**$50,690.00**
Annual Debt	**$31,934.00**
Cash Flow	**$18,756.00**
Cash-on-Cash	**18.76%**

After finding the NOI, this investor decided he could purchase the property for $500,000, anticipating a 20% down payment and a $400,000 mortgage at 7% for 30 years. That would make the annual debt service $31,934. Once he knows that, he can find the cash flow.

Cash Flow

Cash flow is *a measurement of both income and expense items associated with operating the property.* **Cash flow before taxes**, therefore, is the gross amount of income available before considering taxes. Positive cash flow means more money is coming in from the investment than is leaving it. Negative cash flow is the opposite.

If the property was purchased with cash, cash flow would be equal to the net operating income. If the purchase is financed, however, investors must consider the effect that **debt service**, *the amount of money required for the payment of current interest and principal on a long-term debt,* has on cash flow. Debt service typically has two components:

- The **interest** due on the outstanding balance.
- The amortization (or reduction) of the balance by paying back some of the **principal** owed on a regular basis.

When annual debt is subtracted from the net operating income, any amount remaining would be considered the cash flow.

Cash-on-Cash Return

Cash-on-cash return, also referred to as "cash in on cash out," is the *ratio of income generated by the property to the cash investment in the property*. Once the before tax cash flow is determined, cash-on-cash return is found by dividing that number by the **out-of-pocket cost** to purchase the property:

Before Tax Cash Flow / Purchase Costs = Cash-on-Cash Return

As shown on the sample pro forma, the investor anticipates a before tax cash flow of $18,756. He expects to make a $100,000 down payment and get a $400,000 mortgage. He could therefore calculate the cash-on-cash return as shown:

$18,756 Cash Flow / $100,000 Down Payment = 18.76% Cash-On-Cash

Case in Point

When calculating the first year cash-on-cash return, many investors choose to include not only the down payment but ***all*** of the costs associated with purchasing the property, for example, those nonrecurring closing costs such as appraisal fees, attorney fees, title insurance, recording fees, financing fees, etc. This will give a more accurate picture of the return.

If the investor estimates closing costs of $9,800, the total out-of-pocket cost to purchase this property is $109,800. A more realistic estimate of cash-on-cash return for this property would be 17.1%:

$18,756 Cash Flow / $109,800 Total Purchase Cost = 17.1% Cash-On-Cash

Taxable Income

Taxable income is simply the amount of income on which an investor must pay taxes. Property investment gives owners certain income tax advantages when deductions—such as expenses, property taxes, mortgage interest, and depreciation—exceed the cash flow. This, in effect, can "shelter" the owner's other income from taxes. A property owner can deduct any legitimate expense items from his bottom line to find the taxable income. For investment property, that includes mortgage interest as well as depreciation.

Depreciation

Depreciation can be thought of as the *loss of value to a property over the time during which it is expected to be useful.* The Internal Revenue Service recognizes a real estate investment does "wear out" over time and, therefore, allows an accounting deduction that reflects this economic fact in the form of **cost recovery**. It is important not to confuse actual depreciation with the accounting concept of depreciation. The annual statutory amount of depreciation is the result of an arbitrarily apportioned allowance spread over the designated **useful life** of a building. A residential investment property depreciates faster according to the IRS than a nonresidential investment and, therefore, results in a larger annual deduction.

Calculating Depreciation

According to current IRS code, **straight-line depreciation** based on a property's useful life is calculated as follows:

- Residential investment property: 27 1/2 years
- Commercial property: 39 years

The annual depreciation is calculated by dividing the value of the improvement (*not* the value of the land on which the improvement sits) by the designated recovery period.

Improvement Value / Recovery Period = Annual Amount of Depreciation

When establishing depreciation values, many investors allocate as much value to buildings as legally possible. Tax assessors' records are a good source for learning the **percentage** of the allotment of buildings and land (the percentage valuation, *not* the actual dollar amount). An appraisal may also be used.

Even if the value of property increases, depreciation can still occur. Conversely, it is not essential for a property to produce an income to qualify, but it is held with the expectation or intention of producing an income or making a profit. A taxpayer's personal residence, therefore, is *not* depreciable.

Case in Point

Assume that a year has passed and the investor is preparing his first operating statement on the apartment property he purchased. If the land value of the property is $100,000 and the building itself is valued at $400,000, the annual amount of depreciation would be:

$400,000 / 27.5 = $14,546 Annual Depreciation

If the total property value is $500,000 but the value of the land is greater than $100,000, the amount of depreciation the property owner could expense would be lower. Remember: Land is not included in calculations for depreciation, only improvements.

For tax purposes, the amount of depreciation is treated as a line item **expense** on an operating statement, even though the owner did not have to actually pay the depreciated amount to anyone. Since the depreciation amount, like other line item expenses, is **subtracted** from gross revenues, earnings before taxes will, in effect, be reduced by the depreciated amount.



The IRS does require an investor to recognize a **recapture of depreciation** at the time the property is sold, however. Basically, the investor must give back 25% of the depreciation recognized during the tenure of ownership when filing income taxes for the year of sale.

Loan Interest

Typically, when a property owner prepares an operating statement, he includes the mortgage interest payment as a line item expense.

For example, on the first year of that $400,000 mortgage loan, the owner paid $31,934 in total debt service. Of that amount, $27,871 is interest and $4,063 is principal. If the owner includes *only the interest portion of the mortgage payments* on the operating statement, which is the more proper strategy, then no further calculation would be needed to determine taxable income.

If, however, the owner had included the *entire* mortgage payment as a line item expense in his operating statement, it would be necessary to *add the principal portion* of the payments back to the bottom line in order to determine taxable income, since that aspect of debt service is taxable.

Like depreciation, subtracting the amount paid in interest on the mortgage reduces the owner's earnings on which taxes would be calculated, thereby lowering the owner's tax burden.

Capital Gains

Another opportunity to tax the investor occurs when the property is sold. A **capital gain** is the *taxable profit derived from the sale of a capital asset*. It is the difference between the sale price and the **adjusted basis** of property, which is *the original cost of the property (the basis) with gains and losses calculated in*.

A **long-term capital gain** occurs if an asset has been owned for **more than 12 months**. When this is the case, it is taxed at a more favorable capital gains tax rate. A **short-term capital gain** is for disposition of an asset owned for exactly **12 months or less**. This is taxed as ordinary income, which is generally at a higher tax rate than long-term capital gains rates.

Minimizing or Delaying Tax on Capital Gains

There are several important strategies available to investors that enable them to minimize or even defer their taxes due until a later tax year. Remember, however, that you should **never give tax advice** unless you are also a qualified tax attorney or accountant.

Installment Sale. One method of minimizing taxes for any one reporting year is in the form of an **installment sale**, which is when a seller receives payments from a sale throughout multiple tax years. Within certain guidelines, this method of reporting allows taxpayers to claim as income only the amount of payment received in that tax year, thereby deferring all or a substantial part of their taxable income.

1031 Exchanges. The Internal Revenue Code Section 1031 allows a taxpayer to sell investment property and purchase another investment property in its place, deferring payment of capital gains taxes. There are very strict guidelines that apply to 1031 Exchanges, for example:

- The property sold and the replacement property must be held for investment, or for productive use in a trade or business (not allowed for personal residence).
- Properties must be "**like kind**," which simply means real estate for real estate.
- The replacement property must be equal to or greater in value than the asset being sold.

Besides working with a tax and/or financial advisor, this type of transaction requires the services of a **Qualified Intermediary** (QI) who is a professional recognized by the IRS to facilitate 1031 transactions. Without a QI, it is impossible to complete the transaction.

Summary

1. A primary goal of any investor is the **preservation** of the capital invested. Investors trade a lump sum of capital in the present for the expectation of one or more of the following: Receiving a **continuing stream of income**; creating a **tax shelter**, which gives owners certain income tax advantages; building **equity** in the investment through leverage and appreciation; and earning a **return on the investment** when the property is sold.
2. **Risk** is the degree of probability the actual rate of return earned will differ from the return expected when the investment was made. Sources of risk include: Space market risk (related to the demand for space), capital market risk (related to interest rates and availability of financing), financial risk (related to using debt to finance an investment), as well as environmental, legislative, or management risk.
3. **Liquidity** is the ability to convert an asset into cash quickly without the loss of principal. The long-term nature of commercial real estate investments makes it one of the least liquid of investments. **Leverage** is the effect that borrowed funds (other people's money) have on investment returns. Leverage can be positive or negative.
4. Investors often use the **cash flow model** to evaluate the earning potential of a property. The cash flow model is: Gross Potential Income – Vacancy Loss + Miscellaneous Income = Effective Gross Income – Expenses = Net Operating Income – Annual Debt Service = Cash Flow Before Taxes.
5. The cash flow model allows investors to prepare **pro forma statements**, which show the hypothetical projection of income and expenses for this first full year of ownership. A pro forma requires a great deal of financial data, some of which may be available from the current owner's **operating statement**, which shows total revenues generated and expenses for a given period as a means of evaluating the property's performance. The investor will adjust that information as necessary to arrive at an estimate of the property's performance.
6. The most important component of the cash flow model is the **net operating income (NOI)**, which measures the ability of an investment property to produce an income stream or cash flow from its operations. Investors use the **capitalization rate method** to estimate the present value of future income. The capitalization calculation, called the **IRV formula**, relies on three variables: **I**ncome (NOI), **R**ate, and **V**alue. When an investor knows the NOI and knows what capitalization rate is acceptable, he can determine how much he is willing to pay for a property (Value = Income / Rate).
7. **Cash flow** is a measurement of both income and expense items associated with operating the property. This figure allows an investor to find the **cash-on-cash return**, the ratio of income generated by the property to the cash investment in the property. Once the before tax cash flow is determined, cash-on-cash return is found by dividing that number by the **out-of-pocket cost** to purchase the property.
8. **Depreciation** is the loss of value to a property over the time it is expected to be useful. The Internal Revenue Service allows investors to deduct depreciation as a line item expense to reduce the taxable income. The annual depreciation is calculated by dividing the value of the improvement (not the value of the land on which the improvement sits) by the designated recovery period: **27 1/2 years** for residential investment property and **39 years** for other commercial property.
9. **Capital gains** and **losses** are generated when a capital asset is sold, and are categorized as long-term or short-term gains and losses, determined by how long an asset is held.

Quiz

1. ***Morgan took out a mortgage to buy some rental property. He is able to repay the debt with the rent he collects, and he is earning equity. This is an example of***
   a. leverage.
   b. liquidity.
   c. marketability.
   d. return.

2. ***The ability to convert an asset into cash quickly without the loss of principal is***
   a. leverage.
   b. liquidity.
   c. marketability.
   d. utility.

3. ***Which element does not figure into the equation to find net operating income?***
   a. debt service
   b. effective gross income
   c. expenses
   d. vacancy losses

4. ***Which is a characteristic of a pro forma statement but is NOT a characteristic of an operating statement?***
   a. documents a property's performance
   b. illustrates total income and expenses
   c. looks for net operating income
   d. provides hypothetical data to assist in making decisions

5. ***Which is a measure of the present value of future income?***
   a. capitalization rate
   b. cash flow
   c. cash-on-cash return
   d. net operating income

6. ***On a pro forma, gross potential income NEVER considers***
   a. contract rent levels.
   b. economic rent levels.
   c. non-cash revenue.
   d. vacancies.

7. ***Which item is deducted from NOI to find cash flow?***
   a. collection losses
   b. debt service
   c. vacancy losses
   d. variable expenses

8. ***Net operating income minus debt service is equal to***
   a. cash flow.
   b. expenses.
   c. leverage.
   d. rate of return.

9. ***The rent for each unit of a ten-unit strip mall is $1,000 per month. The annual vacancy rate averages 5%. The expenses for the property come to $30,000 per year with depreciation of $15,000. What is the net operating income?***
   a. $49,000
   b. $54,500
   c. $84,000
   d. $96,000

10. ***A strip mall has a net operating income of $84,000. The capitalization rate in the area for similar properties is 12%. What is the likely asking price for the property?***
    a. $184,800
    b. $700,000
    c. $940,800
    d. $1,008,000

11. ***Spencer financed the purchase of an office building with a $100,000 down payment and a $500,000 loan. His NOI is $56,000 and his debt service is $44,000. What is his cash-on-cash return?***
    a. 4.4%
    b. 5.6%
    c. 7.14%
    d. 12%

12. ***Larry paid $240,000 for a two-flat building, and he rents out both units. According to the local tax assessor, the value of the land on which the two-flat sits is $20,000. How much can Larry deduct this year from his income tax?***
    a. $5,641
    b. $6,154
    c. $8,000
    d. $8,727



UNIT 9
Introduction to Property Management

Chapter 27 – The Property Management Profession

Chapter 28 – Property Management Tools

Chapter 29 – Landlord-Tenant Relations



27 The Property Management Profession

Property management is a growing field, and there is a demand for trained and licensed property managers. This chapter provides a broad overview of the property management profession. You'll see that property managers do more than just collect rent. You'll learn about the functions and responsibilities of property managers, as well as the types of properties they manage.

You will learn:

- What license is required in order to manage property in Illinois.
- What skills are necessary to be a successful property manager.
- What comprises the management agreement used to set up and support property management.

Key Terms

Building Manager
Fiduciary
Management Agreement
Principal
Property Management
Property Manager
Resident Manager
Residential Leasing Agent
Risk Management

Property Management as a Career

In the most basic sense, a **property manager** is *a person hired by a real property owner to administer, market, and maintain property—especially rental property.* However, property management goes beyond collecting rent and leasing apartments or office buildings. A property manager is considered the **custodian** and supervisor of an owner's property.

Although property management is a specialized field in itself, many factors have caused property managers today to develop additional specializations. For example:

- Owners might look for property managers with experience in historic buildings to serve the needs of preservation and renovation.
- With the advancements in technology, some owners may be looking for managers skilled in overseeing technological campuses.
- Some property management companies may specialize in one field, such as absentee ownership, and may promote their company to handle complex finances and property monitoring without the owner present.

Functions of a Property Manager

Property managers take on different roles, depending on the type of property they oversee:

- **Property Manager.** Usually oversees the management of a number of properties for various owners.
- **Building Manager.** Manager of just one building.
- **Resident Manager.** Represents a property management firm and may live on the premises of the building being managed.

Property managers need a diverse set of skills, regardless of the type of property they manage. For example, everyone in the property management field must:

- Have an understanding of leasing regulations to collect rents,
- Possess basic construction knowledge to ensure routine maintenance is performed.
- Know how to develop a management proposal.
- Create and manage reports and budgets for property owners.
- Have exceptional communication skills.
- Understand basic marketing principles.

Licensing Requirements

225 ILCS 454/1-10

In order to perform the duties of a property manager in the state of Illinois, one must be licensed. According to the **Illinois Real Estate License Act**, an individual, partnership, limited liability company, corporation, or registered limited liability partnership other than a residential leasing agent who, whether in person or through any media or technology, for another and for compensation, or with the intention or expectation of receiving compensation, either directly or indirectly, is required to be licensed as a broker or managing broker if performing any of the following property management-related tasks:

- Rent, or lease real estate (or offer or agree to do so)
- Negotiate the rental or leasing of real estate (or offer or agree to do so)
- Supervise the collection, offer, attempt, or agreement to collect of rent for the use of real estate
- Advertise or represent himself or herself as engaging in the business of renting or leasing real estate
- Assist or direct in procuring or referring leads or prospects intended to result in the lease or rental of real estate
- Assist or direct in the negotiation of any transaction intended to result in the lease or rental of real estate.
- Open real estate to the public for marketing purposes
- Lease or offer for lease real estate at auction
- Prepare or provide a broker price opinion or comparative market analysis

Referral Fees

While a real estate license is required in order to be compensated for assisting or directing in procuring or referring leads or prospects intended to result in the sale, exchange, lease, or rental of real estate, the Illinois Real Estate License Act (225 ILCS 454/5-10) does permit a landlord to pay a fee to any **resident tenant** of a residential dwelling unit who refers prospective tenants in the same building or complex if the resident tenant:

- Refers no more than three prospective lessees in any 12-month period,
- Receives compensation of no more than $5,000 or the equivalent of two month's rent, whichever is less, in any 12-month period, and
- Limits his or her activities to referring prospective lessees and does not show a unit, discuss terms or conditions of a lease, or otherwise participate in negotiations.

Illinois Licensed Residential Leasing Agent

In Illinois, a **residential leasing agent is** *someone who is employed by a real estate sponsoring broker to engage in licensed activities limited to leasing residential real estate. Such activities include without limitation:*

- Leasing or renting residential real property, or attempting, offering, or negotiating to lease or rent residential real property.
- Supervising the collection, offer, attempt, or agreement to collect rent for the use of residential real property.

A residential leasing agent must also be licensed, as well as associated with a sponsoring broker (225 ILCS 454/5-10). Since residential leasing agents may be engaged by a consumer to find appropriate space to rent, creating a potential **agency relationship**, they have the fiduciary obligation of agency disclosure.

Types of Properties Managed

No matter what type of tenant occupies the space in a building, property managers have the same mission: *To market and rent space effectively, maintain the property in good condition, comply with government regulations, and keep operating costs low with a primary objective of meeting the landlord's financial goals.* There are many types of properties a property manager can specialize in, including commercial office, commercial retail, residential, special-purpose, or industrial.

Commercial Office Buildings

Office space may be located downtown, in a suburban office park, or on a street lined with stores. The space can be a small, single-story building or a high-rise complex. Some buildings feature tenants specific to one industry, like medical professionals, while others have mixed-use tenants.

Property managers should familiarize themselves with competing office spaces throughout the area, so they can establish appropriate rental rates and standards for design and structural elements, like window treatments, as well as telephone and Internet accessibility. It is helpful to set a base rent for a typical office space in the building, and then adjust the rent for other office spaces compared to the base rent.

Negotiating an office lease is more complex than negotiating other kinds of leases. From remodeling to escalation clauses, everything is a bargaining point. The right of tenants to sublet in case their business slumps is a crucial issue. Before starting negotiations, a property manager should be very clear about the owner's priorities. Usually, tenants who request special alterations to their space, like adding or removing walls, special wiring, etc., need to get permission and pay for their alterations themselves. Of course, special alterations can also be a negotiating point between property owners and potential tenants. If the only way to fill non-leased space is by modifying it, the property owner may elect to do so rather than let it sit empty.

Commercial Retail Property

Although small strip shops can be relatively easy to manage, large shopping malls present a range of unique challenges for property managers. A shopping center may have several **anchor tenants**, which are major department or chain stores strategically located within a shopping center to give maximum exposure to smaller satellite stores. When assigning spaces, property managers need to be careful not to place stores selling the same goods side by side.

There are many considerations when managing retail property. For example, there may be restrictions on the hours a business can operate and the kinds of alterations that can be made to the space. Qualifying tenants for retail space is generally more detailed. Parking needs and customer requirements should be considered.

Property managers have to be diligent with maintenance issues to avoid lawsuits. Liability for accidents is complicated in shopping malls. It is often difficult to determine who is liable for an accident that occurs in a common area, like the center of the mall's food court or a fountain. Liability insurance is most effective when the property manager, owners, tenants, and merchants are co-insured. If there is an accident, property managers should notify the insurance company immediately because a consequence of delay can result in a loss of coverage for that accident.

Residential Property

Residential property includes:

- Single-family homes
- Apartments
- Condominiums and cooperatives
- Mobile home parks
- Retirement communities (these can also be considered special-purpose properties)

Whether it is a single-family home, a large apartment complex, or a cooperative, **pricing and marketing** are key elements in successfully renting residential housing. It is helpful for property managers to carefully survey the local market and take into account supply and demand to determine the right amount to charge for rent.

Managing a condominium or co-op is similar to managing multi-family residential properties, with the exception that rent is not collected. Tenants should purchase their own insurance on their personal property, and condo and co-op owners should also be insured. A key difference is that both condos and cooperatives have an owners' association with which a property manager must work.

Property managers of subsidized housing funded through HUD or state or local agencies need to follow those applicable rules and standards as well.

Special-Purpose Properties

Property managers may have the opportunity to manage special-purpose properties, including:

- Hotels, motels, or resorts
- Theaters
- Schools
- Places of worship
- Housing for the elderly
- Planned unit developments

The design of the special-purpose building often mirrors the activities that take place there. For example, a theater could probably never function as commercial office space; it was designed specifically to function only as a theater. These types of facilities often have a staff person who serves as the building manager.

Housing for the elderly includes independent living, assisted living, and nursing homes. These facilities are highly competitive, so smart marketing is essential. Property managers work with elderly tenants plus medical personnel and social workers. The facility itself must have adaptations that meet the needs of this special population.

Property managers should also have some knowledge of **planned unit developments** (PUDs), which are *special types of subdivisions that may combine non-residential uses with residential uses, or otherwise depart from ordinary zoning and subdivision regulations*. In some PUDs, the lot owners co-own recreational facilities or open spaces as tenants in common.

Industrial Property

Industrial property includes manufacturing facilities and warehouses. Because of the heavy equipment, traffic patterns geared for trucks and other specialized vehicles, and storage, industrial tenants are generally long-term, and the space they occupy is usually built or altered specifically for their use. Industrial spaces move slowly on the market. They are often located near each other and may be clustered together in an industrial park, which are frequently located near major transportation hubs. Industrial properties usually have **net leases**, requiring tenants to pay a greater percentage of property expenses than most leases do. Industrial tenants usually pay for and perform their own maintenance.

Property Manager and Owner Relationship

A property management company is in an *agency relationship* with a property owner, and owes the property owner the same statutory duties of obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care owed to all clients. Such an agent is a person in a position of trust, held by law to high standards of good faith and loyalty.

Typically, a property manager is in a **principal-agent relationship**, with the principal being the owner and the agent being the property manager. Here, though, a property manager or property management company is a general agent because of the broad range of duties performed. A **general agent** is an agent authorized to handle a wide variety of the principal's affairs in one area or in specified areas.

An important part of a property manager's job is managing leases in order to achieve the owner's financial objectives. Understanding the landlord's and tenants' needs, plus the documentation needed to be executed, is only part of the overall responsibilities of the property manager.

Obligations to the Property Owner

One of the most important jobs a property manager has is to understand the goals of the owner. An effective property manager is a true asset for a property owner, maximizing an owner's income and minimizing expenses. These are a property manager's three main jobs:

- Fulfill the goals and objectives of the owners
- Maintain or increase the property's value
- Create income and manage expenditures for the owners

Accounting for all income and expenditures is more involved than it sounds. The property manager is responsible for setting rents that cover all expenses associated with operating the building and still return a profit. The property manager must also develop and maintain a plan for the maintenance and rehabilitation of the building so it produces the **greatest amount of rental income** for as long a period of time as possible.

Real Success

A good property manager must see an individual property within the context of the total real estate picture. Although linked to the general economy, the real estate market experiences its own fluctuations.

Effective property managers make the most of real estate cycles and create opportunities or minimize challenges. Property managers can adjust those factors within their control, for example, offering a free month of rent to entice new renters during a tight market. Assessing the market and planning ahead are essential for fulfilling the owner's goals and for success as a property manager.

Of course, most real estate owners invest in property to make a profit. A good property manager is a critical part of the return on investment equation, even to the point of making recommendations to the property owner as to when it's appropriate to sell the property.

The Management Agreement

The **management agreement**, also called the **property management employee contract**, is a *written agreement that governs the relationship between the property owner/investor and the property manager.* This agreement details the duties, responsibilities, and compensation of the property manager. The management agreement is a written contract that should be executed by all the parties (the landlord and the property manager). Some or all of the following components typically comprise the essence of the agreement:

Description of the Property

An exact address must be part of the agreement and sometimes a full legal description is necessary. It is also important to define the perimeters of the property, including any ancillary buildings, structures, or other amenities within the confines of the property being managed. For example, is the landscaping out front or the gift shop in the lobby included in the management responsibilities? If not, those exclusions need to be written in the contract.

Terms of Agreement

The time of the agreement varies from property to property and from owner to owner, and is negotiated between the property manager and owner. One year is a common term. If the owner and property manager are satisfied with the relationship after one year, a longer term can be negotiated, and the contract can be renewed.

It's important to note that Illinois law requires property management agreements to provide for a **definitive expiration date**. Failure to include such a provision in the agreement could result in the loss of license.

Management Authority

Management authority outlines what a property manager is authorized to handle in leasing property. Typically, duties include the following:

- Selecting tenants and leasing units
- Collecting rents
- Returning security deposit
- Evicting tenants

Management authority also authorizes property managers/agents to sign leases. Some owners limit the amount of authority to a specific time frame or amount. Those limits are listed in the management agreement.

Management Fee

Since so many factors can affect the profitability of a property, there is not a single hard-and-fast way to compute management fees. Property managers should determine both the direct and indirect costs associated with their job. They can use this information to arrive at an agreement with the property owner on the management fee they charge.

Management fees may be fixed (flat) or a percentage. A **flat fee** is a *specific fee paid out at specific increments*. A **percentage fee** is *based on the operation's gross collectible income*. The percentage fee could also be a fixed percentage of rent or a bonus when a certain number of leases are signed. Note that if there are multiple leasing agents for the property, the fee is sometimes split.

Insurance and Risk Management

Risk management is the process of *identifying, managing, and minimizing the potential risks on a property.* The property manager must be skilled at risk management to protect the building from loss and insulate the owner from liability with appropriate insurance policy recommendations.

To protect owners from major expenses, property managers need to make certain they have blanketed the property with appropriate insurance sufficient to cover the greatest risks, purchased at the most economical rates. Necessary coverage might be included for issues such as these:

- Damage from fire, flood, wind, and other acts of nature
- Workers' Compensation claims
- Liability for contractors, etc.
- Loss of income and loss of occupancy
- Equipment and machinery
- Automobiles owned by and used for the property
- Injury liability insurance

Accounting Responsibilities and Reports

Accounting for all income and expenditures is more involved than it sounds. Property managers are responsible for **setting rents** that cover all expenses associated with operating the building and to return a profit. Usually distributed on a monthly basis, **property management reports** are *prepared by property managers to inform owners of the status of the property, often including income, expenses, and disbursement information.* The management agreement should clearly explain when the report must be distributed and to whom.

Owner's Responsibilities and Objectives

An owner's responsibilities vary, and should be listed in the management agreement. This could include information on who oversees payroll and insurance, as well as information on monthly, quarterly, and yearly payments the property manager needs to make on behalf of the property owner.

Management Agreement Termination

Details about the termination of the owner-manager relationship should be spelled out in the management agreement. In case an owner wishes to cancel an agreement early, information about the property manager's compensation for negotiated leases and contracts not yet executed should be stated.

Property Management Designations

Several associations and groups offer professional designations and specialized course work in the property management field. These designations and accreditations increase the knowledge, skill base, and marketability of property management professionals. These associations include the following:

- **Building Owners and Managers Association International** (BOMA) offers professional development courses for property managers, including ***Real Property Administrator*** (RPA).
- **Institute of Real Estate Management** (IREM), a National Association of REALTORS® (NAR) affiliate group, provides education and designations in the property management field, including ***Accredited Residential Manager*** (ARM) for those specializing in residential property management and ***Certified Property Manager*** (CPM) for those who meet certain other requirements.
- **National Association of Residential Property Managers** (NARPM) offers designations including ***Professional Property Manager*** (PPM) and ***Master Property Manager*** (MPM).

Summary

1. A **property manager** is hired by a real property owner to administer, market, merchandise, and maintain property, especially rental property. In Illinois, these tasks require a **real estate broker** or **managing broker** license. A **residential leasing agent** license allows someone to lease and collect rents on residential property.
2. **Property management** is the leasing or renting, or the offering to lease or rent, real property to others for a fee, commission, compensation, or other valuable consideration pursuant to a property management employee contract. A property manager is a **general agent**, an agent authorized to handle all of the principal's affairs in one area or in specified areas. He has fiduciary obligations to the owner. The main objectives of a property manager are to fulfill the owner's goals, create income, and maintain or increase the property's value.
3. There are four main types of properties that need to be managed: 1**. Residential property** (single-family homes, apartments, condominiums, co-ops, mobile home parks, and retirement communities); 2. **Commercial property** (retail and office space); 3. **Industrial property** (manufacturing facilities and warehouses); and 4. **Special-use properties** (hotels, theaters, schools, places of worship, PUDs, and nursing homes).
4. A **management agreement** is a written agreement that governs the relationship between the property owner/investor and the property manager, and outlines the responsibilities of each party. The agreement typically contains a description of the property, length of agreement, management authority, management fee, accounting responsibilities and reports, insurance and risk management, owner's objectives, and management agreement termination.
5. **Management fees** may be fixed (flat) or a percentage. A **flat fee** is a specific fee paid out at specific increments. A **percentage fee** is based on the operation's gross collectible income. **Risk management,** an important skill for property managers, is identifying, managing, and minimizing the potential risks on the property.
6. There are a variety of professional organizations, like the Building Owners and Managers Association (BOMA) and the Institute of Real Estate Management (IREM) for property managers. A property manager can earn many designations, including Accredited Residential Manager (ARM), Certified Property Manager (CPM), and Real Property Administrator (RPA).

Quiz

1. ***In the property owner/property manager relationship, who is the principal?***
   a. manager
   b. owner
   c. tenant
   d. tenant and owner

2. ***Sarah is a licensed residential leasing agent in Illinois. Sarah would need a real estate broker's license instead if her job responsibilities included***
   a. collecting rent from tenants in a multi-family building.
   b. getting paid to find an apartment for a client.
   c. negotiating a lease for a small store front.
   d. showing an apartment to a prospective tenant

3. ***As the property manager for owner Ross, Monica is held to high standards of good faith and loyalty, known as***
   a. fiduciary obligations.
   b. goodwill duties.
   c. managerial obligations.
   d. tenancy at will.

4. ***A property manager is most likely to be considered a _____ agent.***
   a. comprehensive
   b. general
   c. limited
   d. special

5. ***In his first week on the job, property manager Tim checks the insurance coverage for the building he manages and indicates potential needs for more coverage. This is an example of Tim's obligation to***
   a. building security.
   b. fiduciary duties.
   c. risk management.
   d. security deposits.

6. ***What is the term used to describe a major department store in a shopping mall that is intended to attract customers to other stores?***
   a. anchor store
   b. draw store
   c. magnet store
   d. pull store

7. ***What is NOT a requirement to be a licensed residential leasing agent?***
   a. 4-year high school graduate or approved equivalent
   b. 15 hours of prelicensing education
   c. at least 21 years old
   d. be of good moral character

8. ***Each of these may be considered special use properties EXCEPT***
   a. hospitals
   b. nursing homes
   c. theaters
   d. warehouses.



28 Property Management Tools

As a property manager, it is important to have some knowledge of appraisal, finance, money markets, depreciation techniques, financial trends, and local market conditions to produce useful reports and accomplish the owner's overall objectives and goals. It is also important to understand real estate licensing laws related to financials, such as avoiding the commingling of personal and business funds in any way. Owners want to know the financial picture of their business and have an understanding of the trends occurring in the marketplace. This helps them decide, for example, when is a good time to sell existing property or add to their portfolio. In this chapter, you'll see tools property managers use to keep on top of this information so they can continue to be a valuable asset to owners.

You will learn:

- Which budgets and reports property managers must develop and analyze.
- How to value income-producing property.
- How to effectively advertise and market managed properties.

Key Terms

Capitalization Rate
Corrective Maintenance
Cosmetic Maintenance
Gross Rent Multiplier (GRM)
Management Proposal
Market Rent
Net Operating Income
Preventive Maintenance
Rent Roll

Property Management Responsibilities

The daily, weekly, and yearly duties of property managers may vary, but these responsibilities should be familiar to all property managers:

- Developing the management proposal
- Reporting
- General accounting
- Managing office operations
- Understanding building systems and construction
- Landlord-tenant relations
- Leasing space
- Advertising and marketing
- Adhering to codes and regulations
- Negotiating with unions
- Purchasing
- Environmental awareness

Management Proposal

After the owner's objectives are understood and a management agreement is signed, developing a well-thought-out management proposal is the next step. A **management proposal** is *the plan created by the property manager for overseeing the property*. It includes an analysis of the market and a variety of financial reports, including an operating budget. The management proposal should lay out an effective strategy for meeting the owner's financial and operational goals. If a plan is already in place, you may be revising it or giving input on it. A management proposal should include the following:

- One-year operating budget
- Five-year plan
- Market analysis of region, neighborhood, and property

The market analysis information allows property managers to gain an understanding of economic factors, population, zoning regulations, transportation, and other factors pertinent to the managed building's location.

Reporting

Property managers are expected to communicate precisely to owners the condition and financial status of the property. This is typically outlined in the management proposal and the property management reports. All financial reports generated should meet the criteria and specifications agreed upon by the owner and property manager. In order to develop a one-year operating budget and five-year plan for the management proposal and to complete the regular financial reporting to the owner, the property manager develops budgets, reports and statements, and recommendations.

Operating Budget

An **operating budget** is *created to project the income and expenses for the property over a one-year period.* This report usually contains the following elements:

- **Effective Gross Income (or Gross Operating Income).** The estimated rental income the owner anticipates collecting and that will be available to cover the expenses of owning the property—the amount that the owner actually takes in and deposits into the bank. To calculate the effective gross income, subtract the allowance for **vacancy and collection losses** from the gross income and add in the miscellaneous income, such as vending machines, coin-operated laundry, etc.

- **Expenses. Fixed** expenses are ongoing operating expenses that do not vary based on occupancy levels of the property (e.g., property taxes and insurance). **Variable** expenses are operating expenses necessary to the property, but dependent on the property's occupancy level (e.g., repairs and maintenance, income taxes, salaries, and utilities).
- **Net Operating Income.** Income after expenses are deducted. The NOI is one of the first indicators of the real value or worth of an investment. It is important to note that NOI does *not* take into consideration the financing of the property, since a property's value should be independent of any financing an investor might obtain for the acquisition of it.

Sample Annual Operating Budget	
Income	
Net rentable area (sq. ft.)	35,000
Rent per square foot	$23.50
Potential gross income	$822,500
– Vacancy and Collection = 10%	$82,250
Effective Gross Income	$740,250
Expenses: Fixed	
Real estate taxes	$91,350
Insurance	$2,450
Utilities	$81,900
Maintenance	$40,950
Repairs	$14,000
Management fees	$8,400
Other	$1,750
Reserves 5% of EGI (roof, HVAC)	$37,100
Total Expenses	$277,900
Net Operating Income	$462,350

Other Reports and Statements

Property managers must consistently track expenses.

Capital expenses are *used to improve the property and increase its value*. Sometimes they are preplanned, but other times they are needed to replace something on the property that is no longer working, such as a roof or an air conditioning unit. These expenses are different from regular maintenance expenses. Capital expenses are generally for long-term investment components. Also, some large remodeling expenses are considered capital expenses and are amortized over several years. Those costs may be reflected in the annual operating budget.

The **capital reserve budget** is *a budget for capital expenses that are not fixed (variable expenses).* The reserve budget is often incorporated into the annual operating budget as an annual average cost of replacing various building components.

After creating an operational budget with fixed and variable expenses, property managers should look toward developing a **stabilized budget,** which is *the income and expenses averaged over a five-year period.* This long-term forecast takes a variety of factors into consideration, such as potential growth, market trends, etc.

This is accomplished by creating and using additional reports:

Budget Comparison Statements. These may be used to *compare the actual working budget with the budget developed at the beginning of the year*. These comparisons should be calculated for both the month and year-to-date income and expenses. This comparison can confirm trends as well as identify areas that need extra work to meet expectations.

Profit and Loss Statement. A *brief statement issued at regular intervals, presenting gross receipts, minus operating expenses, minus total mortgage payment, plus mortgage loan principal to equal net profit*.

Cash Flow Report. Usually issued on a monthly basis and gives the owner a detailed financial picture of the property. The following formula is used to find the sum of operating cash, which will be a key component of the cash flow report.

Net Operating Income – Debt Services = Cash Flow (Operating Cash)

Cash-on-Cash Return. The ratio of income generated by the cash investment to the actual out-of-pocket cash provided by the owner to purchase the property. These out-of-pocket costs, generally in the form of a down payment, represent the owner's **initial equity** in the property. Once you've determined the cash flow, you can divide that by the out-of-pocket purchase cost in order to determine the cash-on-cash return:

Cash Flow / Purchase Costs = Cash-on-Cash Return

Recommendations

After all property management reports have been generated, the property manager should be able to develop the management proposal and then make recommendations to the owner about the property. For example, after reviewing the reports, property managers may recommend adding a pool to a residential apartment complex or renovating the lobby of a commercial building.

Management Office Operations

Whether managing a property that is industrial, retail, or residential, a designated office space for the property manager is often necessary. The most logical site for a management office is in the building itself, since easy access and convenience are important. However, the office should not be located in a space that has a potentially high rental value. Space should be allocated for a reception area, file storage, and for desks and equipment for staff. A well-stocked, well-organized manager's office has these items on hand or readily available:

- Leases
- Correspondence (dating back three years)
- Financial reports (dating back ten years)
- Canceled checks, receipts, etc.
- Annual profit/loss records
- Monthly income/expense reports
- Project bids from companies competing for construction or service work (dating back one year)
- Basic information (property records including mortgage information, title, legal description, management contract, and labor contracts are kept as long as the owners have the property)
- Insurance (checked regularly to ensure coverage is still sufficient and to monitor expiration dates; expired policies are kept for five years)

Leasing Space

A key element of a property manager's job is leasing space. Tenants can be found through effective marketing. For commercial property, there's the additional task of ensuring that the layout of the space is well suited to the tenant's needs. For example, if an advertising agency wants to sign a lease, will the design of the space fit its needs and be functional as well as aesthetically pleasing to the clients? What if the agency signs a major account and needs to expand the company and the space? Is that possible? This is all part of good communication.

Supervising Others

In addition to handling owner-tenant relations, most property managers manage a variety of people, so effective communication skills are necessary. A property manager might manage an assistant property manager, tenant services coordinator, or administrative assistant, depending on the size of the property. And a large, multiple-tenant facility may require the manager to oversee any number of contractual employees, including maintenance and janitorial services, security, and landscaping.

Rent

Rent is the consideration a tenant gives a landlord in exchange for temporary possession of the property. Note the difference between the following terms:

- **Contract Rent.** What tenants are actually paying for in rent, as stated in the terms of the lease.
- **Market Rent.** What the property *could* rent for in the open market if unencumbered by any lease and available.

Determining the appropriate rent to charge tenants can be accomplished by close observation and research on competitive properties. A property manager needs to evaluate factors such as location, amenities, condition of the property, square footage, vacancy rates, etc., in order to determine what would be fair market rent for the property and maintain the desired levels of occupancy.

Rent Roll

Rent roll is a *spreadsheet or listing of key information about a propert*y such as the number of units, tenant names with unit numbers, lease dates, and the rent each tenant pays on a unit. This is helpful for the property manager to manage the level of vacancies and occupancies and to keep tabs on local rent rates.

SUBJECT'S RENT ROLL

Unit	Monthly Rent	Tenant	Unit Sq. Ft.	Original Lease Date	Escalation Provision	Current Lease Term	Term Remaining
1-A	$875	Roberta Glass	840	02/15/2006	No	3 years	5 months
1-B	$900	John Taylor	840	07/05/2010	No	3 years	10 months
2-A	$750	Brady Hill	840	06/30/2004	No	1 year	9 months
2-B	$800	Roger Stafford	840	09/01/2008	No	3 years	36 months

Rent Control

Some states and individual communities have rent regulation programs known as **rent control** or **rent stabilization**. Rent regulations are intended to *protect tenants in privately owned buildings from illegal rent increases while allowing property owners to earn enough from rent to properly maintain their buildings and recognize a profit.* Typical rent control laws restrict the amount of rent charged by property owners and restrict the right of an owner to evict tenants. Rent control regulations may also offer additional tenant protections, for example, the right to have their leases renewed.

Illinois Rent Concession Act

The purpose of the **Illinois Rent Concession Act** *(765 ILCS 730/)* is to regulate the once-prevalent practice of making or using written leases that, because of concessions to the lessees, do not truly state the real net rent being paid. This practice was sometimes used by unscrupulous owners or property managers to mislead prospective purchasers, lessees, and lenders into a belief that the rental value or market value of the property is greater than it really is. Examples of rent concessions include the following:

- Any credit or rebate of the rent after payment
- The right to occupy the leased premises for a period other than the term created by the lease rent free or for a rent less than the average rent fixed by the lease for the entire term

An agreement by a lessor to waive any of the terms or conditions of the lease other than those relating to the payment of rent is not considered a rent concession. When a rent concession is made, the lessor must include on the lease a legend with plainly legible text of at least one-half inch high with the words "Concession Granted." The lease must also include a memorandum stating the amount or extent and nature of each such concession. Anyone who violates this Act could be found guilty of a Class A misdemeanor.

Building Systems and Construction

Property managers should have a general knowledge of major building systems and components, such as electrical, structural engineering, waterproofing, plumbing, HVAC, gas, security, maintenance, elevators. Having a basic understanding of these systems and/or components enables property managers to effectively plan for preventive maintenance and work with maintenance staff, as well as talk with contractors and builders.

Maintenance

Maintenance costs should be carefully scheduled and controlled because they represent a relatively large part of a property's operating budget. A property manager's maintenance responsibilities can generally be divided into three broad categories:

- **Preventive Maintenance.** Includes *routine maintenance and inspections to keep equipment and the property in good working order.* This could include scheduled inspections and the replacement of parts before they fail.
- **Corrective Maintenance.** *Restores broken or failed equipment to a specified condition.* Repair work may be a less frequent expense, but property managers need to line up qualified repair people they can call at a moment's notice.
- **Cosmetic Maintenance.** *Increases a property's appeal*. Adding new wallpaper to a lobby or planting flowers next to a walkway can attract new tenants.

In order to effectively maintain a property, the property manager should:

- Have a thorough understanding of the property.
- Keep a written inventory of property elements with maintenance records.
- Evaluate the cost to perform maintenance and purchase necessary parts and items to keep in supply.
- Determine who will perform the maintenance.
- Keep a detailed schedule for preventive maintenance work.
- Develop a list of qualified contractors and workers, maintain records of work performed, and keep records of competitive bids.

Property Valuation

An **appraisal** is *an opinion of the value of property, as of a specific date, supported by objective data*. When a building is appraised, the property manager is generally the one who interacts with the appraiser. Therefore, it is important to have an understanding of the appraisal process. The condition of the property and the maintenance of building systems can have a large impact on a property's value. Of the three appraisal approaches, the **income approach**, sometimes called the capitalization approach, is most often used for rental property as it *estimates the value of real estate by analyzing the revenue, or income, the property currently generates or could generate often comparing it to other similar properties.*

Although a property manager cannot perform a formal appraisal unless also a licensed or certified appraiser, a property manager or real estate broker can use these methods to analyze a property's potential market value.

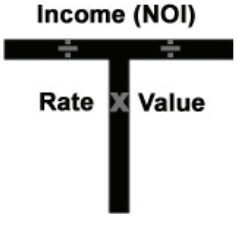
Capitalization Rate Example

Investors and appraisers frequently use the **capitalization rate** method of the income approach to estimate the present value of future income. Most generally, this approach is used for larger residential properties with more than four units or for non-residential commercial properties. The calculation, called the **IRV** formula, relies on three variables: Income, rate and value. When any two variables are known, the IRV formula can be used to solve for the third variable.

I = **Income**, the property's annual net operating income (NOI), is usually based on the prior income the property produced.

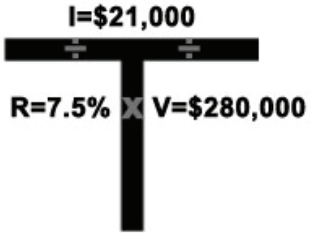
R = **Rate**, the capitalization rate, represents the amount of return the investor expects to earn from the investment.

V = **Value**, the value of the property, is the amount an investor would be willing to pay for the property.



As an investor's desired rate of return increases, the price the investor will pay for the property goes down. This can be looked at mathematically or intuitively. Mathematically, you're dividing by the rate of return, so dividing by a larger rate leads to a smaller result. Intuitively, as an investor expects to get a higher rate of return (with the same expected property income), he must value his *money more* and value the *property less*. Let's look at an example.

Property manager Jack has been asked by owner Barb to help determine an offer on a two-unit apartment building. Barb is looking for a rate of return between 7% and 8%. Jack examines several comparable properties and determines that 7.5% is a reasonable cap rate in that market. The operating statement indicates an annual net operating income of $21,000. Based on these figures, he determines that an offer of $280,000 would be appropriate. Note that as the desired rate of return goes up, the value goes down. So, if Barb wants an 8% return, she may be willing to pay only $262,500 for this property.



Gross Rent Multiplier Example

The **gross rent multiplier** (GRM) is another method for using the income approach to estimate the value of investment property. The GRM represents *a rate of return, stated as a factor or multiplier, used to derive a value opinion from the anticipated monthly rent a property could generate.* Once this factor or multiplier is determined, it can be used to estimate the value of another rental property. The GRM is most commonly used for **one- to four-unit residential properties** and is based on the total gross monthly rent of a property. Let's walk through an example.

Dave is interested in buying a single-family home as another rental property and asks his property manager Karen to help him determine how much to offer. The market rent for the subject property is $950 per month. Karen researches and analyzes transaction data from the market and identifies an indicated GRM. The following is revealed:

	Sale Price	Monthly Market Rent	(Formula)	GRM
1	$116,200	$930	116,200 / 930	124.95
2	$122,493	$990	122,493 / 990	123.73
3	$124,180	$1,010	124,180 / 1,010	122.95
4	$114,524	$925	114,524 / 925	123.81
5	$117,900	$900	117,900 / 900	131.00
6	$108,697	$875	108,697 / 875	124.23
7	$117,600	$1,050	117,600 / 1,050	112.00
8	$120,308	$920	120,308 / 920	130.77

In the final analysis of the developed range of GRMs, it may be noted that the most common result is around 123.00, with those results ranging from just slightly less than 123.00 to the upper 123.00 range.

In reconciling a GRM conclusion, Karen chooses to place most weight on property #2 (123.73) and property #4 (123.81), since the GRM from those transactions most closely brackets the subject's estimated market rent of $950. For this reason, she chooses a GRM of 123.75 to apply to the subject. Thus, the results of her conclusions are as follows:

123.75 x $950 = $121,125



Caution: Use the gross rent multiplier with caution. Don't forget that the application of the GRM does **not take into account the expenses** attributable to the property. This, of course, could have a significant adverse impact on the value.

Advertising and Marketing

A solid marketing and promotional plan is needed to attract tenants. A good marketing campaign helps property managers reach a pool of preferred tenants, and can help to convince prospects to sign leases. By deciding whom they need to reach and the best ways to reach them, managers can build an effective campaign.

All advertising should comply with federal, state, county, and municipal laws, as well as federal, state and municipal civil rights and fair housing guidelines. Display ads should include the equal housing logo, and all ads must be non-discriminatory.

Marketing Campaign

First, property managers should do what they can, within the budget, to make the property more attractive to potential lessees. Then they need to assess the supply and demand in the area and decide, based on prevailing conditions, how much of a marketing effort is needed. For example, if there is a high-vacancy rate, they will need a more aggressive marketing campaign than if there is a single vacancy in a high-demand market. There are several routes a property manager can take to advertise a property available for rent. Common strategies include:

- **Word of Mouth.** This is a powerful marketing tool, and current tenants are an excellent source for referrals. Managers should offer a bonus for good referrals.

- **Advertisement.** A property manager should determine which publications the target audience reads to get the most out of print advertising dollars. Classified ads are less expensive, but display ads deliver greater impact. Be careful, however, to consider fair housing laws that prohibit steering.
- **Signage.** Signs should specify the kind of unit available, the management firm, and a phone number. Depending on local zoning ordinances related to signage, it may be possible to provide highlights of available complex amenities to entice potential tenants driving past a complex to stop and further investigate the complex and inquire about unit availability.
- **Brochures.** Brochures should be designed and written to appeal to the target audience. Keep copy brief, include attractive photos, and use a clean layout to give the brochure appeal.
- **Direct Mail.** Fliers can be mailed to a list that includes prospective tenants and targeted real estate brokers. Fliers are usually less expensive than brochures and can be produced more quickly.
- **Online.** A website with easy-to-navigate photos and information is convenient and cost effective.
- **Press Release.** If a property has special features, a press release highlighting the property's significance, along with a photo, is a good form of advertisement. If a publication chooses to run the release, it is an extremely cost-effective way to promote the property.

Evaluating Effectiveness

Whether you choose a simple classified ad or a full-scale campaign, marketing space can be expensive. Property managers need to give owners an idea of how effective their marketing effort is at attracting prospects. By tracking how prospective tenants heard about an open unit, property managers can begin to get a handle on what is working. To calculate the costs and results of each method, note how much each promotional effort costs and how many prospects responded.

Cost per Prospect

A basic formula to track marketing costs most likely includes the **cost per prospect** approach. For example, you are leasing a space in a commercial building for $3,000 a month and you have taken out an ad that costs $800. To determine the cost per prospect, factor in how many prospects viewed the space before it was leased. For this example, assume 10 people walked through the space before a lease was signed.

$800 (cost of ad) / 10 (number of prospects) = $80 cost per prospect

Advertising Costs Plus Vacancy

In addition to the cost of the advertising, you may also need to factor in how many days, weeks, or months it takes to lease a space. To determine advertising costs plus vacancy, property managers must figure not only how much advertising a unit costs, but also how much it is costing to have empty space. For this example, let's assume a unit was empty for two weeks and the manager took out one classified ad for each of those weeks.

$100 (cost of ad) x 2 (weeks) = $200 in advertising costs

Then consider the money lost by *not* renting the space:

$3,000 (per month rent) x 12 months = $36,000 total rent per year

$36,000 / 52 (weeks in a year) = $692.31 rent per week

$692.21 x 2 (weeks the space sat empty) = $1,384.62 in lost income

Now, add the cost of advertising plus the lost rent.

$200 (advertising) + $1,384.62 (lost income) = $1,584.62 total cost

Real Success

It may seem as though a property manager's job never ends. Property managers must secure the premises for the enjoyment of the tenants, keep it clean and free of garbage, and keep it safe. This means property managers may be required to stop noisy parties, add security features if needed, rearrange parking to make it safer, add lights, and take other actions to ensure tenants are safe and happy.

No matter how big or small a property is, or how many people there are to manage it, all property managers should have an understanding of **purchasing**. It is not unusual for property managers to be responsible for purchasing supplies, writing purchase orders, and paying a wide variety of contractors. Many larger companies have purchasing departments that can assist the property manager in these duties. They should also be aware of and have an understanding of **union contractors**. Maintenance staff, or other building service staff, may be part of unionized labor, which has different needs and schedules than non-union labor staff members.

Finally, in addition to the responsibilities already mentioned, a property manager must comply with:

- Federal Fair Housing laws and the Americans with Disabilities Act.
- Local occupancy laws.
- Environmental laws.
- Health and building department laws.
- Zoning regulations.

Summary

1. Property managers have a variety of responsibilities, starting with the **management proposal,** which is a plan created by the property manager for overseeing the property and involves analysis of the market and financial reports, including an operating budget. Property managers need to provide regular reporting and financial analysis to their owners, including an **operating budget**, created to project income and expenses for the property over a one-year period, and a **stabilized budget,** which is the income and expenses averaged over a five-year period. The property manager also keeps track of the capital reserve budget, capital expenses, variable expenses, fixed expenses, budget comparison statements, profit and loss statements, and cash flow reports.
2. Property managers supervise others, interact with appraisers if necessary, and manage the office operations and the rent roll. They also monitor building systems, construction, and maintenance. **Preventive maintenance** includes routine maintenance and inspections to keep equipment and the property in good working order. **Corrective maintenance** restores broken or failed equipment to a specified condition.
3. **Market rent** is what the property could rent for on the open market. **Fixed expenses** are ongoing and do not vary based on occupancy (e.g., taxes, insurance). **Variable expenses** depend on occupancy (e.g., maintenance, management, utilities). **Reserves for replacement** are monies, considered as an operating expense, set aside for future replacement of major items. Operating expenses do **not** include debt service or depreciation.
4. A **direct capitalization rate** is a rate of return, also called a **cap rate**, stated as a percent, used to derive a value opinion from the anticipated net operating income a property could generate. It uses the IRV formula: Income (NOI) divided by Rate equals Value. Most small residential properties use the **gross rent multiplier** (**GRM**). A GRM is derived from comparable rental properties by taking the sale price divided by gross monthly rent. To apply a GRM, the gross monthly market rent of the subject is multiplied by the GRM to arrive at a value indication.
5. Property managers must also develop an **advertising** and **marketing** campaign, which may include word of mouth, advertisements, signage, brochures, direct mail, online and website marketing, and press releases.
6. Property managers need to follow codes and regulations and must secure the premises for the safety and enjoyment of tenants. Other responsibilities of property managers include understanding union negotiations, purchasing, and finding environmentally friendly ways to run a property.

Quiz

1. ***The total income, both cash and non-cash, received from an investment or business before expenses are paid is***
   a. cash flow.
   b. gross income.
   c. profit.
   d. stabilized budget.

2. ***For the purposes of an operating budget, property taxes and insurance are examples of what type of expenses?***
   a. capital
   b. fixed
   c. net
   d. variable

3. ***Which of these is NOT included in a typical operating budget?***
   a. expenses
   b. net operating income
   c. petty cash
   d. total income

4. ***The operating statement on Kathy's rental property shows an effective gross income of $48,750 and a net operating income of $28,000. She pays $2,900 a year for insurance, $7,000 a year for property taxes, and $15,600 a year on her mortgage. What is the cash flow?***
   a. $2,500
   b. $12,400
   c. $18,100
   d. $23,250

5. ***An operating budget is created***
   a. weekly.
   b. monthly.
   c. annually.
   d. every five years.

6. ***Property manager Nora gets bi-monthly inspections of the HVAC system in the building she manages. This is an example of what type of maintenance?***
   a. corrective
   b. cosmetic
   c. preventive
   d. routine

7. ***Bart manages a building with 30 units. No one has moved in about five years. What should Bart, as property manager, recommend to the owner?***
   a. enhance the apartments
   b. raise the rent
   c. reduce the rent
   d. make no changes

8. ***A typical management proposal should include a***
   a. six-month expense projection.
   b. one-year operating budget and a five-year plan.
   c. one-year stabilized budget and a six-year plan.
   d. five-year employment contract and a one-year plan.



29 Landlord-Tenant Relations

Creating good relationships with tenants is a key aspect of a property manager's job. Generally speaking, property managers and landlords who maintain good relationships with tenants have fewer problems and lower turnover. Spelling out the rules so tenants understand and respect them is basic, but important. For example, tenants need to know all of the landlord's policies, including how to pay their rent and how to place requests for maintenance. Complying with federal, state, and local regulations and communicating them to tenants when necessary are other important elements. This chapter starts a brief review of leasehold estates and the contract that creates them—leases. You will also have the opportunity to look at specific Illinois laws related to residential leases.

You will learn:

- Considerations for selecting tenants.
- Provisions of Illinois Landlord Tenant Act.
- The process of eviction.

Key Terms

Covenant of Quiet Enjoyment
Estate at Will
Estate for Years
Eviction
Holdover Tenant
Individual / Master Metered Utilities
Lease
Leasehold Estate
Lessee / Lessor
Lock-outs
Occupancy
Periodic Estate
Retaliatory Evictions
Tenancy at Sufferance

Leasehold Estates and Leases

A leasehold estate is an interest in real estate that gives the holder a temporary right to possession, without conveying title. The holder of a leasehold estate is known as a tenant or lessee. The property owner is known as the landlord or lessor. Leasehold estates are created by lease agreements that provide contractual rights and obligations to all parties involved. A leasehold interest is reversionary, meaning that once the lease ends, possession of the property reverts to the landlord. Let's review the different types of leasehold estates:

Leasehold Estate	Term	Renewal/Termination
Estate for Years/ Term Tenancy	Lasts a specific defined period, could be years, months, etc.	• Terminates automatically at end of defined term but not before unless both agree • Does not terminate with death of lessor or lessee or sale of property
Periodic Estate	Continues for defined successive equal periods	• Renews automatically at end of each term • Termination requires proper notice from either party • Does not terminate with death of lessor or lessee or sale of property
Estate at Will	No lease and no specific rental period	• Either party may terminate at any time with proper notice • Automatically terminates with death of lessor or lessee or sale of property
Tenancy/Estate at Sufferance (not technically a leasehold estate)	Holdover tenant does not vacate after valid lease expires	• Lessor must provide notice of termination • May require legal eviction proceedings • Becomes periodic tenancy or holdover tenancy if landlord accepts rent • If landlord does not accept rent, can charge double rent

Lease Review

Leases are *contracts in which one party (*the **lessee**) *pays the property owner* (the **lessor**) *rent in exchange for possession of real estate. Thus, a lease is the conveyance of a leasehold estate from the fee owner to a tenant.* Owners are expected to receive money in the form of rent plus the reversionary interest in the property. Lessees are entitled to quiet enjoyment of the property, which is the *right to the use and possession of real property without interference from the previous owner, the lessor, or anyone else claiming title*.

Leases are generally categorized by the method of rent payment. A **gross lease** is one in which the *tenant pays a fixed rent, while the owner or landlord pays all ownership expenses,* such as property taxes, repairs, insurance, and sometimes utilities. Residential leases are usually gross leases. A **net lease**, on the other hand, is a lease for which *the tenant pays some or all of the ownership expenses in addition to a monthly rent payment.* With net leases, which are typically used for commercial properties, the property owner or landlord has shifted much of the risk for increased costs to the tenants, who get the additional tax benefit of the business expense.

See Chapter 18: Leases to review a sample residential lease agreement.

Lease Covenants

While there is no statutory form of a lease, since the lease is a contract, the essential elements of a valid contract are also necessary for a valid lease. In addition, leases often contain **covenants**, which are *promises or guarantees.* Privacy and the right of entry are part of the implied **covenant of quiet enjoyment**. Most leases also contain clauses concerning the right to assign or sublet, the required security deposit, and the responsibility for repairs and maintenance. Other issues often addressed in the terms of a lease include the landlord's right to **access the property** during the lease term, tenant's responsibility for alterations or damage to the property, renewal rights, and the consequences of default. These rights are generally spelled out in a state's landlord-tenant laws.

Illinois Liability Exemptions. Section 1 of the Illinois Landlord and Tenant Act *(765 ILCS 705/1)* indicates that it is forbidden to include any covenant, agreement, or understanding in a residential lease that would exempt the lessor from liability from damages for injuries to people or property resulting from any negligence on the part of the lessor, his agents, servants, or employees.

Finding Tenants

Finding the right tenant who is a good fit for the property is one of the primary challenges of property manager or landlord. When working with potential tenants, landlords and property managers are required to follow all federal, state, and local laws and treat all applicants equally. It is especially critical that property managers are well-versed in federal, state, and local fair housing laws.

Real Success

Suppose you're working with a prospective tenant who asks, "What types of families live in this building?" How would you respond?

As a real estate licensee, you are not obligated to respond to every question that a customer or client asks. **Steering**, which is defined as ***channeling prospective buyers or renters to or away from specific neighborhoods based on their race, religion, national origin, or other protected class to maintain or change the character of a neighborhood,*** is specifically prohibited by the Fair Housing Act. It is illegal even if requested by a prospective buyer or tenant.

And questions about the ethnic or racial makeup of a neighborhood or building, even when answered in good faith with no intention to discriminate or encourage discrimination, are particularly tricky. Just remember, responding is done at your own risk. Anything beyond a very simple, factual answer could be considered steering. It's safest to ***avoid*** any discussion of race or ethnic background, and so an easy and appropriate response may simply be, "Legally, I cannot answer that."

Also remember: ***Never*** render an opinion regarding the racial makeup or the amenities (e.g., schools) of an area. Encourage your clients and customers to do their own homework. Direct your client to local libraries, government offices, or online sources where statistical data is available.

Lease Application

In order to ensure that every applicant is treated equally and fairly, a standard lease application should be used. The detailed information contained in a lease application gives a landlord or property manager an objective basis on which to evaluate **every potential tenant**. A typical residential lease application would ask the applicant and any co-applicant to provide the following information:

- Full legal name of applicant (and any other names the applicant may use or be known as)
- Names of all anticipated occupants
- Contact information
- Driver's license number (or some other government-issued ID number)
- Social Security number
- Date of birth
- Dependants and their ages
- Pets
- Employment information, including employer name and contact information, job title, status, years at the job, salary/hourly pay
- Details about previous residence(s), including location, rent, reason for leaving, and contact information

- Credit history, including banks and account numbers
- Personal references
- Other sources of income that the applicant wishes to disclose

Remember: The federal **Equal Credit Opportunity Act** (ECOA) prohibits discriminating against someone based on the **source of his or her income**. This applies to leasing residential property as well. For example, the income that someone who receives from regular and continuing public assistance should be considered equal to any other stable income. While the ECOA clearly indicates that reliable alimony, child support, or separate maintenance payments should also be considered as income, an applicant is not required to disclose such income, nor may applicants be discriminated against for exercising their good faith rights of nondisclosure of those sources of income.

Investigation

Although you cannot refuse to rent to applicants based on their membership in a protected class, there certainly are legitimate reasons to turn down an applicant, for example if the applicant:

- Has a criminal record (unless that is a protected class in the jurisdiction where the property is located).
- Has been evicted or has a history of not paying rent on time.
- Does not have a reasonable level of income to support the rent payment and other reasonable living expenses.
- Has a previous bankruptcy or a history of not paying bills.

Most rental applications will contain a section asking the applicant to sign authorizing the lessor or property manager to investigate certain types of personal information about an applicant, such as credit history, criminal history, and rental history. Applicants may be asked to provide a non-refundable fee to cover the costs of this background check.

Real Success

Again, property managers and landlords should treat **every** applicant equally in order to avoid any possibility of discriminating against someone because of his or her membership in a protected class. That means:

- Every applicant gets the **same lease application** and every applicant must complete every section as applicable.
- Ask every applicant the **same questions**.
- If a **credit or criminal check** is run on one applicant, it must be run on every applicant.
- If you ask to see **pay stubs or W-2s** from one applicant, you must ask to see them from every applicant.
- If you **check references** for one applicant, you must check references for every applicant.
- If an **application fee** is required of one applicant, the same fee must be required of every applicant.
- If a specific **pet deposit** is required of one applicant, it must be required from every applicant with a pet (although it is acceptable to impose different fees for different types of animals or numbers of animals).

If you treat everyone equally, you're following the law and you're not going to get in trouble.

Occupancy Standards

While landlords and property managers cannot place limits on tenants based on their membership in a protected class, they may limit occupancy if the number of people in the apartment violates local occupancy and health laws. An occupancy standard or policy is the establishment of the **maximum number of occupants allowable** in a given rental unit. It is intended to help promote an adequate and safely occupied inventory of housing. Great care should be taken when establishing an occupancy standard so as to not infringe on any fair housing laws.

To establish an occupancy standard, a property manager should research the local housing, building, zoning, and fire codes. The licensee should also determine if the dwelling has any physical configuration or utility service limitations that might affect the establishment of a reasonable occupancy standard. Based on the information gathered, the licensee would prepare a **written statement** establishing the maximum number of occupants that the dwelling can reasonably accommodate. Each dwelling under ownership or management should be reviewed in this manner.

If the occupancy standard *reasonably* makes available housing to households with children, then the licensee who established it has more than likely abided with the intent of the familial status portion of federal and state fair housing laws. It should be noted that the reasonableness of all occupancy standards will be considered by the **U.S. Department of Housing and Urban Development** (HUD) on a *case-by-case basis*.

Occupancy standards must *not* restrict the number of children, their ages, or their "sex mix" in a dwelling, and standards should have no differences in terms or rates established for other various household configurations.

Situation	Discussion Points
Frank is the property manager for a large apartment complex. Based on the size of the apartments, an occupancy standard of two people per bedroom is established. The prospect for one of the building's two-bedroom units is a mother and father with a 16-year-old son and a 15-year-old daughter. Aren't separate bedrooms required for the children because of their age and sex?	Many licensees, when faced with issues like this tend to naturally react in accordance with their own particular set of life experiences and apply that thinking to their solution. This may put them in violation of the law. There are many different cultures and many different points of view among consumers. A real estate practitioner should not "moralize" or withhold housing from a prospect because of concerns about where tenants are sleeping. Simply assure that the number of occupants will not exceed the occupancy standard.
James is a property manager. He's willing to rent a two-bedroom dwelling to a "traditional family" with a mother, father, and two children. Does he have to rent it to a same-sex couple with two children?	There is no such thing as a "traditional family" anymore. There are families with a single parent and children, families with two parents and children, same-sex couples with children, grandparents tending grandchildren, guardians caring for their charges, aunts and uncles taking care of nieces and nephews. The important point is that no maximum occupancy standard can restrict the number of children. It can only restrict the number of total occupants based on the local housing codes, and that standard must be reasonable. The property manager should just "count the heads."
Laura is expecting her third child in three months. She and her husband want to rent a two-bedroom apartment from landlord Jay. How should Jay do the "head count" for these prospective tenants?	This issue is subject to many interpretations. Here again, many landlords and property managers may want to apply their own beliefs and standards in making decisions. To do so may lead to a violation. As a general rule, the practitioner should count a pregnant woman and the unborn child (or children) in the "head count" at the time of application. However, the practitioner should be well informed of, and consistently incorporate, local occupancy codes in the occupancy standards. Sometimes, local codes do not count unborn or very young children as occupants in a head count.

Lead Paint Disclosure

The federal **Residential Lead-Based Paint Hazard Reduction Act of 1992** applies both to homes that are sold as well as residential leases. From the perspective of rental property, it requires landlords and agents to disclose known lead paint hazards for homes and rental units built **prior to 1978**, with some exceptions, for example, dormitories and leases for less than 100 days, such as vacation rentals. To comply with this law, landlords must:

- Disclose any known lead-based paint hazard in homes and must give tenants any reports available from prior lead tests.
- Give renters a pamphlet about how to protect families from lead in homes.
- Include certain language in leasing agreements, either in the lease itself or as an attachment, to ensure that disclosure and notification actually take place. This disclosure must be signed by landlords, agents, and tenants.

Obligations of Tenants and Landlords

As with any contract, the landlord and tenant are generally free to negotiate the terms of their lease. There are, however, some special limits on freedom of contract with residential leases. Housing shortages often put residential landlords in a much stronger bargaining position than their tenants. Furthermore, residential landlords tend to be more sophisticated than tenants, with a much better understanding of the legal effects of lease provisions. To protect residential tenants against overreaching landlords, most states have passed some type of landlord/tenant laws. In the State of Illinois, many of the laws relating to landlord-tenant relationships are found in **Chapter 765** (Real Property) of the Illinois Compiled Statutes. Others, especially those related to rent and eviction, are found in **Chapter 735** (Code of Civil Procedure). As we discuss some key elements in this relationship, we'll reference several of the relevant laws. Some of this may be a review.

Security Deposits

To protect themselves from tenants who move out without paying all the rent that's due or who leave the property in a mess or even badly damaged, most landlords require tenants to pay a **security deposit** before the tenancy begins as a way of ensuring compliance with all lease provisions. If the tenant pays the rent in full and keeps the property in good condition, the whole security deposit should be refunded when the lease ends and possession is returned to the landlord. If the tenant has breached the terms of the lease or failed to look after the property, the landlord may be able to keep part or all of the deposit to cover any damages that result.

A security deposit isn't supposed to be used to repair ordinary wear and tear, however, or to put the property into better shape than when the tenant moved in. The security deposit may be used only to reimburse the landlord for:

- Actual damages to a rental unit or shared facility that go beyond normal wear and tear.
- All rent that may be in arrears according to the lease.
- Any rent due when a tenant prematurely terminates a lease.
- Any of the tenant's unpaid utility bills.

Generally speaking, a security deposit may **not** be used for cleaning the rental unit. When negotiating the lease, however, a landlord could have imposed a separate non-refundable cleaning fee or pet fee.

Illinois Security Return Act

765 ILCS 710/

The **Illinois Security Return Act** defines the process that a lessor of residential real property containing **five (5) or more units** must follow in order to retain a portion of the security deposit to cover property damage.

If the landlord—after performing a thorough walk-through of the property with the tenant upon their vacating the property—finds it necessary to make repairs as a result of the tenant's occupancy, the landlord must deliver—in person or by mail to the last known address—an itemized statement of the damage alleged to have occurred **within 30 days** of the tenant vacating the premises.

The statement must contain:

- The **estimate** or **actual cost** for repairing or replacing each item.
- **Paid receipts**—original or copies—for the repair or replacement. If estimated, paid receipts must be supplied within 30 days of providing the original statement.

If there are no repairs required or if the landlord does not have paid receipts for any repairs, state law requires the landlord to return the security deposit in full **within 45 days** of the tenant vacating the premises. If the security deposit is not returned within the given timeframe, the lessor is liable as follows:

- An amount equal to twice the security deposit due
- Court costs and reasonable attorney fees

Inventory Checklists

In order to document any damage that could affect how much of the tenant's security deposit may be returned, residential landlords generally give two copies of an **inventory checklist** to the new tenant when a security deposit is required. The list documents the condition of all items in the unit that are owned by the landlord, and may include items such as carpet, draperies, appliances, shelves, paint, doors, furniture, plumbing fixtures, etc. When the tenant moves in, he or she should complete the "commencement" checklist, noting the condition of the listed property, and return one copy of the list to the landlord.

When a tenant moves out of their leased residential property, the landlord will generally use his or her copy of the tenant's commencement inventory checklist to complete a "termination" inventory checklist. The landlord will go through the property with the list in hand, indicating any damages or missing items that may be attributed to the tenant. The landlord will then determine an estimate for any repairs and define the amount, if any, he or she intends to withhold from the balance of the security deposit.

Habitability and Maintenance

Property owners are required to lease property that is habitable and livable at the beginning of the lease term and to maintain the premises in habitable and livable conditions throughout the lease term. Owners are also obligated not to subject tenants to conditions that are dangerous, or detrimental to their life, health, and safety. Both tenants and landlords bear some responsibility for maintenance, repairs, and the habitability of leased property.

Tenant's Duty

Tenants must not intentionally or negligently damage any part of the property, or permit guests to damage it. Furthermore, a tenant is expected to keep the rental unit safe and sanitary, dispose of rubbish and garbage, keep the plumbing fixtures clean, use all electrical and plumbing fixtures properly, and comply with health and safety codes.

A tenant isn't liable for the ordinary wear and tear that results from normal use of the property, although a tenant may be responsible for keeping the appliances in working order if the lease specifically gives the tenant that duty.

Landlord's Duty

Generally speaking, a residential landlord is expected to:

- Comply with all building, housing, health, and safety code provisions that materially affect health and safety.
- Make all repairs and do whatever is necessary to put and keep the property in a fit and habitable condition.
- Keep the common areas safe and sanitary.
- Maintain the electrical, plumbing, sanitary, heating, ventilating, and air conditioning equipment in good and safe working order.
- Supply running water, hot water, and heat.

These duties are referred to as the **implied warranty of habitability.** By offering residential property for rent, the landlord implicitly guarantees to the tenant that it's fit for human habitation. Disclaimers in the lease can't change that.

4350.3 REV1

Appendix 5

OMB Approval 2502-0204
Exp. 05/31/2011

Appendix 5: Move-In/Move-Out Inspection Form

[Company name]
[Company address]

Property		Resident	
Apartment No.	Unit Size	Move-In Inspection Date	Move-Out Inspection Date

Item	Condition		Cost to Correct
	Move-In	Move-Out	
ENTRANCE/HALLS			
Steps and landings			
Handrails			
Doors			
Hardware/Locks			
Floors/Coverings			
Walls/Coverings			
Ceilings			
Windows/Coverings			
Lighting[1]			
Electrical Outlets			
Closets[2]			
Fire alarms/equipment			
LIVING ROOM			
Floor/Coverings			
Walls/Coverings			
Ceiling			
Windows/Covering			
Lighting[1]			
Electrical outlets			

SAMPLE

4350.3 REV-1

Appendix 5

OMB Approval 2502-0204
Exp. 04/30/2009

Item	Condition		Cost to Correct
	Move-In	Move-Out	
DINING ROOM			
Floor/Coverings			
Walls/Coverings			
Ceiling			
Windows/Coverings			
Lighting[1]			
Electrical outlets			
KITCHEN			
Range			
Refrigerator			
Sink/Faucets[3]			
Floor/Coverings			
Walls/Coverings			
Ceiling			
Windows/Coverings			
Lighting[1]			
Electrical outlets			
Cabinets			
Closets/Pantry[2]			
Exhaust fan			
Fire alarms/equipment			
BEDROOM(S)			
Doors and locks			
Floor/Coverings			
Walls/Coverings			
Ceiling			
Windows/Covering			
Closets[2]			
Lighting[1]			
Electrical outlets			

SAMPLE

4350.3 REV-1

Appendix 5

OMB Approval 2502-0204
Exp. 04/30/2009

Item	Condition		Cost to Correct
	Move-In	Move-Out	
BATHROOM(S)			
Sink/Faucets[3]			
Shower/Tub[3]			
Curtain rack/Door			
Towel rack			
Toilet			
Doors/Locks			
Floor/Coverings			
Walls/Coverings			
Ceiling			
Windows/Coverings			
Closets[2]			
Cabinets			
Exhaust fan			
Lighting[1]			
Electrical outlets			
OTHER EQUIPMENT			
Heating Equipment			
Air-conditioning unit(s)			
Hot-water heater			
Smoke/Fire alarms			
Thermostat			
Door bell			
TOTAL			

1. Fixtures, Bulbs, Switches, and Timers
2. Floor/Walls/Ceiling, Shelves/Rods, Lighting
3. Water pressure and Hot water

SAMPLE

4350.3 REV-1

Appendix 5

OMB Approval 2502-0204
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Move-In

This unit is in decent, safe and sanitary condition. Any deficiencies identified in this report will be remedied within 30 days of the date the tenant moves into the unit.

_____
Manag er's Signature

I have inspected the apartment and found this unit to be in decent, safe and sanitary condition. Any deficiencies are noted above. I recognize that I am responsible for keeping the apartment in good condition, with the exception of normal wear. In the event of damage, I agree to pay the cost to restore the apartment to its original condition.

_____
Re sident's Signature

_____
Re sident's Signature

	By	Date
Prepared		
Reviewed		
Prepared		
Reviewed		

Move-Out

_____
Manag er's Signature

___Agree with move-out inspection

___Disagree with move-out inspection

If disagree, list specific items of disa greement.

_____

_____

_____

_____
Re sident's Signature

_____
Re sident's Signature

	By	Date
Prepared		
Reviewed		
Prepared		
Reviewed		

SAMPLE

Public reporting burden - HUD is not requesting approval of any burden hours for the move-in/move-out inspection report since use of move-in/move-out inspection reports are a standard business practice in the housing rental industry. This information is required to obtain benefits and is voluntary. HUD may not collect this information, and you are not required to complete this form, unless it displays a currently valid OMB control number. The owner/management agent and tenant together conduct a move-in/move-out inspection to document the condition of the unit at the time of move-in/move-out. Conducting move-in/move-out inspections are a standard business practice in the housing rental industry and are used for determining damages caused by the tenant during tenancy and allowable deductions from the tenant's security deposit held by the owner. This information is authorized by 24 CFR 5.703 and 5.705, 886.123, 886.223 cover unit inspections. This information is considered non-sensitive and does not require any special protection.

Illinois Tenant's Right to Repair Act

765 ILCS 742/5

If repair is required—either under the terms of residential lease or under law, rule, or local ordinance—tenants may have the right to have the repair made at the landlord's expense. The **Illinois Residential Tenant's Right to Repair Act** applies to residential rental property, with the following exceptions:

- Public housing
- Condominiums or cooperatives
- Owner-occupied rental property containing six or fewer units

To fall under the provisions of this Act, the cost of the repair may not exceed the lesser of $500 or one half of the monthly rent.

When choosing to make a repair, the tenant must notify the landlord in writing of his or her intent to have the repair made at the landlord's expense. If the landlord fails to make the repair **within 14 days** after being notified (or more promptly if an emergency), the tenant may have the repair made. After submitting a paid bill from an appropriately licensed or certified tradesman or supplier (unrelated to the tenant and with contact information available), the tenant may **deduct the cost from his or her rent**. Emergencies include:

- Conditions that will cause irreparable harm to the apartment or any fixture attached to the apartment if not immediately repaired.
- Any condition that poses an immediate threat to the health or safety of any occupant of the dwelling or any common area.

A tenant may *not* repair at the landlord's expense if the condition was caused by the deliberate or negligent act or omission of the tenant, a member of the tenant's family, or another person on the premises with the tenant's consent.

Rent Strike

Under certain circumstances, tenants may withhold rent, a situation that may be referred to as a **rent strike**, if the landlord violates the covenant of habitability. This may happen if:

- Heat, water, electricity, or wastewater disposal facilities are not supplied.
- The building is infested with rodents.
- The owner has threatened their health, safety, and welfare.

Tenants who chooses to withhold rent should understand the laws where they live. For example, they may need to file a petition with a local housing authority or bring legal action in civil court. A rent strike does **not** generally excuse tenants from paying rent. They may have to make payments directly to the court or housing authority where they filed to be held in escrow until the matter is resolved, at which point it would be distributed according to the court's ruling.

Utilities

In residential property, utilities—gas, electric, and water—may be metered differently:

- **Individually Metered Utilities.** The utility service to one or more rental dwelling units in a building is registered by an individual meter for each dwelling unit.
- **Master Metered Utilities.** The utility service to a building with one or more rental dwelling units is registered by a single meter for the building.

Illinois Tenant Utility Payment Disclosure Act

765 ILCS 740/

According to the **Illinois Tenant Utility Payment Disclosure Act** (765 ILCS 740/), before leasing property (or renewing a lease) where a tenant is required for pay for common area utilities or utilities for anyone other than the tenant or someone occupying that unit, the landlord:

- Must provide a written statement setting forth the specific areas of the building and other appurtenances that will be in the tenant's name.
- Must provide copies of the utility bills for the unit for the previous 12 months (unless waived by the tenant).

- Cannot suggest nor require a tenant to collect any money for utility bills from other tenants.
- Must set forth, in writing, the amount of any proposed rent reduction to compensate the tenant for paying for utilities outside his or her unit.

A landlord cannot request or change from landlord-paid master-metered utilities to tenant-paid individually-metered utilities or any landlord-paid to tenant-paid utilities during the term of the lease. The landlord can, however, effect this change after the lease term expires, but must provide tenants with at least 30 days' notice. At that point, the landlord and tenant could agree to amend the lease.

Any condition or term in a rental agreement between the landlord and tenant inconsistent with this Section is **void** and **unenforceable**.

Illinois Rental Property Utility Service Act

765 ILCS 735/

According to the **Illinois Rental Property Utility Service Act**, landlords or property managers who are required under the terms of the lease to pay for any water, gas, or electrical service must do so to ensure that the services are available to the tenant throughout the term of the lease. Payments for services must be made in a timely manner so as not to cause an interruption of the services. If the landlord or property manager does *not* pay for any master metered utility serving more than one tenant, including electrical service to common areas, the tenant(s) may:

- Terminate the lease,
- Pay for such service if the nonpayment jeopardizes the continuation of the service to the tenant or tenants, or
- Request to have the utility service be put in their name and take on the responsibility for future billing.

The utility company cannot terminate service for such nonpayment until it mails, delivers, or posts a notice to all tenants of buildings with three (3) or more residential apartments. Upon receipt of such payment of the past due cost of such water, gas, or electrical service owed by the landlord, the provider of such service shall immediately restore service to such tenant or tenants. Any sums the tenant or tenants, as the case may be, pay for water, gas, or electrical service that the landlord or property manager was required to pay may be **deducted from the rent due** by the tenant or tenants.

Chicago Residential Landlord and Tenant Ordinance

It's important to note that municipalities may have their own landlord-tenant laws that define specific responsibilities and rights for both lessee and lessor. For example, residential lessors in the city of Chicago (with some exceptions) are required to attach a copy of Chicago's **Residential Landlord and Tenant Ordinance (RLTO) Summary** to every written lease agreement (or present a copy to tenants who have an oral agreement). Topics covered in the summary include:

- Tenant's duties
- Landlord's right of access
- Handling security deposits
- Landlord's responsibility to provide essential services
- Subleasing
- Handling late rent payments
- Lockouts
- Tenant remedies

Make sure you are familiar with the laws in the jurisdictions where you practice.

Eviction

If a tenant breaches the lease contract, an owner can choose to terminate the contract by evicting the tenant. **Eviction** is *the forced removal, by legal means, of a tenant and the tenant's belongings from a leased premise*. The key word in this definition is *legal*. This process is known as **actual eviction.** In most states, a landlord has a legal right to evict a residential tenant if the tenant:

- Hasn't paid the rent.
- Causes extensive and continued physical damage to the property.
- Engages in activity that results in a serious and continuing health hazard.
- Engages in illegal drug activity or other criminal offense on the property.
- Violates a provision of the lease that allows for termination.
- Remains in the property after the lease has naturally expired.

In addition, a landlord may also commence eviction proceedings against someone who illegally occupies the landlord's property that he or she does not own, rent, or otherwise have permission to use. This person may be referred to as a trespasser or squatter.

In the case of rent delinquency, the property manager may decide to offer a grace period to try and correct the situation.

Constructive Eviction

Lease contracts may also be terminated when **constructive eviction** occurs, which is when *a tenant is prevented from the quiet enjoyment of the property*, for example, inoperable plumbing or lack of heat due to the owner's negligence. To claim constructive eviction, tenants must vacate the premises while the conditions that make the property uninhabitable still exist. Constructive eviction claims are not automatic and may require litigation.

Violating the Drug Free Housing Addendum

765 ILCS 705/5

Lessors who include a **Lease Addendum for Drug Free Housing** as promulgated by HUD (or a substantially similar addendum) in a lease have the right to **void** a lease if any lessee or occupant is charged during the term of the lease with having committed an offense on the premises constituting a **Class X felony**.

If the decision is made to void the lease, the lessor must post written notice at the premises requiring the lessee or occupant to **vacate the premises within five (5) days**. The notice must state the basis for the action on forms provided by the Circuit Court Clerk of the county in which the property is located.

If the lessee or occupant does not vacate, the lessor/owner can initiate legal eviction proceedings. Note that when evicted under these provisions, the tenant does *not* forfeit his or her security deposit.

Actual Eviction Process

In Illinois, the legal eviction process—called a **forcible entry and detainer**—is described in Article IX of the **Illinois Code of Civil Procedure**. The eviction process is comprised of three basic steps:

1. Notice to quit
2. Forcible entry and detainer action
3. Writ of execution

These steps must be followed, in order, as prescribed by law.

Notice to Quit

735 ILCS 5/9

A **notice to quit** (sometimes referred to as a **notice to vacate**) is *a notice to a tenant demanding that he vacate the leased property*. For most evictions, this is the landlord's first step. The landlord sends a written notice that tells the tenant who has breached a condition of the lease to move out and explains that legal action to regain possession will begin if he does not move out. The notice, signed by the landlord or property manager, generally will include language similar to the following:

> *You are hereby notified that in consequence of your default in [here insert the character of the default] of the premises now occupied by you, being, etc., [here describe the premises] I have elected to terminate your lease, and you are hereby notified to quit and deliver up possession of the same to me within [here enter the number of days] of this date [dated, etc.].*

The notice to quit may be delivered to the tenant in one of these ways:

- Hand-delivering a written copy directly to the tenant
- Leaving a written copy with anyone residing on the property who is at least 13 years old
- Sending a copy of the written notice by certified or registered mail
- Posting the notice on the premises (usually done as a last resort)

The time period indicated in the notice to quit will be different based on the reason:

Reason for Notice	Days to Quit
Non-payment of rent	5
Breaking terms of the lease	10
Any reason for year-to-year tenants	60
Any reason for month-to-month tenants	30
Any reason for week-to-week tenants	7

When the order to quit is initiated because of non-payment of rent, the tenant can make **full payment** of the rent that is due **within five days** of receiving the notice, which waives the landlord's right to terminate the lease. The landlord could agree, in writing, to accept partial payment.

Forcible Entry and Detainer

A **forcible entry and detainer action** is *a lawsuit filed by a landlord to evict a defaulting tenant and regain possession of the property*. The landlord may begin legal proceedings to evict the tenant when a tenant does not move out within number of days specified in the notice to quit. This legal proceeding uses the word "detainer" because the tenant is "detaining" the property without right and against the landlord's wishes. A forcible entry and detainer action can be filed in applicable court in the county in which the property is located. Because possession of property is at issue (not just money), these lawsuits are supposed to be resolved as quickly as possible and take priority on a court's schedule.

The central issue at trial is whether the landlord has a right to possession of the property. In some cases, other issues are decided at the same time (e.g., whether one party is entitled to damages because the other breached the lease). In other cases, though, those issues will be dealt with later in a separate trial that does not have priority on the court's schedule.

Order of Eviction

If the court finds that the landlord is entitled to possession of the property, an **order of eviction**, sometimes called a writ of execution, is issued *directing a public officer (often the sheriff or marshal) to seize the property to regain possession for the owner*. If the tenant does not move out within the mandated period, the sheriff can forcibly remove the tenant and his belongings from the property. If the tenant files an appeal, the court will issue a stay of execution, directing the sheriff to wait for further orders from the court.

Emergency Eviction

735 ILCS 5/9-118

In Illinois, a landlord may have the right to bring **emergency eviction proceedings** when there is direct evidence that unlawful activity is taking place on the property, such as:

- Selling, making or cultivating, possessing illegal drugs (cannabis, illegal narcotics or controlled substances).
- Possession, use, or sale of prohibited firearms.
- Murder or attempted murder, kidnapping, arson, aggravated battery, sexual assault or abuse.

The landlord must serve the tenant with a **notice to quit the premises** at least **14 days** before a hearing on the complaint is held. The summons shall advise the tenant that a hearing on the complaint will be held at the specified date and time, and that the tenant (defendant) should be prepared to present any evidence on his or her behalf at that time.

If the court finds for the property owner, the property owner will be entitled to re-enter the premises **immediately**. If the tenant does not appear at the hearing, judgment for possession of the premises in favor of the property owner will be entered by default. The sheriff or other lawfully deputized officers will give priority to service and execution of orders entered over other possession orders.

Illegal Eviction

There are other scenarios in which a form of eviction is used as a remedy for landlord-tenant disputes, although both are illegal in Illinois.

Self-Help Eviction

Landlords can certainly become frustrated with bad tenants, but they must resist the temptation to take matters into their own hands. A **self-help eviction**, sometimes called a **lock-out** or a **freeze-out**, is when a landlord uses physical force or other means to get rid of a tenant instead of going through the legal process. Although some commercial leases may include a clause giving the landlord the right to retake possession without going through the legal process if the tenant defaults, a residential landlord is not allowed to force tenants off the property by any means other than the legal process. It's **illegal** for the landlord to:

- Threaten the tenants.
- Change locks or otherwise lock them out.
- Shut off utility services to make them leave.
- Introduce noise or other nuisance to make them leave.

Retaliatory Eviction

765 ILCS 720/1

A **retaliatory eviction** is when a landlord evicts a tenant in retaliation for complaining about the condition of the property, code violations, violations of state landlord/tenant laws, or for participating in a tenants' rights group. This is called retaliatory eviction because the landlord is retaliating against the tenant for asserting his or her rights. Retaliatory eviction is generally illegal in residential tenancies. Landlords are also generally prohibited from raising the rent or reducing services in retaliation for the tenant's actions. Of course, landlords aren't prevented from raising the rent for legitimate reasons, such as to reflect the cost of property improvements or to cover an increase in operating costs.

When a landlord takes any type of retaliatory action, however, the tenant may have the right to terminate the tenancy. A tenant who proves that an eviction was retaliatory is usually entitled to stay in possession of the property. But a tenant can't use the landlord's retaliatory motives as a defense against eviction if the tenant has failed to pay rent or is holding over after expiration of the lease.

Retaliatory evictions are **illegal** in Illinois. According to the Illinois **Retaliatory Eviction Act**, it is:

> *"…against the public policy of the State for a landlord to terminate or refuse to renew a lease or tenancy of property used as a residence on the ground that the tenant has complained to any governmental authority of a bona fide violation of any applicable building code, health ordinance, or similar regulation."*

Distress for Rent

735 ILCS 5/

When a tenant owes back rent, the property owner has the right to seize the tenant's personal property that may be found in the county in which the property is located. This action, called **distress for rent**, requires the property owner, or his property manager or attorney, to file a distress warrant and inventory with the clerk of the circuit court, who will issue a summons against the tenant. If the court finds in favor of the property owner, the tenant's personal property may be seized and sold to reimburse the property owner for rent due. The right to **destrain** the tenant's property **expires six months** after the expiration or termination of the lease.

In all cases when the leased premises are sublet, or the lease is assigned, the landlord shall have the same right to enforce his or her lien against the sublessee or assignee, that he has against the tenant to whom the premises were leased.

Summary

1. A **leasehold estate** gives the holder (tenant) a temporary right to possession, without title. Lease agreements create leasehold estates and provide contractual rights and obligations to all parties involved. There are several types of leasehold estate including: **Estate for years**, which is set to last for a specific period, after which it automatically terminates; **periodic estate**, which continues for successive equal periods of length, such as week-to-week or month-to-month; **estate at will**, when a tenant is in possession with the owner's permission, but there is no lease and no specific rent terms (terminates at the death of either party). A **tenancy at sufferance**, which is not a leasehold estate but is when a **holdover tenant** refuses to vacate the property when the lease ends.
2. **Leases** are contracts in which one party (lessee) pays the property owner (lessor) rent in exchange for possession of real estate. It conveys a leasehold estate from the owner to a tenant. Lessees, or tenants, are entitled to **quiet enjoyment** of the property, which is the right to the use and possession of real property without interference from the previous owner, the lessor, or anyone else claiming title. Lessors have a **reversionary interest** in the property, which means the property reverts to them at the end of the lease term. A **gross lease** is one in which the property owner pays all the expenses associated with the property, most typical for residential leases. With a **net lease**, the tenant pays some or all the expenses associated with the property. More typical for commercial leases.
3. A primary task for property managers and landlords is finding tenants. In order to follow federal, state, and local laws against illegal discrimination, all applicants must be treated equally. One way to achieve equal treatment is by using a standardized **lease application**. **Steering** is the channeling of prospective tenants to specific properties or neighborhoods based on their membership in a protected class. It is prohibited by the federal Fair Housing Act.
4. An occupancy standard or policy is the establishment of the **maximum number of occupants allowable** in a given rental dwelling, regardless of their age or sex. It is intended to help promote an adequate and safely occupied inventory of housing.
5. Most landlords require tenants to pay a **security deposit** before the tenancy begins as a way of ensuring compliance with all lease provisions. If the tenant has breached the terms of the lease or failed to look after the property, the landlord may be able to keep part or all of the deposit to cover any damages that result. **Inventory checklists** are helpful. The **Illinois Security Return Act** defines the process that a lessor of residential real property containing five (5) or more units must follow in order to retain a portion of the security to cover property damage.
6. Property owners are required to lease property that is habitable and livable at the beginning of the lease term and to maintain the premises in habitable and livable conditions throughout the lease term. In Illinois, landlords have 14 days to make a requested repair (more promptly if an emergency). The **Illinois Residential Tenant's Right to Repair Act** defines the process that tenants may take to deduct the costs of needed repairs from their rent.
7. Utilities (gas, electric, and water) may be metered with a master meter or for individual units. The **Illinois Rental Property Utility Service Act** requires residential leases to explicitly define the utility metering in the unit and the formula for determining utilities with a master meter. The **Illinois Rental Property Utility Service Act** defines the process that allows tenants to recover the cost of paying for common utilities if the landlord does not make the payment. Tenants may also terminate the lease if a landlord does not pay for common utilities as required by the lease.
8. When tenants breach the terms of the lease, property managers/landlords may have to evict the tenant. **Actual eviction** is the **legal process** of making a tenant vacate the property. In Illinois, the steps for actual eviction are: (1) Deliver a notice to quit to the tenant with a deadline to vacate the property. (2) File a **forcible entry and detainer action** with the court in the county in which the property is located. (3) If the court agrees with the landlord, it will direct an officer of the county to remove the tenant and his or her belongings from the property. If there is evidence of criminal activity on the property, landlords may bring **emergency eviction proceedings**; an expedited hearing will be held and the tenant could be removed immediately if judgment is in the landlord's favor. **Self-help** evictions, also known as **lock-outs**, are illegal. Also illegal are **retaliatory evictions**.

Quiz

1. ***A leasehold estate gives a tenant a _____ right to possession _____ title.***
   a. permanent / with
   b. permanent / without
   c. temporary / with
   d. temporary / without

2. ***Lyle leases his property to Shawn. Lyle is the _____ and Shawn is the _____.***
   a. landlord / lessor
   b. lessee / lessor
   c. lessor / lessee
   d. tenant / landlord

3. ***Which type of leasehold estate has a definite expiration date?***
   a. estate at sufferance
   b. estate for years
   c. periodic tenancy
   d. tenancy at will

4. ***Larry is a property manager for a large apartment complex. The occupancy standard established for the complex indicates that two residents per bedroom is reasonable for the space. Larry could refuse to rent a two-bedroom apartment to***
   a. David, his partner John, and their adopted son and daughter.
   b. Lula, her daughter Kelly, and Kelly's two children.
   c. Margaret, her mother Alma, her sister Martha, and Martha's twin infants.
   d. Sherry, a single mother with three children.

5. ***Luther is a property manager trying to find tenants for his building. Which statement on his advertisement is NOT likely to get him into trouble?***
   a. Mature adults only, please.
   b. Must have good credit.
   c. Quiet building; no children or pets.
   d. Synagogue within walking distance.

6. ***When Angela moved out of her apartment, she left behind quite a bit of damage. If landlord Andy wants to retain part of her security deposit to pay for the damage, he must send her an itemized statement of the damage and the estimate cost to repair within _____ of her vacating the property.***
   a. 10
   b. 21
   c. 30
   d. 45

7. ***Rachel is a property manager for a large apartment complex. Most of her tenants are elderly and Hispanic. Ali, a transfer student from Somalia, calls to ask about a vacancy. She suggests that he would feel more comfortable in a complex she manages downtown where there are more young people from Africa. This might be considered an example of***
   a. blockbusting.
   b. looking out for your prospective tenant's best interests.
   c. redlining.
   d. steering.

8. ***Mary, who is in a wheelchair, wants to install a ramp in her rented apartment. Property owner Jack***
   a. can ask Mary to find a more appropriate place to live.
   b. can refuse to allow the ramp since it's on the outside of the unit.
   c. must allow Mary to install the ramp at her expense.
   d. must install the ramp for Mary at his expense.

9. ***Which is NOT an option residential tenants in a building may exercise if the landlord does not pay the water bill on a master meter as required by the lease?***
   a. pay for such service themselves and withhold that amount from the rent
   b. request to have the utility service be put in their names
   c. sue for title of the property under terms of adverse possession
   d. terminate the lease

10. ***Tenant Pat is behind in her rent, yet again, and landlord Sue has had enough. What is Sue's best option for dealing with Pat?***
    a. change the locks to keep Pat out of the apartment
    b. cut off electricity to the apartment so Pat will leave
    c. file a complaint with the county court
    d. give Pat a notice to quit

11. ***A forcible detainer or unlawful detainer action is a lawsuit brought by a***
    a. landlord against a tenant to evict the tenant.
    b. landlord against a tenant who removes fixtures at the end of the lease.
    c. tenant against a landlord who does not refund a security deposit.
    d. tenant against a landlord who wrongfully refuses to perform repairs.

12. ***Tenant Tom complains about everything. Landlord Lois is on the phone listening to Tom's rants at least three times a week. When Tom involves the city building inspectors, Lois decides that she can't wait until the lease is up to get Tom out. She begins eviction proceedings. This is an example of***
    a. actual eviction.
    b. constructive eviction.
    c. retaliatory eviction.
    d. self-help eviction.



UNIT 10

SELLER RELATIONSHIPS AND COUNSELING

Chapter 30 – The Seller's Agent

Chapter 31 – The Listing Appointment

Chapter 32 – Property Concerns

Chapter 33 – Marketing and Communication



30

The Seller's Agent

Agency, you'll recall, is a ***relationship of trust created when one party gives another the right to represent him in dealings with third parties.*** This is a consensual relationship that both enter into willingly. Recall that a real estate broker is usually considered to be a special agent of his or her seller client, meaning that the seller expressly gives the agent limited authority to perform a specific task or conduct a specific transaction. In this chapter, we'll review how an agency relationship is created with someone wishing to sell real estate and a broker's disclosure obligations related to agency. We'll also discuss strategies for working with other licensees while maintaining the appropriate relationship with seller clients.

You will learn:

- Agency disclosure obligations.
- Statutory duties owed to a seller client.
- Considerations related to dual agency.
- Strategies for working with teams and cooperating brokers.
- Strategies for finding seller clients.

Key Terms

Confidential Information
Designated Agent
Dual Agency
Farming
Implied Agency
Informed Consent
Listing Agreement
Minimum Services
Non-Agency

Agency Obligations

Article 15 of the Illinois Real Estate License Act, as amended in 2009, defines the statutory law of agency. Specifically, Section 15-10 indicates:

> *"Licensees shall be considered to be representing the consumer they are working with as a designated agent unless there is a written agreement between the sponsoring broker and the consumer providing that there is a different relationship."*

Although a very simple comment, it specifically states that under the law there is **a natural presumption you are representing the interest of the party whom you are currently working with**. When you accepted the responsibility to represent the interests of the seller, you undertook a unique obligation commonly referred to as "agency." This concept of agency reflects a relationship in which a real estate sponsoring broker, whether directly or through an affiliated licensee, represents a consumer with the consumer's consent, whether express or implied, in a real property transaction.

Duties to Seller Clients

The role of a **seller's agent** is fairly clear: *When representing only the seller in a transaction, the agent owes all loyalties to that seller client.* Section 15-15 of the Illinois Real Estate License Act indicates that a licensee representing the interests of a seller in an agency relationship should:

- Seek a purchase offer with the best possible terms and conditions acceptable to the seller.
- Accept delivery of and present any purchase offer to the seller in a timely manner, even if the property is subject to a contract of sale, lease, or letter of intent to lease.
- Within the scope of knowledge required for licensure, answer the seller's questions and provide information regarding any offers or counteroffers.
- Assist the seller in developing, communicating, and presenting offers or counteroffers.
- Within the scope of knowledge required for licensure, answer the seller's questions regarding the steps needed to fulfill any contract terms.

Statutory Obligations

Can you name the common law fiduciary obligations owed by an agent to a client?

O _____

L _____

D _____

C _____

A _____

R _____

Case in Point

Sam and Martha are forced to sell their property due to a pending divorce. Because they are in a desperate situation, they are very eager to make a sale quickly so that they can split the proceeds of the sale and finalize the terms of the divorce. Sam tells his listing broker Marcia that they are willing to accept less than the listing price if necessary. Such information cannot be disclosed to anyone without Sam and Martha's written authorization. This prohibition even applies to Marcia's co-worker, licensee John, who has a buyer client eager to purchase that property. ***Marcia cannot tell John ANY confidential information about her clients that would damage their negotiating position.***

Six months go by and Sam and Martha have had no acceptable offers on the property. The listing agreement expires and they list the home with a different agency. Marcia has acquired a new buyer client looking for a property in that specific neighborhood, and she remembers Sam and Martha's property. She sees on the MLS that they have dropped the listing price by $4,000, but that's still higher than what they told her they would accept. Even though Sam and Martha are no longer her clients, Marcia **cannot** share with her new buyer client either the existence of the pending divorce nor the minimum acceptable price Sam or Martha would accept as a result of confidential information. Her duty of confidentiality to her former clients Sam and Martha supersedes her duty to her current buyer client.

What if Marcia looks in the public court records and sees that Sam and Martha have finalized their divorce even though they have not sold their house? Do you think she could share that fact with her new buyer client, since such information was available to the general public? Probably, but she **still cannot** discuss what Sam and Martha may or may not accept for the sale of their house.

Designated Agency

Technically, the default agency relationship is that of **designated agent**. When the sponsoring broker enters into an agency agreement, a specific broker (or multiple brokers) is assigned to act as the legal agent of the client **to the exclusion of any other affiliated licensee**. A positive consequence of the designated agent function is the ability to establish—within a single office environment—individual representation of both buyer and seller interests. Designated agency is an effective way to eliminate the issues inherent in dual agency in a brokerage office.

Still, it is critical that all licensees within the office recognize that any idle chatter between associates concerning the position of individual clients is a breach of the statutory obligation of confidentiality. Even if your co-workers do not have a client who is currently interested in one of your listed properties, that's not to say that they may not in the future. Any information you let slip, even innocently, about your client has the potential to create a confidentiality nightmare at some point in the future.

Disclosure of Non-Agency

We've discussed the licensee's obligations to a seller client. Now let's look at it in reverse: If you are **not** representing the interests of an individual, you must provide that individual written confirmation that they are pursuing a real estate investment *without* your insight, guidance, and recommendation. You will simply provide that customer with **clerical tasks** that are **administrative** in nature and which do **not** lend themselves to agency representation.

So when are you required to divulge to the party you are working with that you are not acting as an agent on their behalf?

When buyer prospects meet the seller's **designated agent** at an open house, for example, they must be made aware that if they make comments about the property or about their financial situation, that licensee is *obligated to share such information with his or her seller client*.

As the seller's designated agent in that circumstance, you need to:

- Stop prospective buyers (customers) *before* they pass along any confidential information.
- Disclose what their options are with regard to representation.

Under such circumstances, you are simply performing **clerical tasks** that do not elevate to an agency relationship. In most cases, you are simply responding to a specific question with specific facts regarding a specific property. To protect yourself and to avoid misinterpretation in the future, it is wise to obtain a **signed non-agency disclosure**, from prospective buyers. Remember: The goal of this disclosure requirement is to inform the customer of the nature of the agency relationship so that there are no questions about who represents whom.

The Administrative Rules of the Illinois Department of Financial and Professional Regulation are also very clear about the requirement to provide both customers and consumers specific knowledge of your agency status while representing the interests of another. It is too easy to use language which can be misinterpreted as building an unintentional agency relationship, in other words, an "implied agency."



Caution: Recall that while you have no fiduciary duties to a customer, you are obligated to disclose known material adverse facts about the transaction.

Real Success

Licensees should take great care with their behavior, especially the words they use and the way statements are made. A licensee who follows the law related to agency disclosure should ***never*** be in danger of creating **implied agency**. When no relationship exists or is intended, however, real estate licensees should be cautious of using the following statements, which may imply an agency relationship:

- "My seller…"
- "My buyer…"
- "I have a property…"
- "I have a buyer…"
- "I am working for you (or another unrelated party)."
- "I will work hard for you."
- "I will do my best to see that you (get the best deal, fulfill your goals, etc.)."
- "I am on your side."
- "As your agent…"

It is imperative that you recognize the necessity of disclosing your agency ***status before any confidential information is provided*** which may subsequently damage the individual's negotiating position. In fact, it is not only considered unethical, but it is a violation of Illinois Administrative Rules to fail to **reasonably safeguard** confidential information or **improperly use** confidential information.

Working with Other Brokers

Cooperating Brokers. The use of cooperating brokers in a real estate transaction can have a significant positive impact: Obviously, the more people working to find a buyer, the better chance of closing the deal. Although working with cooperating brokers is more common in residential sales—primarily because of the Multiple Listing Service—commercial transactions today are becoming more likely to involve cooperative relationships between competing brokers. How a brokerage proposes to utilize the resources of cooperating brokers—and how to compensate cooperating brokers—must be discussed with the seller as part of the listing process. Remember that Section 10-10 of the Illinois Real Estate License Act requires a licensee to disclose to a seller client the sponsoring broker's compensation and policy with regard to cooperating brokers who represent other parties in a transaction.

Office Teams. Traditionally, real estate licensees have relied on their own resources to generate and sustain business activities. In recent years it has become more prevalent to employ a "team environment" within the brokerage to generate activity. This can certainly result in greater productivity, but it could open up an agent to unintentional breaches of his or her fiduciary obligations to a client. It is imperative that when working within a team environment, each member of the team acknowledge the need to maintain confidentiality and other statutory agency obligations.


When you are interviewing sponsoring brokers, make sure you ask about office policies related to working on teams within the brokerage and with cooperative brokers from other brokerages.

Open for Discussion

Let's say that you and another broker in your office elect to work together as a team. Your sponsoring broker assigns you both as a designated agent of seller client Sebastian. You've worked together to market Sebastian's property, you've shared open house duty, and you've both worked with other brokerages to allow them to show the house to their buyers. Two months into a six-month listing agreement, you sign up a new buyer client, Chris, at an open house for another property. You think that Sebastian's house is a perfect match for what Chris wants. Do you think you can change your relationship with Sebastian at this point and let your teammate be his sole designated agent in order to avoid a dual agency situation? What are some things to take into consideration?

Dual Agency

Consider this situation: You've taken on the responsibility to market a specific piece of real estate with a list price of $365,000. Your marketing efforts and hard work have resulted in an offer for $360,000 being presented by a cooperating broker. You present the offer directly to the seller, explaining the various components that comprise the offer. Your seller accepts the buyer's offer with no changes. Later that afternoon, while completing your office paperwork, you calculate the commission you will earn upon closing. The office policy is to charge a seller 6% of the sale price, so the total commission owed by the seller would be $21,600 ($360,000 x .06). The brokerage offers 3% of the seller's commission to any cooperating broker who procures a buyer. If you're on a 50-50 split with your sponsoring broker, you will take home $5,400. What would happen if there was no cooperating broker and *you* were the one who procured a buyer for your listed property? Of course, without having to split the commission with a cooperating brokerage, you would have taken home $10,800 on that deal. While this may look attractive, it introduces additional issues that you need to be very cautious about. These issues are commonly called "**dual agency**."

Illinois law allows for a real estate licensee to act in the capacity of a dual agent, which means that a single agent represents both sides to a transaction simultaneously. This can be done, however, only with the **informed written consent of all the parties to the transaction**. When you have an opportunity to represent buyer and seller simultaneously, you must provide each party with specific information regarding their consent and subsequent consequences of granting that consent.

You can see examples of dual agency notices in the sample listing agreements in Chapter 15: Brokerage Agreements. You can also review what a dual agent can and cannot do and what can and what a dual agent can and cannot disclose.

When Negotiating Offers

It is important when accepting consent to dual agency that you clarify to the seller that as a dual agent **you will not be able to provide them with insights or counsel** as to how they respond to an offer by a prospective buyer. You're able to provide them with the **facts**, but not any interpretation.

Refusing Dual Agency

What happens if the seller refuses to accept your right to undertake a dual agency? How do you pursue the effective marketing of the property if you're limited in how you can approach a prospective buyer?

First, you must acknowledge that every interested party you have contact with must be advised in advance that you will be performing a simple administrative task while communicating the information concerning that specific property. To ensure they understand the role you will undertake, you need to have them sign a document that clearly establishes the customer's understanding that you are not **their agent**. This document needs to be executed before they inadvertently provide you with confidential information.

The real issue however, arises when they've shown little interest in the property you have listed and want to pursue alternative options listed by other brokers with your assistance. If this takes place, are you now their agent with an obligation to provide all the fiduciary obligations provided for within the law? The answer is yes.

And if you do undertake a fiduciary position with that purchaser, what role will you play if they decide to go back and pursue the property for which you are the listing agent? You must recognize that under Illinois law when you have accepted the obligation to represent the interest of another, that obligation takes forefront and cannot be retracted in order to provide administrative duties. If you cross the line and assume the role as an agent you must remain the agent. If the seller has denied you the right to undertake dual agency you must make a decision as to whom you intend to represent. You must place the representation interests of either the buyer or the seller into the hands of another licensee. In doing so, if you are entitled to a **referral fee**, you must provide the client you are referring written knowledge as to the receipt of the compensation. Further, you must define with the agent you are giving the referral the position each of you will undertake if this sale does not occur.

Listing Agreements

An agency relationship with a seller is created with a listing agreement. A **listing agreement** is a written agency contract between a seller and a real estate sponsoring broker stipulating the sponsoring broker will earn a fee for finding a ready, willing, and able buyer for a seller's property. Listing agreements can be exclusive or non-exclusive:

- An **exclusive right to sell listing agreement** provides for commission to the broker when a ready, willing, and able buyer is found, no matter who procures the buyer.
- An **exclusive agency agreement** provides for commission to the broker when a ready, willing, and able buyer is found, unless it is the seller who procures the buyer.
- **Open listing agreements** are non-exclusive, which means that commission is earned only by the broker who is the **procuring cause** of the sale.

Review of Required Elements

In Illinois, exclusive contracts **must be in writing** and must list the **minimum services** related to offers, counteroffers, notices, and contingencies that an agent is legally required to provide. Additionally, all written listing agreements in Illinois, whether exclusive or non-exclusive, must contain certain elements. ***How many of them can you list?***

Other Provisions

Other provisions that may be negotiated between a seller and broker for inclusion in a listing agreement may include, but are not limited to, the following:

- Cooperation with other brokers
- Broker protection clause (for commission)
- Permission to advertise
- Personal property to be included or excluded from the sale

Finding Clients

As you begin a real estate career, getting listings may be one of your biggest challenges. Many people are reluctant to work with new agents without much experience, but you can't get experience if people are reluctant to work with you. Let's look at some tips that can help you find seller clients.

First, remember that when you're selling **yourself**, you are also selling the services offered by your sponsoring broker. Take advantage of your sponsoring broker's reputation, history, and experience. Mention that you work closely with your managing broker, who has vast experience closing real estate deals. Your managing broker can help you answer the "experience" questions you'll get from prospective clients.

Never lie or exaggerate about your experience. Clients won't trust you (or recommend you) when they learn the truth—***and they will,*** because it only takes a few clicks on the State's website to find out when your license was issued.

Sphere of Influence: Personal Network

One way to get new clients is through **people you know**. This is often referred to as your **sphere of influence**. The experience factor may not play such an important role because they know you or the person who has recommended you. Of course, **family** and **friends** come to mind, but think beyond this circle. Everyone knows influential individuals like lawyers, bankers, accountants, doctors, people from a religious or civic organization, and other business or professional people. Each of these people interacts with lots of people every day, and a referral from them could get you started.

If the seller is especially happy with your professional and courteous service, he or she may recommend you to others. You could also ask clients for names of people they know who might be in the market to buy or sell real estate; neighbors who see your sign are another source of prospects, as are any people who come through an open house.

Then, of course, there's phone calling, advertising, and word of mouth.

Technology

Like everything else, the real estate industry has been forever changed by technology, specifically, the computer. Potential clients can browse the Internet and see list after list of homes for sale, and they can sort that list by various criteria that are important to them. They have a wealth of easy-to-access data at their fingertips that previously was available only to real estate professionals. And you need to keep up.

Farming: Selective Marketing

When starting in this business you are an unknown commodity. You need to develop a personal reputation that causes future business to find you rather than you having to find that business. Consider the success of a farmer. A successful farmer takes a parcel of land and cultivates the land to produce a productive crop each year. A successful real estate practitioner, whether residential or commercial, must undertake the same philosophy. Your success is dependent upon your ability to create a reputation for yourself within a given market environment. Whether selecting a geographical location or specific category of property cultivating the contacts within that selection will enhance your ability to succeed while creating a consistent business platform that will produce positive returns for you in the future.

Like the farmer, you plant seeds, and wait for them to grow. **Do not expect overnight results.** It will take time and effort on your part. Like food farming, prospect farming in an area is a patient endeavor needing constant attention. You want to keep your name in people's minds, so they think of you when they're ready to buy or sell a parcel of real estate. Farming encompasses a number of techniques from **cold calling** the property owners to passing out **brochures** in an area. You must find what works best in your area. Ask your managing broker for suggestions. You can't work a whole city, so pick an area where you feel comfortable and keep working it for results.

Summary

1. **Article 15** of the Illinois Real Estate License Act requires that **written disclosure of an agency relationship** by the agent be provided at the **first substantive contact** before any confidential information is shared. The agency disclosure may be made as part of a brokerage agreement or may be made in a separate document. Agency disclosure provides affirmation that the agency relationship was disclosed to the consumer and that informed consent of the party for a specific relationship has been given.
2. Illinois licensees owe the following **statutory duties** to clients: Promote the client's best interests, which includes seeking acceptable terms, timely presentation of offers, disclosure of material facts, accounting, obedience, loyalty, reasonable skill, confidentiality (which survives the termination of agency), and following the law.
3. When a licensee is **not performing the minimum services** required under an exclusive brokerage agreement, and is, therefore, not acting as the customer's agent, that licensee must disclose this fact **in writing** to the customer. This situation may be referred to as **non-agency**. Signing a non-agency disclosure does not create an agency relationship. Records of agency disclosure must be maintained by the brokerage firm either electronically or in hard copy format for **five years**.
4. **Dual agency** is a situation where the buyer and the seller in the same real estate transaction are both clients of the same designated agent. Both parties in the transaction must consent to the dual agency, in writing, and acknowledge that they understand that certain duties in the relationship cannot be delivered. When a brokerage allows dual agency, that fact must be disclosed to the client at the time the brokerage agreement is entered into even if a dual agency situation does not yet exist. Written confirmation of **prior consent** for dual agency must be obtained before entering into any offer or contract.
5. A listing agreement is considered an **employment contract** and creates an agency relationship. These contracts can be exclusive or non-exclusive. Exclusive contracts **must be in writing** and must list the minimum services related to offers, counteroffers, notices, and contingencies. All listing agreements in Illinois must contain: List **price**, amount and timing of **commission**, **duration** with definite **end date**, **name** of sponsoring broker, seller, and designated agent, **property** identification, **signatures**, **duties** of the listing broker.
6. Finding seller clients is one of the challenges of a new broker. Some outlets include tapping your own personal network, taking advantage of the Internet, farming an area, and other marketing techniques. Also, ask potential sponsoring brokers about their office policies related to sharing leads that come into the brokerage.

Quiz

1. ***If you procure a buyer client for one of your own listings for which you are the designated agent, you are a***
   a. buyer's agent.
   b. designated agent.
   c. dual agent.
   d. open agent.

2. ***Brandy, a licensed real estate agent, took a seller's listing but later decided she wants to buy the property herself. Brandy can purchase the property for herself***
   a. if she gets someone else to represent the seller.
   b. if she has disclosed to the seller that she is the buyer.
   c. only after the listing agreement expires.
   d. never; a licensee cannot purchase one of her own listings.

3. ***A real estate broker who works for the seller must provide agency disclosure to a prospective buyer***
   a. after first receiving confidential information.
   b. after the first property showing.
   c. no later than beginning to work as a designated agent.
   d. at the time the buyer wishes to make an offer on the property.

4. ***What is the most common way to create an agency relationship between a property seller and a broker?***
   a. buyer brokerage agreement
   b. by implication
   c. listing agreement
   d. oral contract

5. ***Licensee Terry works very hard to convince Spencer to list his house with her. She knows that to show well, the walls need to be painted and the carpet needs to be replaced. Terry recommends Ultimate Remodeling to do the work. Can Terry accept a fee from Ultimate if Spencer hires them?***
   a. Yes, as long as Spencer knew about it beforehand, Terry can accept the fee.
   b. Yes, if before Spencer hires Ultimate Remodeling, Terry discloses the referral fee in writing to Spencer, she can accept the fee.
   c. No, Terry can only accept payment from her sponsoring broker.
   d. No, a licensee can never accept a fee or rebate for expenditures by her principal.

6. ***How long must an agent keep confidential information obtained from the client?***
   a. Agents have no duty to keep information confidential.
   b. Agents must maintain confidentiality for three years after the transaction closes.
   c. Agents must maintain confidentiality only until the relationship ends.
   d. This duty never ends, even when the relationship does.

7. ***Marge of Midwest Realty discloses the fair housing laws to her client; however, the client refuses to show the property to a Native American couple. Which statement is TRUE?***
   a. Marge has fulfilled her duty by disclosing the laws to her client; no other action is necessary.
   b. Marge should contact the Native American couple and inform them of her client's violation of the fair housing laws.
   c. Marge should ignore her client's wishes and show the house to any potential buyer without regard to race, religion, etc.
   d. Marge should inform her sponsoring broker so that he may determine the method in which to proceed or terminate the listing.

8. ***What is NOT negotiable in a listing agreement?***
   a. the broker's cooperation with other brokers
   b. a clause for automatic renewal
   c. the commission
   d. the scope of activities permitted

9. ***Which statement indicates that the listing agreement is an exclusive right to sell?***
   a. a notice to terminate the agreement at the end of the listing period
   b. a notice regarding the existence of the Real Estate Recovery Fund
   c. a statement that the broker is paid regardless of who sells the property
   d. the commission expected on the sale price

10. ***Which statement about listing agreements in Illinois is TRUE?***

    a. All listing agreements must indicate the duration of the agreement.
    b. All listing agreements must list the minimum services provided by the sponsoring broker.
    c. Only exclusive listing agreements must state that discrimination against protected classes is illegal.
    d. Non-exclusive listing agreements may contain an automatic extension clause.

11. ***You are currently associated with Ace Realty. They recently changed the commission structure and so you're looking for a new sponsoring broker. You decide to go to work for Tip Top Real Estate. On your last day at Ace, you have three active listings. What happens to them?***

    a. Ace can agree to sell the listings to Tip Top.
    b. Ace has the option to let you take the listings with you if you agree to give them their commission split.
    c. The listings remain at Ace.
    d. You can take them with you to Tip Top.

12. ***Which of these is a fiduciary duty that a designated agent does NOT owe to a seller client?***

    a. disclose the financial condition of buyer client interested in the seller's property
    b. disclose the relationship between the buyer and broker
    c. present all offers to purchase in a timely manner
    d. provide a good faith estimate of the current value of the seller's property



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The Listing Appointment

You might want to think of a listing appointment as a job interview. After all, the goal of that appointment is to come away with a signed listing agreement, which is the contract that creates a business relationship between the broker and the seller. Your challenge is to understand the seller's needs, show the seller how you can meet those needs, and negotiate an appropriate listing agreement that will turn that seller customer into your seller client. In this chapter, we'll look at considerations for a successful listing appointment, including a quick review of the anticipated result of a successful transaction: Commission for you and money for your seller.

You will learn:

- How to handle a listing appointment.
- Factors to consider when establishing a probable selling price.
- How to present a comparative market analysis.
- What documentation to collect from a seller.
- Strategies for addressing personal property in real property transactions.
- Income tax considerations on the sale of real property.
- How to calculate seller's share.
- Compensation-related issues.

Key Terms

Adjusted Basis
Antitrust
Attachment
Bill of Sale
Chattel
Comparative Market Analysis (CMA)
Contribution
Equity
Fixture
Homestead
Listing Presentation
Personal Property
Procuring Cause
Real Property
Seller's Share
Title

Listing Cycle

Real estate brokers do a lot of selling. You'll need to sell real estate as well as yourself, your brokerage, and your services. In fact, convincing a seller to hire you requires as much sales ability as convincing a buyer to purchase. A **listing presentation** is any communication—written or oral, and through any means or media—between a licensee and a consumer for the purpose of attempting to secure a brokerage agreement to market property for sale or lease. Let's begin with a quick overview of the typical listing cycle from the perspective of a seller's agent:

1. The broker meets with a seller and presents the marketing strategy developed to enhance the salability of the seller's property. This will also include a presentation of the marketing assets of the broker's office.
2. Acquiring a signature to a listing agreement that authorizes the broker to represent the seller in the distribution or dissemination of the features of the property at the price and terms defined by the seller.
3. Implementation of marketing activities consistent with the marketing strategy presented to the seller during the listing presentation.
4. Receipt and presentation of all offers tendered on the seller's property. This will include the broker analyzing the essential components of the offer to assist the seller and making a rational decision as to the viability and acceptability of that offer.
5. Coordinating and communicating to the seller, cooperating broker, lender, attorneys, and any other parties to the transaction to ensure a smooth transition to the closing table.
6. Participating at the closing showing support for the seller. This is also where the broker will collect any additional monies that may be due to satisfy the commission earned.

Qualifying the Seller

When you first meet with a potential client, your first task is probably to inspect the property, noting the positive selling points as well as obvious problem areas. Get a feel for the community and how this specific property fits. Is it the best site on the block? The worst? Average? On that first appointment, you should be gathering data that will help you form an initial opinion of a marketing strategy and a reasonable range for an asking price. Of course, before you discuss the seller's financial needs related to the property to be sold, you should have already disclosed agency relationships.

Don't be afraid to ask questions. Many times, sellers *think* they know what they're getting into, but may have misconceptions about the process. A straightforward discussion is best. Never assume your clients know something. Clarify and explain as you work with them, but **never talk down to anyone** or make a client feel foolish for not knowing something. No one knows everything!

Seller's Expectations

Right from the first meeting with the seller, you need to begin uncovering and assessing the seller's expectations about selling the property. Get them to talk about their needs, and write down everything they say. If it's important to them, it should be important to you. Ask the seller questions such as:

- Why are you selling?
- How long have you occupied the property?
- Have you sold real estate before?
- What were some positive experiences and negative experiences you have had with other agents?

Their answers will help you make the appropriate presentation to the seller when you ask them to hire you. Don't forget that you're selling yourself in this initial interview, too.

Managing Expectations

Each client will bring different expectations to the table. Expectations can be based on the client's own experiences, can be formed by observations of someone else's experience, or can come from stories related by friends and family. Keeping in mind that **each client's set of expectations is unique** will help you avoid assuming that anything is "common knowledge" among all clients.

Remember that part of the job is to **educate** your client. As the professional, you'll need to spend whatever time is necessary to ensure that a client understands the entire process. It's a good idea to allow the client to repeat your words back to you after you explain each part of the process. This will also ensure that you have said what you intended to say. Giving the client a written explanation of what you will do for them will help the client know what to expect.

Real Success

It's no surprise that you will face time constraints. While it's good to be busy, a client should ***never*** feel as though he or she is being rushed. Whether it's true or not, a client will likely conclude that you, as their agent, feel as though you have more important things to do. When time gets to be an issue, agents, like anyone else, can look for short cuts. They start to gloss over problem areas or fail to provide adequate information to the other person, who will likely sense this and not give the feedback needed.

More trouble can arise when problems that should have been taken care of promptly are allowed to fester and grow. The old saying about "nipping it in the bud" rings loud and clear here. Not taking the time to address little problems and to make sure everyone is clear about the issues at hand will just make these issues bigger the next time they are discussed. If you do not have the time to address an important issue now, you will be forced to find the time later when the problem is two or three times larger.

Gathering Data

Many times licensees enter into a listing relationship with little to no knowledge of the property, the seller and the community in which the property is located. It is important that you gather as much information as possible concerning the property and the seller in order to represent both effectively.

As you walk through the property and talk with the sellers, there are obvious points of information you can acquire, such as room dimensions, property taxes, and seller's motivation for selling. However, this only touches the surface of information that you should acquire in order to effectively represent the seller and the property in the marketplace. While there may be different lists available for commercial and residential, there are commonalities between the lists. Using Multiple Listing Service worksheets as a guide for maintaining a consistent approach with every seller to ensure that you have the necessary information to represent them effectively. Some of the information that is frequently overlooked when taking a listing includes (but is not limited to):

- Special assessments and special services assessments
- Status of current tax bill or pending tax increases
- Pending school redistricting
- Zoning, deed, or use restrictions
- Easements, including the location of any utility easements
- Business license restrictions (primarily for income-producing property)
- Environmental concerns (primarily for income-producing property)
- Electrical amperage (primarily for income-producing property)
- Rent roll (for income-producing property)
- Lease copies (for income-producing property)

Proof of Title

Consider this scenario: You have worked diligently for a number of weeks convincing a specific seller that you and your firm are the best choices to represent their interests in effectively marketing their property. Three months after acquiring the listing, you secure a ready, willing, and able buyer who has tendered an offer acceptable to the seller. Sixty days later you are sitting at the closing table expecting this transaction to come to a successful conclusion—resulting in payment of your commission—only to learn that the person who signed your listing agreement never had the legal right to market the property in the first place! Are you still entitled to commission? Unfortunately, the answer is no.

Although rarely done in residential real estate, it is important to know who the owners of record are on a particular parcel of land. Illinois law provides that in order for you to claim the right to a commission you must have acquired the **written authorization of all the property owners** on your listing agreement. The absence of this authorization may cause you the loss of commission should challenges arise at a later date. In the commercial realm, unlike residential, it is commonplace to check the ownership records to ensure the person you represent has the legal authority to engage your services. Most Multiple Listing Services provide access to the public records database whereby you can confirm the name of the owner of record. If not, most county recorder's offices now post basic owner information on the Internet. To protect your rights to compensation, it is in your best interest to confirm the party with whom you are dealing has the authorization to engage you.

Homestead Rights

Be alert for a seller who engages you to list a primary dwelling indicating that he or she is the sole owner of the property, but is also married. Illinois law requires that **both spouses—or partners in a legal civil union—must sign** the listing agreement to release any **homestead rights**. "Homestead" property can generally be defined as a farm, personal residence, condominium, or cooperative that the property owners use as their primary residence.

Corporate Authorization

In addition, if you are engaged by a **corporation** to represent their interests in the disposition of real estate, you need a copy of the **board resolution granting your contact the authorization to execute** a listing and/or sales contracts on behalf of the corporate entity.

Comparative Market Analysis

One of the first things a seller wants to know is how much the agent thinks the property should list for. The list price is an important decision for everyone: If it is set too low, both the seller and the broker lose money; if the price is set too high, it may not sell. When putting a property up for sale, it is ultimately the **seller's responsibility** to determine the listing, or asking, price. They often turn to their broker to help them set a price, of course. The agent offers knowledge, experience, and information that the average person usually doesn't have. Since the seller often relies on the agent's advice to determine the price, you must avoid over representing or under representing the value of the property. The more knowledge a broker has of particular areas and markets, however, the more likely the property will be listed for an appropriate price and sell quickly.

To be fair to a seller, you might not want to discuss specifics on an initial interview. The purpose of a first visit is to allow you to evaluate the property, to begin to establish a rapport with the sellers, and to start to get an idea of their needs and expectations. You need to gather facts so that you can go back to your office, do your research, and provide the sellers with relevant data so that *they* can decide how much *they* want to ask for their property.

A **comparative market analysis (CMA)** is a service that real estate brokers provide for clients, prospective clients, and customers. A CMA, sometimes called a competitive market analysis or a residential market analysis, is a *method of determining the approximate market value of a home by comparing the subject property to other homes in the same neighborhood or vicinity that have sold, are presently for sale, or did not sell.* Brokers perform CMAs for sellers to help them decide on an appropriate list price of the home, and for buyers to determine a fair price to offer for a home.

You may see many similarities between a comparative market analysis and the sales comparison appraisal approach. While a CMA is an opinion of value that is backed up by analysis of the marketplace, it is **not an appraisal** and may never be referred to as such.

Selecting Comps

Comparables, also known as "comps," should be as similar as possible to your subject property. Most brokers will use the Multiple Listing Service system to retrieve the comps they need, but unlike the sales comparison appraisal approach, which looks only a comparable properties that have recently sold, a CMA allows a wider range of comps to be used:

- Recently sold properties
- Currently listed competing properties
- Recently expired listings

For new brokers, it will take time and experience to be able to pick the right properties to use and to be able to explain to the homeowner the reasons for their use.

Recently Sold Properties

When researching recently sold properties, choose several located in the same area as your subject property that are similar in style. The comparable properties should be analyzed as to number of days on the market, location to subject property, condition, lot size, listed price, any reduction in price, and final sale price. This is where your experience will come into play. As a new licensee, you probably will not have any knowledge of these homes. The job is to research the comparables with any means possible—talking to your managing broker or other brokers—you must have an understanding of these properties before you can discuss them with your potential sellers.

You might be asking: "Why can't I just look at properties that have sold?" The assumption is that if a property sold, then it must have been priced correctly. While this logic appears sound, it's not complete for these reasons:

- It's possible there was a unique buyer who desired or needed a particular property or who was under duress to purchase something quickly, so an individual sale cannot be used to justify the price of the subject property.
- It is impossible to know all of the factors that went into an individual buying decision.
- The competition that existed in the marketplace at that time cannot be determined only by looking at properties that sold.
- The whole market must be considered to arrive at the best price for the subject property.

Currently Listed Competing Properties

Another important factor in the residential market analysis concerns the properties in **competition** with your listing. When analyzing competing listings, again, pay close attention to the following factors:

- Number of competing properties on the market
- Length of time the properties have been listed
- Whether the list price has been reduced
- How many times the list price has been reduced

The important point here is that these homes are the competition to your seller's property. This must be explained in a professional way. Sellers must understand that everyone feels their property is unique and always better than the competition. The market is the way properties are sold, very rarely through emotion, even though it is an important part of the buying process.

You can also use, if needed, properties that are under contract. This will not give you a sold price but an idea of how the property was listed and what transpired with price—if there were any price changes—days on the market, the listed price when it went to contract, which could or not be the selling price.

How much weight should be given to properties currently for sale? With a CMA, active listings are given significant emphasis from the standpoint of competition. Sold properties provide an indication of what property in the area *might* sell for, but the subject property's competition will be other properties currently for sale. The subject property has to be viewed from the perspective of a typical buyer.

Prospective buyers usually look at many properties before arriving at a decision. A competitive and favorably priced property will attract more buyers. If the property is at or exceeding the high end of the range indicated by the CMA without justification, the market will dismiss the property as being overpriced—buyers will move on to the competition, which may be more reasonably priced.

Recently Expired Listings

As you know, a listing expires when a property does not sell within the time frame stated in the listing agreement. When listings expire because the price was more than market conditions justified, researching these properties can give you valuable insight on what is an acceptable list price. Properties that didn't sell can often provide more useful information to a real estate professional and prospective buyers or sellers than properties currently for sale. This is because the market's reaction to the property has already been determined.

If a property didn't sell at a certain price after being tested on the market, that is most often a strong indication the property was overpriced, didn't have the features desired by the marketplace, or there was an oversupply of properties in the market. Regardless, the property has been tested on the market and potential buyers were not interested in the property at that price. Real estate experts agree that price can overcome any condition of a property. Thus, the indication here is the property should have been priced lower, and the subject (assuming the subject is comparable to the property that did not sell) should be priced lower as well, in order to attract buyers and market activity.

Again, as the new broker, you have work to do in discovering the possible reasons for the high prices. There are times when owners are just not motivated to sell at the price they were told is fair market value. This is what you must ascertain: If the property was just overpriced or if there were other reasons it did not sell. A seller may still insist on pricing his property higher—and perhaps this can be justified if the subject property has features or characteristics superior to the properties that did not sell—but the market has spoken. Marketing time is also a factor in pricing. The more a property is listed above what the market indicates it should be listed for, the longer it will take to sell the property.

CMA Comps Summary	
Homes	**Why Consider**
Active. Homes currently listed for sale in the market, both from the Multiple Listing Service (MLS) and any homes For Sale By Owner (FSBO)	• Active listings are the competition • Provides insight into the buyer's perspective
Sold. Homes recently sold (typically within the past six months or so) in the market and area where the subject is located	• Generally indicates proper pricing, but cannot assume as there may have been other factors in the buyer's decision
Not Sold. Listing agreements that have recently expired because the home was not sold during the listing period or homes that were taken off the market	• Market's reaction to the home has already been determined • May indicate that the price was too high, the supply too great, or the property lacked desired features

Whole Market Approach

A comparative market analysis is an *in-depth study of your listing as it stands on its own, as well as in light of current market conditions*. This is where your expertise comes in. A well-executed CMA takes a **whole market approach**. The more knowledge you have of particular areas and the whole market, the more likely you are to sell the property quickly and for the best price. These conditions will determine how the property should be marketed and help you understand the data on comparable properties. Remember: A "property priced correctly is half sold."

Market Conditions

An agent must consider the impact of **current market conditions**, for example, the general supply and demand of homes, local economic issues, availability of credit, etc. The stability and health of the real estate market as a whole directly impacts your business and what your clients can expect – whether they are buying or selling a home. If market conditions are favorable, homes are likely to sell faster than in a slow market. Of course, this determines your marketing strategy and is why researching the area's market conditions is an important component to a CMA. If there are more competing properties it may take longer to sell.

Sometimes it may even be beneficial to look at seasonal conditions, like weather, holidays, or time of year for school. If the market is favorable, these conditions very rarely will have an impact on the sale.

Market Position

It's also important to analyze a subject property's **market position**, which is not possible to do by looking only at homes that have sold, as is the case with an appraisal. Market position is relatively simple: Compared to your listing, how many similar properties are for sale in the same neighborhood and for a similar price? Now, where does your listing fit in among these properties? Once you have determined your listing's market position, you can effectively market it.

Days on the Market

Agents must understand that any property they include in the CMA must be explained fully to the sellers. They may ask why one property sold for one price and another did not sell. This again is where your experience and expertise comes in. Another important factor in the CMA is **"DOM"** or Days on the Market. This is important because it shows how long it took the different properties to sell, or if there was a price change. It also shows how long expired listings were on the market until expiration. This is one key factor you will address with the owners.

By looking at the DOM for each of the homes that entered the market, an agent can get a rough idea of how long the subject property might take to sell. For example, if only six listings sold in the last 125-180 days (about one house sold per month), it would take about 18 months for the market to absorb the 18 listings that are currently on the market. If the seller wants a property sold sooner, then a more aggressive pricing strategy (i.e., lower price) should be considered to make the home more attractive in the marketplace.

Recommended Terms of Sale

Note that the terms of a sales agreement may directly affect how long a home is on the market. For instance, the seller gets an offer on her home after it has been on the market for only 11 days. Her new home, however, will not be ready to move into for four months. She did not anticipate selling so quickly. Do the buyers still agree to the sale? What if they are not in the position to live in their current residence four more months? Here, the terms of the sale directly affect the buyer and the seller. Other terms that are often a concern include:

- Interest rates
- Types of financing available (i.e., seller financing)
- Seller concessions (i.e., paying closing costs)

Case in Point

A real estate broker was making a recommendation to a seller regarding a property's listing price. The broker looked at four current listings and five listings sold in the prior six months. The price recommendation was made based on this analysis. The price was at the high end of the range, but deemed acceptable because it fell within the range.

After several weeks, and no showings, the seller was upset. It turns out the price was too high after all. The real estate broker had not considered the whole market. Examining the whole market revealed:

- 18 active listings
- 6 listings sold in past six months—average days on market: 125
- 12 listings expired in past six months—average days on market: 180
- 2 withdrawn or canceled listings in past six months

Upon examination of the whole market, the real estate broker realized the listing price was too high. But it was too late. The seller did not relist the property with the real estate broker (when the listing agreement expired) and listed with another real estate brokerage.

Other Data Considered in a CMA

Like an appraisal using the sales comparison approach, a CMA compares the *assets* and *drawbacks* of the subject property to those of several comparable properties. A CMA, however, is primarily concerned with the *observable differences* between houses that would draw a buyer to one house over another, for example:

- **Size.** Lot size, square footage, room counts, number of stories, etc.
- **Location.** On a cul-de-sac, near water, on a golf course, etc.
- **Buyer appeal.** Architectural style, construction and building materials, landscaping, etc. While subjective, this factor, sometimes called curb appeal, is critical.
- **Condition.** Age and relative condition of the property.
- **Neighborhood.** Amenities such as public transportation, parks, access to shopping, infrastructure, schools, etc.

This information can come from many different sources, for example, the Multiple Listing Service, personal inspection, in-company listing data sheets, tax assessment rolls, etc.

Assets and Drawbacks

Your comparative market analysis should include a comparison of the assets and drawbacks of your listing relative to competing properties. Your research should reveal how these things affected the sale and/or sale price of the comparable properties. A property in a cul-de-sac or quiet residential street will have more appeal than one on a main road or busy street. Property condition will stand out from inferior ones. Also look at properties with nice landscaping that have been well maintained. This will help you in evaluating your subject property to the comparables. How does the subject property compare to these homes?

Curb Appeal

Even though this portion of the comparative market analysis is subjective, it is still an important part of your research. Since many buyers make a decision on whether they will consider at a home simply by how it looks from the street, curb appeal is very important. Items like landscaping, color, building materials, and the distance from the house to the road are all part of curb appeal. Compare your subject property to others in the neighborhood and then work with clients to maximize curb appeal. You may have a property that doesn't have the same appeal as your subject property, but it may offer other amenities that may be better. No matter what the feeling on curb appeal, the first impression is a lasting one.

Comparative Market Analysis

Prepared for:

Mr. and Mrs. John and Mary Smith
100 Main Street
Anytown, NY 10000

SAMPLE

Prepared by:
D. JONES, LICENSED BROKER
ABC REAL ESTATE

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October 20, 2008

Mr. and Mrs. John and Mary Smith
100 Main Street
Anytown, NY 10000

Dear Mr. and Mrs. Smith,

Thank you for the opportunity to present this Comparative Market Analysis for 100 Main St. This carefully prepared report of current and part market activity compares this home with other similar homes in the area. The analysis enables you to easily compare the features of this home with others and to determine the best pricing strategy for today's market.

We look forward to working with you in the future. Our firm is committed to providing you with professional and dedicated service. Please do not hesitate to contact me should you require any further information.

Sincerely,

D. Jones
Licensed Broker
ABC Real Estate

SAMPLE

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Subject Property Information

Location:	100 Main Street Anytown, NY 10000 School District #: 12	
Suggested Price: And Taxes:	From: Taxes:	To:
Property Characteristics:	Cape Det 1Family 7 Rooms, 4 Bedrooms, 2 Baths, 1 Kitchen Eat In Kitchen: Y Basement: Full Finished Bsmt: Y Garage: 1 Driveway: Pvt Fuel: Oil Heat: Hw Approx. Year Built: 1960 Appearance: Excel	
Comments:	Beautiful Cape on tree-lined street. All updated.	

SAMPLE

D. Jones
Licensed Broker
ABC Real Estate

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Side By Side Listing Comparison

	Subject Property	On The Market	On The Market	On The Market	Recently Sold
					
ML#		2107849	2117676	2120353	2064912
Address	100 Main St	251 Meadowbrook Rd	210 Fox Ct	2076 Bruce Ln	1113 South Dr
Town	Anytown	N. Merrick	N. Merrick	N. Merrick	N. Merrick
School Dist #	12	29	29	29	29
Price		$424,900	$449,990	$449,990	$345,000
Style	Cape	Cape	Cape	Cape	Cape
# Families	1	1	1	1	1
Det/Att	Det	Det	Det	Det	Det
Rooms	7	7	7	7	6
Bedrooms	4	3	4	4	3
Baths	2	1	2	2	2
# Kitchens	1	1	1	1	1
Eat In Kitchen	Y	N	N	N	Y
Basement	Full	Full	Full	Full	Full
Fin Bsmt	Y	N	N	Y	N
# Fireplaces	0	1	0	0	0
Fuel	Oil	Oil	Oil	Gas	Oil
Heat	Hw	Hw	Steam	Hw	Ha
Garage	1	2	0	1	1
Driveway	Pvt	Pvt	N	Pvt	Pvt
Pool	N	N	N	N	N
Taxes		$9,596	$8,960	$8,849	$8,417
Approx. Year Built	1960	1933	1949	1950	1949
Appearance	Excel	Excellent	Excellent	Good	As-Is
Lot Size	60x100	65 X 179	36 X 138 Irr	38 X 100 Irr	60 X 100
Waterfront	N	N	N	N	N
Waterview	N	N	N	N	N
Waterfront Desc					
Adult Community		N	N	N	N
Minimum Age					
Listing Date		8/14/2008	9/18/2008	9/26/2008	4/4/2008
Contract Date					6/25/2008
Title Date					8/27/2008
Exp Date		2/14/2009	12/31/2008	3/26/2009	9/14/2008
Days On Market		73	38	30	82
Original Price		$424,900	$449,990	$449,990	$404,900
Listing Price		$424,900	$449,990	$449,990	$359,910
Sold Price					$345,000
Adjustments					
Price		$424,900	$449,990	$449,990	$345,000
Adjustment					
Adjusted Price		$424,900	$449,990	$449,990	$345,000

SAMPLE

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Side By Side Listing Comparison

	Subject Property	Recently Sold	Recently Sold	Expired From Market	Expired From Market
					
ML#		2086260	2109315	2054754	2073188
Address	100 Main St	1671 Stevens Ave	2076 Bruce Ln	1242 Jerusalem Ave	1671 Stevens Ave
Town	Anytown	N. Merrick	N. Merrick	N. Merrick	N. Merrick
School Dist #	12	29	29	29	29
Price		$349,000	$350,000	$429,000	$434,500
Style	Cape	Cape	Cape	Cape	Cape
# Families	1	1	1	1	1
Det/Att	Det	Det	Det	Det	Det
Rooms	7	7	7	6	7
Bedrooms	4	3	4	4	4
Baths	2	2	2	2	2
# Kitchens	1	1	1	1	1
Eat In Kitchen	Y	N	N	Y	N
Basement	Full	Full	Full	Full	Full
Fin Bsmt	Y	Y	Y	Y	Y
# Fireplaces	0	0	0	0	0
Fuel	Oil	Gas	Oil	Oil	Elec
Heat	Hw	Elec	Hw	Ha	Hw
Garage	1	1.5	1	0	1.5
Driveway	Pvt	Pvt	Pvt	Pvt	Pvt
Pool	N	N	N	N	N
Taxes		$8,460	$7,729	$8,867	$8,462
Approx. Year Built	1960	1955	1950	1949	1955
Appearance	Excel	Good	Good	Excellent	Good ++
Lot Size	60x100	50 X 125	38 X 100	58 X 94	50 X 125
Waterfront	N	N	N	N	N
Waterview	N	N	N	N	N
Waterfront Desc					
Adult Community		N	N	N	N
Minimum Age					
Listing Date		6/6/2008	8/20/2008	3/6/2008	4/29/2008
Contract Date		8/8/2008	9/15/2008		
Title Date		10/17/2008	9/24/2008		
Exp Date		12/6/2008	11/18/2008	6/6/2008	5/31/2008
Days On Market		63	26	92	32
Original Price		$399,000	$349,900	$429,000	$234,500
Listing Price		$369,000	$349,900	$429,000	$434,500
Sold Price		$349,000	$350,000		
Adjustments					
Price		$349,000	$350,000	$429,000	$434,500
Adjustment					
Adjusted Price		$349,000	$350,000	$429,000	$434,500

SAMPLE

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Side By Side Listing Comparison

	Subject Property	Expired From Market
		
ML#		2055502
Address	100 Main St	28 Wellington Rd
Town	Anytown	N. Merrick
School Dist #	12	29
Price		$469,000
Style	Cape	Cape
# Families	1	1
Det/Att	Det	Det
Rooms	7	7
Bedrooms	4	4
Baths	2	2
# Kitchens	1	1
Eat In Kitchen	Y	Y
Basement	Full	Full
Fin Bsmt	Y	Y
# Fireplaces	0	0
Fuel	Oil	Gas
Heat	Hw	Hw
Garage	1	1
Driveway	Pvt	Pvt
Pool	N	N
Taxes		$9,417
Approx. Year Built	1960	1947
Appearance	Excel	Mint
Lot Size	60x100	54 X 120
Waterfront	N	N
Waterview	N	N
Waterfront Desc		
Adult Community		N
Minimum Age		
Listing Date		3/8/2008
Contract Date		
Title Date		
Exp Date		6/30/2008
Days On Market		114
Original Price		$499,000
Listing Price		$469,000
Sold Price		
Adjustments		
Price		$469,000
Adjustment		
Adjusted Price		$469,000

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SAMPLE

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Comparable Summary Report

For:

100 Main St

Anytown, NY 10000

10/26/2008

SAMPLE

Subject Property

ML#	Address	Town	Style	Rooms	Bedrooms	Baths	Suggested Price
-	100 Main St	Anytown	Cape	7	4	2	

Homes Recently Sold

ML#	Address	Town	Style	Rms	Br	Bth	List Price	Sold Price	% Dif	List Date	Cont Date	Title Date	DOM
2064912	1113 South Dr	N. Merrick	Cape	6	3	2	$359,910	$345,000	4.14	4/4/2008	6/25/2008	8/27/2008	82
2086260	1671 Stevens Ave	N. Merrick	Cape	7	3	2	$369,000	$349,000	5.42	6/6/2008	8/8/2008	10/17/2008	63
2109315	2076 Bruce Ln	N. Merrick	Cape	7	4	2	$349,900	$350,000	-0.03	8/20/2008	9/15/2008	9/24/2008	26
	# Properties: 3			Averages:			$359,603	$348,000	3.18				57

Homes Currently On The Market

ML#	Address	Town	Style	Rms	Br	Bth	Orig Price	List Price	% Dif	List Date	DOM
2107849	251 Meadowbrook Rd	N. Merrick	Cape	7	3	1	$424,900	$424,900	0.00	8/14/2008	73
2117676	210 Fox Ct	N. Merrick	Cape	7	4	2	$449,990	$449,990	0.00	9/18/2008	38
2120353	2076 Bruce Ln	N. Merrick	Cape	7	4	2	$449,990	$449,990	0.00	9/26/2008	30
	# Properties: 3			Averages:			$441,627	$441,627	0.00		47

Homes Expired From The Market

ML#	Address	Town	Style	Rms	Br	Bth	Orig Price	List Price	% Dif	List Date	Exp Date	DOM
2054754	1242 Jerusalem Ave	N. Merrick	Cape	6	4	2	$429,000	$429,000	0.00	3/6/2008	6/6/2008	92
2073188	1671 Stevens Ave	N. Merrick	Cape	7	4	2	$234,500	$434,500	-85.3	4/29/2008	5/31/2008	32
2055502	28 Wellington Rd	N. Merrick	Cape	7	4	2	$499,000	$469,000	6.01	3/8/2008	6/30/2008	114
	# Properties: 3			Averages:			$387,500	$444,167	-26.43			79

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Recently Sold



1113 South Dr — List Price: **$359,910**
N. Merrick — School Dist# 29 — Sold Price: **$345,000**
Cape1 Family Det — Taxes: $8,417
Approx. Year Built: 1949

Rooms: 6	Fuel: Oil	Appearance: As-Is
Bedrooms: 3	Heat: Ha	Lot Size: 60 X 100
Baths: 2	Garage: 1	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: Y	Basement: Full	Pool: N
#Fireplaces: 0	Finished: N	Porch:
Dining Room: None	Construction: Frame	Patio:
List Date: 4/4/2008	Contract Date: 6/25/2008	DOM: 82
Title Date: 8/27/2008		ML#: **2064912**



1671 Stevens Ave — List Price: **$369,000**
N. Merrick — School Dist# 29 — Sold Price: **$349,000**
Cape1 Family Det — Taxes: $8,460
Approx. Year Built: 1955

Rooms: 7	Fuel: Gas	Appearance: Good
Bedrooms: 3	Heat: Elec	Lot Size: 50 X 125
Baths: 2	Garage: 1.5	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: N	Basement: Full	Pool: N
#Fireplaces: 0	Finished: Y	Porch:
Dining Room: Formal	Construction: Siding	Patio: Rear
List Date: 6/6/2008	Contract Date: 8/8/2008	DOM: 63
Title Date: 10/17/2008		ML#: **2086260**



2076 Bruce Ln — List Price: **$349,900**
N. Merrick — School Dist# 29 — Sold Price: **$350,000**
Cape1 Family Det — Taxes: $7,729
Approx. Year Built: 1950

Rooms: 7	Fuel: Oil	Appearance: Good
Bedrooms: 4	Heat: Hw	Lot Size: 38 X 100
Baths: 2	Garage: 1	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: N	Basement: Full	Pool: N
#Fireplaces: 0	Finished: Y	Porch:
Dining Room: Formal	Construction: Frame	Patio:
List Date: 8/20/2008	Contract Date: 9/15/2008	DOM: 26
Title Date: 9/24/2008		ML#: **2109315**

SAMPLE

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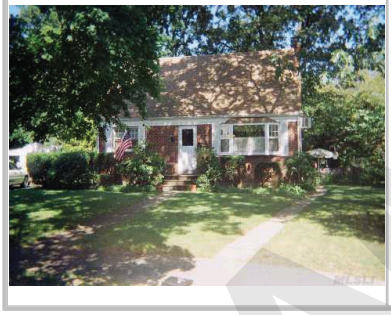
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On The Market



251 Meadowbrook Rd List Price: **$424,900**
N. Merrick School Dist# 29
Cape1 Family Det
Taxes: $9,596
Approx. Year Built: 1933

Rooms: 7	Fuel: Oil	Appearance: Excellent
Bedrooms: 3	Heat: Hw	Lot Size: 65 X 179
Baths: 1	Garage: 2	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: N	Basement: Full	Pool: N
#Fireplaces: 1	Finished: N	Porch:
Dining Room: Formal	Construction: Sided	Patio: Y
List Date: 8/14/2008		DOM: 73
		ML#: **2107849**



210 Fox Ct List Price: **$449,990**
N. Merrick School Dist# 29
Cape1 Family Det
Taxes: $8,960
Approx. Year Built: 1949

Rooms: 7	Fuel: Oil	Appearance: Excellent
Bedrooms: 4	Heat: Steam	Lot Size: 36 X 138 Irr
Baths: 2	Garage: 0	Waterfront: N
#Kitchens: 1	Drive: N	Waterview: N
Eat In Kitchen: N	Basement: Full	Pool: N
#Fireplaces: 0	Finished: N	Porch:
Dining Room: Other	Construction: Brick/Viny	Patio: Yes
List Date: 9/18/2008		DOM: 38
		ML#: **2117676**



2076 Bruce Ln List Price: **$449,990**
N. Merrick School Dist# 29
Cape1 Family Det
Taxes: $8,849
Approx. Year Built: 1950

Rooms: 7	Fuel: Gas	Appearance: Good
Bedrooms: 4	Heat: Hw	Lot Size: 38 X 100 Irr
Baths: 2	Garage: 1	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: N	Basement: Full	Pool: N
#Fireplaces: 0	Finished: Y	Porch:
Dining Room: Formal	Construction: Frame *	Patio: Yes
List Date: 9/26/2008		DOM: 30
		ML#: **2120353**

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SAMPLE

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Expired From The Market



1242 Jerusalem Ave List Price: **$429,000**
N. Merrick School Dist# 29
Cape1 Family Det

		Taxes: $8,867
		Approx. Year Built: 1949
Rooms: 6	Fuel: Oil	Appearance: Excellent
Bedrooms: 4	Heat: Ha	Lot Size: 58 X 94
Baths: 2	Garage: 0	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: Y	Basement: Full	Pool: N
#Fireplaces: 0	Finished: Y	Porch:
Dining Room: None	Construction: Vinyl	Patio:
List Date: 3/6/2008		DOM: 92
Expiration Date: 6/6/2008		ML#: **2054754**



1671 Stevens Ave List Price: **$434,500**
N. Merrick School Dist# 29
Cape1 Family Det

		Taxes: $8,462
		Approx. Year Built: 1955
Rooms: 7	Fuel: Elec	Appearance: Good ++
Bedrooms: 4	Heat: Hw	Lot Size: 50 X 125
Baths: 2	Garage: 1.5	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: N	Basement: Full	Pool: N
#Fireplaces: 0	Finished: Y	Porch: None
Dining Room: L-Shaped	Construction: Framed	Patio: Rear
List Date: 4/29/2008		DOM: 32
Expiration Date: 5/31/2008		ML#: **2073188**



28 Wellington Rd List Price: **$469,000**
N. Merrick School Dist# 29
Cape1 Family Det

		Taxes: $9,417
		Approx. Year Built: 1947
Rooms: 7	Fuel: Gas	Appearance: Mint
Bedrooms: 4	Heat: Hw	Lot Size: 54 X 120
Baths: 2	Garage: 1	Waterfront: N
#Kitchens: 1	Drive: Pvt	Waterview: N
Eat In Kitchen: Y	Basement: Full	Pool: N
#Fireplaces: 0	Finished: Y	Porch:
Dining Room: Formal	Construction: Brk/Alum	Patio:
List Date: 3/8/2008		DOM: 114
Expiration Date: 6/30/2008		ML#: **2055502**

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Market Statistical Report

For:

100 Main St
Anytown, NY 10000
10/26/2008

SAMPLE

Subject Property		*Suggested Listing Price*
100 Main St		
Recently Sold	*DOM*	*Sold Price*
2076 Bruce Ln	26	$350,000
1671 Stevens Ave	63	$349,000
1113 South Dr	82	$345,000
On The Market	*DOM*	*List Price*
2076 Bruce Ln	30	$449,990
210 Fox Ct	38	$449,990
251 Meadowbrook Rd	73	$424,900
Expired From The Market	*DOM*	*List Price*
1671 Stevens Ave	32	$434,500
1242 Jerusalem Ave	92	$429,000
28 Wellington Rd	114	$469,000

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Presenting a CMA

After conducting your research, you will want to assign a price range to the listing. At this time, you will want to explain how you arrived at the value range and give your recommendation for the list price. A successful presentation will generally include ample facts and data. The presentation and style of a CMA can vary depending on a particular market and the particular tools available to the real estate professional to complete the CMA. There are several ways a real estate agent can present a CMA to prospective buyers or sellers, but a comparative market analysis usually takes some form of a grid or table—often using computer software. A grid or table allows all relevant data to be easily evaluated.

Although there is not a single "right" answer, certainly some analyses will be more accurate than others. This is where a broker's expertise comes in. A real estate broker offers knowledge, experience, and information that the average person usually doesn't have. Above all, a broker must be able to justify the value range and recommended list price for the subject property.

When discussing a possible listing price with a seller client, you might want to remember the value characteristic of **contribution**, which states that a particular item or feature of a home is only worth what it actually contributes in value to that piece of property, not what it actually cost the owner to install or construct it. For example, the seller may think that the custom-built wine cellar, which cost him $12,000 to build, should translate to a $12,000 bump in the asking price. But if a custom-built wine cellar is not a desirable feature for most prospective buyers, the seller cannot expect his pet project to add significantly to the value of the home when it's sold.

Case in Point

You will soon find that many sellers think their property is exceptional and will garner the highest price you have presented, even if you show them why it is unlikely they will be able to sell it for that price.

Let's say that you've listed a property for $249,000. What is the importance of the number to you? You have an obligation to defend that price against objections from buyer customers under all circumstances. As the listing agent, you are obligated to act in the best interests of your client, the seller. And if they want $249,900 for their property, your obligation—if you take that listing—is to get them $249,900. What if the property is only worth $195,000? That stays confidential and you still try to get $249,900, or you can refuse the listing. But, if you do take an overpriced listing, you cannot tell a buyer that if they make an offer of $195,000, you'll talk the seller into accepting it. That would be a breach of the statutory obligation you have to act in your client's best interest.

Use caution in these situations. Remember, sellers have a right to want whatever they want for their property; and agents have the right to not take a listing if the seller is unrealistic about what it's going to sell for. It may be more prudent for you to walk away from this listing rather than try to sell it for more than the market supports. In the end, your clients will be frustrated their property is on the market longer than expected, and you will be frustrated because your marketing effort is not producing a sale.

Accounting for Personal Property

Recall that a real estate transaction most typically involves the transfer of ownership of **real property**, which is the land, its attachments (natural or man-made), as well as all of the rights associated with the property. A major attachment, such as a home, driveway, pipeline, or other structure, is known as an **improvement**. **Personal property** or chattel, on the other hand, is any other property. It is moveable, and it is not attached to the land. Personal property can become a **fixture**, in other words, part of real property, when it is permanently attached to land or its improvements.

Examples of typical fixtures include ceiling fans, built-in bookcases, wall-to-wall carpet, furnaces, even customized window treatments. Items that have been temporarily removed from the real property for servicing (e.g., built-in dishwasher at the repair shop on the day of closing) might still be considered fixtures.

Since fixtures and improvements are affixed to the land, they don't normally need to be stated in purchase contracts; they're included by implication in the description of real estate. Unless otherwise established, all *real* property is included in the transfer, but *personal* property that happens to be on the premise is *not* included. Thus, when there is a disagreement between a seller and a buyer on property, it can often be traced back to how the property is classified. This can be a result of determining if the property is attached or not, or even what exactly is considered to be transferred with the actual land.

Can you see the potential for problems? Since a seller and a buyer may not agree on what items are fixtures and are therefore included in the transfer of real property, a real estate agent should take great care to make certain that the seller and buyer are clear on this.

Clear Identification

Is a built-in dishwasher a fixture? Is a shed an improvement? Is a chandelier personal property? Is a satellite dish a fixture? To avoid confusion and even possible legal action, always notate what personal property is included in the sale of a home in your listing agreements. It is also important to indicate what is *not* included. For instance, if the seller will be taking a chandelier or the kitchen appliances, you will want to note this in the listing agreement. That way, potential buyers know up-front what to expect when they take possession of the property.

Some agents use what is called a "red tag" method, where a tag is placed on items that are or are not included in the sale. This might not be the best solution since the tag could accidentally be removed or buyers may misunderstand the meaning of the tag, assuming that the item *is* part of the transaction. At the very least, items that might be questionable should be written down so no confusion takes place, and they should **always be noted as exclusions in the purchase agreement.**

Perhaps the most reasonable strategy you can suggest to the seller is to simply remove or replace the item(s) prior to showing the house. This makes it impossible for a buyer to expect a particular item to be included in the sale and resolves all issues regarding whether the buyer saw the item and assumed it would transfer. For example, if the seller intends to take the dining room chandelier to his new home, he should just go ahead and replace it with an appropriate light fixture before ever showing the property.

Bill of Sale

What if a buyer wants to purchase items that the seller had not intended to sell with the property? For example, a buyer really likes the curtains in the living room and would like them to be sold with the house. If the buyer and seller come to a private agreement on personal items, a reasonable solution is to have the parties draw up a **separate bill of sale**, which transfers title to personal property (like a deed transfers title to real property). Still, the agents—and the attorneys on both sides—should be made aware of any such separate deals.

Financed Personal Property

If an item of personal property is **financed**, the lender could require a security agreement in the event that the purchaser defaulted on the loan. The security agreement could be reflected in the public records if a financing statement is recorded. When such a statement is in the public records, any personal property is considered to be **separate** of the real property, even if the item were attached to the real property.

For example, a homeowner finances the purchase of an in-wall room air conditioning unit. Since it's installed in the wall, that air conditioning unit would generally be considered real property. But if the homeowner doesn't keep up with the payments, the company who sold the unit could theoretically remove it, leaving the homeowner with a hole in the wall. Why? As long as the homeowner owes money toward the financing costs, it's personal property. If the homeowner had paid cash, it would clearly be real property.

Open for Discussion

What about leased property such as a satellite dish that's bolted to the roof? Do you think that would be real or personal property? What if the seller tells the buyer that they're getting satellite TV as part of the purchase of the property? Then three days after the buyer moves in, he gets a bill for the monthly rental of that satellite dish. As a real estate broker, what could you have done to prevent the situation with the satellite dish from going to court?

Settling Property Disputes

If a seller does not clearly label items as personal property in a listing agreement, it could ultimately result in a legal dispute with the buyer. If these types of disputes end up in court, there are some key legal questions that help determine if an object is a fixture, in other words, **not** personal property. For example:

- Can the object be removed without damaging the property?
- Was the item custom made or designed specifically to fit or be used in the property?

Physical attachment of an item is taken into account when the court decides if something is a fixture, but it's not decisive. The court still looks at other factors. One of the most important issues a court considers in deciding whether an item is a fixture is the **intent** of the annexation. The annexer is the owner of the personal property that was brought onto real property. Did he or she intend for it to become part of the real property, or to remain as personal property? Did he or she buy the item to improve the real property or simply for personal use?

It's not enough to claim that an intention to remove the item. Other considerations, such as the nature of the item and manner of annexation, are viewed as objective evidence of intent. For example, setting a statue in concrete shows intent to make it a permanent feature; just setting one out on the lawn doesn't.

Relationship of the Parties

Another factor courts often take into consideration in fixture disputes is the relationship of the parties. Between a seller and a buyer of real property, the rules for determining whether an item is a fixture are usually interpreted in favor of the buyer. Between a landlord and a tenant, the rules tend to be interpreted in favor of the tenant. A tenant who installs a chandelier (or some other ornamental item) usually has the right to remove it at the end of the lease. These rules tie to considering the annexer's intentions; the law presumes a homeowner intends to improve real property, but a tenant installs things only for personal use.

That doesn't mean a tenant is invariably allowed to remove everything he or she installed, especially if it were done without written permission. If a tenant built a deck onto the back of a rented house, it would almost certainly be considered a fixture and part of the landlord's real property. As usual, the court would look at the nature of the item, the manner of annexation, and how difficult it would be to remove. Remember: Once a dispute gets to a court, anything could happen!

Written Agreement

Regardless of the previously discussed considerations, if there's a written agreement between the parties stating how an item is to be treated, a court will enforce the agreement. So, sellers who want to remove items that may be considered fixtures should inform a buyer by including a statement in the listing agreement naming items that are excluded from the sale. This way, there are no assumptions regarding whether something will or will not be included. A separate **bill of sale** should then account for any personal items the buyer wants to purchase from the seller.

Bottom line: Recommend that everything be put in writing, and you can be of genuine assistance to your client or customer should a dispute arise.

Seller's Share

A **seller's share**, or **net to seller**, is an *estimate of the money a seller should receive from a real estate transaction based on a certain selling price after all costs and expenses have been paid*. Also known as the seller's **net equity**, this is *not a guarantee* but an approximation of what the seller should receive. Seller's share is an important factor for a seller in determining the listing price of the property and what price to accept in a final offer from a buyer. Buyer's agents should also have an idea of what this figure is so that they can talk intelligently with the listing agent.

Purpose of Seller's Share

There are two main reasons to compute a **net to seller**. First, the seller needs to know how much money can be expected from a transaction after everything has been paid. This is often an important piece of information a seller wants before deciding whether to accept an offer.

Second, the seller needs to know what to expect from the closing. One of the most frustrating situations a seller faces is getting less money than anticipated. This can reflect on you as the seller's agent and could hurt the chance for future referrals.

Furthermore, it's your job to explain to the seller that there are many parties involved who must be paid in the transaction, for example, lenders, title companies, escrow companies, etc., in addition to taxes. Invite the seller to compare costs if there are any questions about fees.

Calculating Seller's Share

Finding the seller's net share is quite straightforward. Essentially, start with the sales price and deduct all known costs for which the seller is responsible to calculate how much money the seller will actually receive when the transaction is complete. Of course, the seller must pay off all mortgages unless some other arrangement has been made, such as a loan assumption. You need to find the pay-off amount from the lender and whether any penalties need to be paid.

As you know, most other costs are open to negotiation between buyer and seller, so make sure you read the purchase agreement carefully to see who's paying what. In the case of taxes and insurance, the seller typically pays for the portion used until the property transaction actually closed. These are **prorated items**. The broker's commission must be subtracted also.

Traditionally, the total commission amount came out of the seller's portion. The settlement statement should reflect the commission amount agreed to in the listing contract. Typical seller's expenses in a residential real estate transaction include, but may not be limited to, the following:

- Broker's commission
- Paying off any existing mortgages
- Prorated mortgage interest for the month of the sale
- Prorated property taxes
- Prorated special assessments
- Title insurance
- State and county transfer taxes
- Municipal transfer taxes
- Any other prorated assessments
- Prorated association fees or special assessments

Most brokerages will likely provide some sort of seller's share worksheet to assist in determining this critical information.

Seller's Share Example

You're at the stage in your listing presentation where the seller is curious about what their net equity would be based on your recommended list price. Let's assume the following facts:

- Your market research indicates a likely sales price should be approximately $410,000.00.
- You anticipate a closing on August 23.
- Your firm charges a 6% commission.
- The outstanding balance on the seller's existing first (and only) mortgage is $205,000.00, with an interest rate of 6%.
- The monthly payment due August 1 has been paid.
- The annual property tax bill of $10,750.00 is unpaid.
- The estimated title insurance is $1,100.00.
- The transfer tax due the county and state is calculated at a rate of 75 cents for every $500 (or portion thereof) of sales price.
- The survey is estimated to cost $650.00.

So let's walk through the calculations necessary to complete the sample net to seller worksheet based on the above information and determine the seller's net equity. After figuring all expenses, you can subtract that from the sale price to find the estimated proceeds or net to seller.

Commission

If the home does indeed sell for $410,000 and the broker commission is 6%, the total commission is **$24,600.00**:

$410,000 x .06 = $24,600.00

Prorated Mortgage Interest

If the closing date is **August 23**, the payoff on the existing mortgage is **$205,000**, and the interest is **6%**, the prorated interest for the month of sale is **$785.83**:

$205,000 x .06 = $12,300 / year

$12,300 / 360 days = $34.17 / day

$34.17 / day x 23 days = $785.83

Prorated Property Tax

Assuming that property taxes are paid in arrears, the prorated property taxes owed by the seller is **$6,957.38**:

$10,750.00 annual tax / 360 days = $29.86 / day

7 months (January through July) x 30 days = 210 days

210 days + 23 days = 233 days

$29.86 x 233 days = $6,957.38

Transfer Tax

If the home does indeed sell for $410,000 and the total transfer tax is $0.75 for every $500 (or portion thereof) of the sale price, the total transfer tax is **$615**:

$410,000 / 500 = 820

820 x .75 = $615

Use this data to calculate the seller's share using the sample worksheet on the next page.

SELLER'S ESTIMATED NET PROCEEDS			
Sale price			
Broker commission	%		
Existing first mortgage			
Prorated interest for the month of sale			
Existing second mortgage			
Prorated interest for the month of sale			
Prorated property taxes			
Prorated county special assessment			
Title insurance			
State and county transfer taxes			
Municipal transfer taxes			
Prorated assessments			
Prorated association special assessment			
Survey			
Total expenses			
Estimated Net Proceeds			

The information provided on this worksheet is estimated based upon reasonable expectation as to the charges applicable at the time of closing. Sellers should seek additional information from their attorney and accountant.

Math Challenge

Let's say that the sellers in this example want to purchase a new home using the equity they gained from the sale of their present home. If they plan on using all of that earned equity to make a 25% down payment on the new property, what is the potential purchase price of the sellers' new home?

Sale of a Principal Residence

It is probably no surprise that taxes come into play during the sale of a principal residence. Losses on the sale of a personal residence are not realized since it is a personal asset. However, gains from the sale are normally taxable. The **Taxpayer Relief Act of 1997** created a provision for this with **Section 121** of the Internal Revenue Code. Section 121 provides some relief to taxpayers by exempting most, if not all, of the gain.

Section 121 Conditions

Specific conditions must be met for the rules of Section 121 to apply. For example, the taxpayer must have owned and used the property as a principal residence for at least **two of the last five years** prior to the date of sale. It does not have to be the principal residence on the date of sale. Generally, the provisions of Section 121 of the Taxpayer Relief Act can be invoked only **once every two years** unless there are special circumstances, such as:

Change in place of employment. A change in employment can qualify taxpayers for the eligible moving expenses deduction, but there is a specific requirement. The location of the new place of employment must be at least 50 miles farther from the old residence than that residence was from the former job.

Health considerations. In order for health exceptions to apply, reasons for the sale of the home must include obtaining a change in residence to provide for the diagnosis, cure, or treatment of a disease, illness, or injury; or to obtain or provide medical or personal care for someone suffering from a disease, illness, or injury. Some examples include:

- Moving because a person is unable to care for herself
- Moving to a climate that will minimize the effects of a disease
- Moving closer to a recognized treatment facility

Unforeseen circumstances. Occasionally, circumstances arise that are beyond the taxpayer's control. The last set of provisions makes exceptions for these conditions. These are the most common:

- Involuntary conversion (eminent domain)
- Disaster
- Death
- Cessation of employment
- Divorce
- Multiple births

Exclusion Limits

There are limits on the total allowable exclusions under Section 121. The exclusion amount for:

- A single person is $250,000.
- A married couple filing joint tax returns is $500,000.

There are some additional requirements to be eligible for the $500,000 exclusion:

- One or both spouses must have owned and used the property as their primary residence for two of the last five years.
- Neither spouse has sold another principal residence within the last two years.

In the event of the death of a spouse, the maximum exclusion on the sale of a primary home by the unmarried surviving spouse is $500,000, as long as joint filing requirements were met prior to the death and the sale occurs no later than two years following the spouse's death.

Calculating the Realized Gain

The exclusion is applied to the **realized gain**, not the sale price of the property. To calculate the realized gain, you must first determine the **adjusted basis**, which is *the original cost plus capital improvements minus depreciation*. Then you subtract the adjusted basis from the amount realized, or *the sale price minus selling expenses*. Next, the Section 121 exclusion is subtracted from the realized gain.

The exclusion amount may seem extraordinarily large; however, lawmakers considered **appreciation,** or *the increase in value of an asset over time,* when they drafted the law. It prevents most people from an enormous tax burden simply because they have lived in a home for many years.

Case in Point

Kent sold his primary residence for $325,000. His selling expenses were $22,000 (commission, fees, lawyer, etc.) so the amount realized ($303,000) represents the sale price minus selling expenses. His original investment in the home was $150,000. He renovated the kitchen for $28,000 (capital improvement) and recognized $14,000 in depreciation, and so his adjusted basis is $164,000. Kent meets all the conditions for the Section 121 exclusion. What is Kent's recognized gain?

Amount Realized (sales price – selling expenses)	$303,000
Adjusted Basis (original cost + capital improvements - depreciation)	($164,000)
Realized Gain	$139,000
Section 121 Exclusion	($250,000)
Recognized Gain	$ 0

Since the amount of the Section 121 exclusion is greater than the realized gain, there is no recognized gain for tax purposes. However, the excess amount is lost and cannot be rolled over into future transactions.

Partial Exemption

Although there are circumstances where the two-year rule could be waived, even under those conditions, only a portion of the exemption may be used. The exemption amount is multiplied by a fraction to determine the appropriate exemption amount. The numerator of the fraction is the number of qualifying months and the denominator is 24 (number of months in the two-year period).

$$\frac{\text{Qualifying Months}}{24}$$

Case in Point

Dave and Sarah moved to another state and used the Section 121 provision to eliminate any gain on the sale of their home. They purchased a new home for $275,000. After living there for 17 months, Sarah received a promotion and was required to relocate to a different state. Due to a strong housing market, they were able to sell the home for $575,000. What, if any, gain must they recognize?

Step 1: Calculate the realized gain on the sale by subtracting the adjusted basis from the amount realized.

Amount Realized – Adjusted Basis = Gain

$575,000 – $275,000 = $300,000

Step 2: Calculate the amount of the Section 121 exclusion. Dave and Sarah were in the home 17 months, so the fraction is 17/24. Multiply this by the standard exclusion amount of $500,000.

$$\frac{17}{24} \times \$500{,}000 = \$354{,}167$$

The amount of the exclusion equals $354,167, which is more than the gain realized by Dave and Sarah. Therefore, they have no recognized gain for tax purposes.

Special Considerations

There are other factors and circumstances to consider when a primary residence is sold. If a taxpayer depreciates a portion of his home by converting it to a home office, he cannot apply the Section 121 exclusion to the depreciation—it must be recaptured as income upon the sale of the home.

The same applies if he uses the Section 121 exclusion on a rental or vacation home for which depreciation expenses were claimed in the past. **Recaptured depreciation** most commonly occurs on a *personal asset used for business purposes when that asset is sold*. Since a benefit from the asset has occurred in a prior period, taxpayers cannot benefit from the expense twice, and the *previous depreciation must be included as normal income when the asset is sold*.

Caution: By understanding the principles behind Section 121, real estate professionals can help clients avoid large tax bills, in addition to allowing them to move as their circumstances require. However, **clients should always be encouraged to consult with tax professionals or attorneys for tax and legal advice**.

Compensation

Whatever terms the broker and seller agree to in the listing contract should be **clearly spelled out in writing.** And it's not just the *amount* of commission that should be documented, but the *timing* at which it will be paid. Is commission earned when a willing buyer is found? When a purchase contract is signed? When the transaction closes? Every broker will negotiate with his or her client to decide what's acceptable.

It's more than possible you, like most brokers, will be working in a marketplace where there is a wide range of home prices, from starter homes to million dollar homes. Let's say your sponsoring broker makes the decision to charge 7% commission. If you sell a $100,000 house, the commission will be $7,000. But if you sell a $1 million house, the commission would be $70,000.

What do you do when the owner of that $1 million property asks you, "What do I get for that additional $63,000 that the owner of the other $100,000 house didn't get?" That's certainly a fair question, and one that could be difficult to respond to. Obviously, you would do things differently when marketing a million dollar property, such as more expensive brochures, pricier advertising outlets, etc., but would it necessarily allow you to justify such a difference in commission due? You need to be able to support the value you and your brokerage offer to a seller.

Real Success

You might think that it makes sense for brokers to work with other local brokers to establish standard commission rates. Remember that not only does it **not** make sense, it's against the law. This would be considered an example of **price-fixing**, which violates state and federal antitrust laws against restraint of trade. The key thing to remember is that commission is **negotiable** between the client and the broker.

Earning Commission

Payment of a broker's commission may be dependent on any lawful condition. The listing agreement may specify that commission is due once the seller signs a binding contract with a buyer or only if a sale actually closes. Of course, this is a negotiable point in the employment contract. Unless otherwise agreed, however, the traditional consensus is that the broker is entitled to a commission when a **ready, willing, and able buyer is found.**

A buyer is considered **ready and willing** if he or she makes an offer that meets the terms established by the seller in the listing agreement. A buyer is considered **able** if he or she has the financial ability to complete the purchase. Under the terms of most listing agreements, once a ready, willing, and able buyer has submitted an offer, the broker has earned a commission, even if the sale never closes.

If a buyer's offer doesn't exactly match the terms the seller specified in the listing, the seller can refuse to contract with that buyer, without owing the broker a commission. This makes it very important to have the seller's terms clearly defined in the listing agreement.

Summary

1. **Real property** is land and its attachments, as well as all of the **rights** associated with the property. **Improvements** are artificially attached to real property and are transferred with ownership. They are considered to be **real property** and include man-made attachments, such as fences, buildings, roads, sewers, etc., and **fixtures,** which are items of personal property that have been attached to, or closely associated with, real property in such a way that they legally becomes part of the real property. The sale of real estate generally includes real property, its improvements, and fixtures. **Personal property** is most easily defined as any property that is *not* real property. It is **not** generally included in the sale of real estate. Any personal property included or excluded should be clearly stated in the listing agreement and the purchase agreement. Transfer of personal property is usually handled with a separate **bill of sale.**
2. A **comparative market analysis** (CMA) is a method of determining the approximate market value of a home by comparing the subject property to other homes in the same neighborhood or vicinity. It is also known as a competitive market analysis or a residential market analysis. A CMA will look at homes that have sold, are presently for sale, or did not sell. Real estate brokers provide CMAs to sellers so they can determine the home's potential list price. Buyers might need a CMA to determine a fair price to offer for a home. A CMA is not an appraisal. Though similar to the sales comparison appraisal approach, CMAs rely mostly on observable differences between properties, such as lot size, home style and condition, curb appeal, location, etc.
3. A **seller's share**, or **net to seller**, is an estimate of the money a seller should receive from a real estate transaction based on a certain selling price after all costs and expenses have been paid. The seller's share, then, represents the seller's actual **equity** in the property. To calculate seller's share, start with the sales price and deduct all known costs for which the seller is responsible, including any mortgage pay-off.
4. The **Taxpayer Relief Act of 1997** provides an exemption from capital gains taxes for the sale of a principal residence for those who qualify. To qualify, the seller must have resided at the property for two of the last five years. This exemption can be claimed only once every two years, unless the seller has had a change in place of employment, health considerations, or unforeseen circumstances. A single person can exclude up to $250,000; a married couple filing jointly can exclude up to $500,000.
5. To be eligible for a sales commission, an individual must be a real estate **licensee** and **employed** by the buyer or seller under a valid contract. A broker receives the agreed upon share of the commission from his or her sponsoring broker, and **only from his or her sponsoring broker.** Rates and terms are set by each sponsoring broker individually and **negotiated** with the client. Commission is generally earned when a **ready, willing, and able buyer** is found.

Quiz

1. ***During a listing interview, a seller demands that the listing agent reduce the proposed commission by 1%. What is the best course of action for the agent?***
   a. call the managing broker and discuss the matter
   b. explain that commissions are generally fixed in each locality
   c. go ahead and reduce the commission
   d. refuse the listing as commissions are not negotiable

2. ***Of these, what would be the most common example of personal property that is included in a purchase agreement?***
   a. a dining room table
   b. an in-ground swimming pool
   c. a lawn mower
   d. a refrigerator

3. ***The sale of a property closes on May 10. Taxes are $3,600 per year and have not been paid. What is the seller's share of taxes, based on a calendar year (assuming it's not a leap year)?***
   a. $1,200.00
   b. $1,282.19
   c. $1,300.00
   d. $1,374.16

4. ***A comparative market analysis is _____ the equivalent of an appraisal.***
   a. always
   b. usually
   c. sometimes
   d. never

5. ***Bonnie sold her condo for $105,050. She paid off the $58,000 owed on her mortgage, 7% commission, attorney fees of $200, prorated interest of $345 and transfer taxes of $157.58. What was the net to seller?***
   a. $38,993.92
   b. $39,189.65
   c. $43,053.92
   d. $46,347.42

6. ***The listing agent presents a full-price cash offer with no contingencies to the seller during the listing period. The seller refuses to sign the contract, because he does not like the buyers. Which statement do you think is true?***
   a. No commission can be due unless there is a closing.
   b. The buyer could sue for specific performance.
   c. The listing agency is due a commission.
   d. The listing contract would be automatically terminated.

7. ***You think a house should list for $225,000 but your clients insist that they need $249,000 to pay off their mortgage and get their next house. If you decide to take the listing anyway, which of these fiduciary duties requires you to list at $249,000?***
   a. accountability
   b. disclosure
   c. obedience
   d. reasonable care

8. ***If you have a client who questions your firm's commission fee, you should NOT***
   a. defend your firm's prices and other competitive business decisions in terms that are consistent with competition, not conspiracy.
   b. present prices to the client in a manner that confirms the fees were established independently.
   c. point out the value of the services your client will receive for the fee charged.
   d. refer to the pricing policies of the local association of REALTORS®.

9. ***Agent Alex is using a comparative market analysis to set his seller client Pam's expectations about the sale of her property. His research shows that there are 12 current listings and only three listings have sold in the past 90 days. Based on this, how long should Pam expect that her house might be on the market?***
   a. 60 days
   b. 180 days
   c. 6 months
   d. 12 months

10. ***The primary purpose of a comparative market analysis is to determine***
    a. an estimate of a home's value for a secondary lender.
    b. a range of probable selling prices for a homeowner.
    c. the potential gross income that a rental property may be able to bring in.
    d. the remaining economic life of the subject property.

11. ***Nancy and Jim own a condo together as tenants by the entirety. You met with both of them last week and hammered out some details related to listing their condo. When you go to take the listing agreement, only Nancy is home. You should***
    a. allow Nancy to sign the agreement by herself and assure her that it is a legally binding contract.
    b. ask Nancy, since she is his wife, to sign Jim's name for him.
    c. ask when both will be available to sign the contract.
    d. sign the contract for Jim.

12. ***When determining a listing price, the value of an improvement is equal to***
    a. the amount the owner adds to the selling price of the home when the improvement is made.
    b. what it actually contributes in value to that piece of real estate.
    c. only what the owner spent on the materials necessary to make the improvement.
    d. what it actually cost to make the improvement in both materials and labor.



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Property Concerns

There are two maxims in real estate: Location, location, location. And, when in doubt, disclose. The most basic definition of "disclosure" is to reveal something that was hidden. As you know, disclosure is one of the fiduciary obligations that an agent owes his or her client, and in real estate, disclosure is an obligation related to many different things, for example, a licensee's disclosure obligations related to agency relationships and conflicts of interest, or a seller agent's obligation to disclose all offers.

In this chapter, we'll spend time looking at property-specific issues, including the critical legal obligation for sellers to disclose to potential buyers any defects in the property of which the owner is aware but which are not obvious to the buyer. As you'll see, courts have held that ***owners*** may be liable for undisclosed defects of which they "should be aware," even if they have no actual knowledge of them.

You will learn:

- A seller's property disclosure obligations.
- An agent's property disclosure obligations.
- Considerations for handling distressed properties.
- Strategies for showing property.

Key Terms

Distressed Property
Fraud
Latent Defect
Material Fact
Patent Defect
Radon
Short Sale
Stigmatized Property

Let the Buyer Beware?

Traditionally the seller was deemed to be the most important person in a real estate transaction. Purchase contracts were typically written with the best intentions for the seller. The rule of *caveat emptor*, which in Latin means "Let the buyer beware," said that a buyer was expected to examine property carefully, instead of relying on the sellers to point out problems. Buyers had to look after themselves through inspectors, lenders, appraisers, etc., but most importantly, by relying on their ability to inquire about the home just by seeing a potential problem or inquiring about something that they were unsure of.

This theory of seller superiority has certainly been diminished in recent years by the increased use of buyer agency. As you know, the buyer has the right to his own representation as well as fair and honest dealings that are not biased toward protecting the seller. Another thing that has evened the playing field between buyer and seller is the requirement for sellers to disclose information about the property to potential buyers.

Purpose of Property Disclosure

Most states have some sort of seller disclosure law that requires a seller to complete a standardized form disclosing **material defects** about the property. These disclosure laws protect potential buyers, giving them the right to make an informed decision on the property.

The disclosure forms are typically required to be presented to a potential buyer **prior to signing a sales agreement.** The disclosure either allows the buyer to consider such facts prior to entering into contract, or to get out of the purchase contract within some timeframe if some item in the disclosure is found to be unacceptable. Additionally, if part of the disclosure is found to be fraudulent, there are other remedies available to the buyer.

Disclosures normally include structural, mechanical, or other conditions of the property such as hazardous materials, visible insect damage, etc. Most of the time, property disclosure should **not** be construed as a warranty, but is merely informational in nature.

Patent or Latent

Now, some important terminology to review: Defects are generally categorized as either **patent** or **latent**.

Patent defects are those that are **plainly observable**. A simple example might involve a large crack in a basement wall. If this crack were easily observable upon entering the basement, then it would be considered patent. If the defect is patent, then there is generally **no** obligation to disclose it.

Latent defects are defects that are **not** plainly observable or that would not be discovered in a reasonable inspection. If that crack in the basement wall were covered by paneling, and therefore not observable, it would be considered latent. As a general rule, Illinois law indicates that the seller and the seller's agent have a duty to **disclose latent defects** to buyers. This seems reasonable considering that if the defects are latent, not obvious, only the seller could know of them.

Seller Liability

The seller indicates by his or her signature that the disclosure form is complete and accurate based on available information. While the seller is liable for intentional misrepresentations or omissions, the seller is **not** liable for errors or omissions if:

- The seller had no knowledge of the error or omission.
- The seller had reason to believe that the defect had been corrected.
- The seller based his statements on information obtained from a source of authority (for example, a public agency, licensed engineer, home inspector, contract, land surveyor, structural pest control inspector) and the seller was unaware of the error or omission.

Residential Real Property Disclosure Report

The following information is provided pursuant to the Illinois Residential Real Property Disclosure Act of 1993

NOTICE: THE PURPOSE OF THIS REPORT IS TO PROVIDE PROSPECTIVE BUYERS WITH INFORMATION ABOUT MATERIAL DEFECTS IN THE RESIDENTIAL REAL PROPERTY. THIS REPORT DOES NOT LIMIT THE PARTIES RIGHT TO CONTRACT FOR THE SALE OF RESIDENTIAL REAL PROPERTY IN "AS IS" CONDITION. UNDER COMMON LAW SELLERS WHO DISCLOSE ADVERSE MATERIAL DEFECTS MAY BE UNDER A CONTINUING OBLIGATION TO ADVISE THE PROSPECTIVE BUYERS ABOUT THE CONDITION OF THE RESIDENTIAL REAL PROPERTY EVEN AFTER THE REPORT IS DELIVERED TO THE PROSPECTIVE BUYER. COMPLETION OF THIS REPORT BY SELLER CREATES LEGAL OBLIGATIONS ON SELLER. THEREFORE SELLER MAY WISH TO CONSULT AN ATTORNEY PRIOR TO COMPLETION OF THIS REPORT.

Property Address: _____ City, State and ZIP Code: _____

Seller's Name: _____

This report is a disclosure of certain conditions of the residential real property listed above in compliance with the Residential Real Property Act. This information is provided as of: _____ [Date of Report] and does not reflect any changes made or occurring after that date or information that becomes known to the seller after that date. The disclosures herein shall not be deemed warranties of any kind by the seller or any person representing any party in this transaction.

In this form, "am aware" means to have actual notice or actual knowledge without any specific investigation or inquiry. In this form, a "material defect" means a condition that would have a substantial adverse effect on the value of the residential real property or that would significantly impair the health or safety of future occupants of the residential real property unless the seller reasonably believes that the condition has been corrected.

The seller discloses the following information with the knowledge that even though the statement herein are not deemed to be warranties, prospective buyers may choose to rely on this information in deciding whether or not and on what terms to purchase the residential real property. The seller represents that to the best of his or her actual knowledge, the following statements have been accurately noted is "yes" (correct), "no" (incorrect), or "not applicable" to the property being sold. If the seller indicates that the response to any statement, except number 1, is yes or not applicable, the seller shall provide an explanation, in the additional information area of this form.

	Yes	No	N/A	
1.	[ ]	[ ]	[ ]	Seller has occupied the property within the last twelve months.
2.	[ ]	[ ]	[ ]	I am aware of flooding or recurring leakage problems in the crawl space or basement.
3.	[ ]	[ ]	[ ]	I am aware that the property is located in a flood plain or that I currently have flood hazard insurance on the property.
4.	[ ]	[ ]	[ ]	I am aware of material defects in the basement or foundation (including cracks and bulges)
5.	[ ]	[ ]	[ ]	I am aware of material defects in the roof, ceilings, or chimney.
6.	[ ]	[ ]	[ ]	I am aware of material defects in the walls or floors.
7.	[ ]	[ ]	[ ]	I am aware of material defects in the electrical system
8.	[ ]	[ ]	[ ]	I am aware of material defects in plumbing system (includes such things as water heater, sump pump, water treatment system, sprinkler system, and swimming pool).
9.	[ ]	[ ]	[ ]	I am aware of material defects in the well or well equipment.
10.	[ ]	[ ]	[ ]	I am aware of unsafe conditions in the drinking water.
11.	[ ]	[ ]	[ ]	I am aware of material defects in heating, air conditioning, or ventilating system.
12.	[ ]	[ ]	[ ]	I am aware of material defects in fireplace or woodburning stove.
13.	[ ]	[ ]	[ ]	I am aware of material defects in septic, sanitary sewer, or other disposal system.
14.	[ ]	[ ]	[ ]	I am aware of unsafe concentrations of radon on the premises.
15.	[ ]	[ ]	[ ]	I am aware of unsafe concentrations of or unsafe conditions relating to asbestos in the premises.
16.	[ ]	[ ]	[ ]	I am aware of unsafe concentrations of or unsafe conditions relating to lead paint, lead water pipes, lead plumbing, pipes, or lead in the soil on the premises.
17.	[ ]	[ ]	[ ]	I am aware of mine subsidence, underground pits, settlement, sliding, upheaval, or other earth stability defects on the premises.
18.	[ ]	[ ]	[ ]	I am aware of current infestations of termites or other wood boring insects.
19.	[ ]	[ ]	[ ]	I am aware of a structural defect caused by past infestations of termites or other wood boring insects.
20.	[ ]	[ ]	[ ]	I am aware of underground fuel storage tanks on the property.
21.	[ ]	[ ]	[ ]	I am aware of boundary or lot line disputes.
22.	[ ]	[ ]	[ ]	I have received notice of violation of local, state, or federal laws or regulations relating to this property, which violation has not been corrected.
23.	[ ]	[ ]	[ ]	I am aware that this property has been used for the manufacture of methamphetamine as defined in Chapter 10 of the Methamphetamine Control and Community Protection Act.

Note: These disclosures are not intended to cover the common elements of a condominium, but only the actual residential real property including limited common elements allocated to the exclusive use thereof that form an integral part of the condominium unit.

SAMPLE

Note: These disclosures are intended to reflect the current condition of the premises and do not include previous problems, if any, that the seller reasonably believes have been corrected.

If any of the above are marked "not applicable" or "yes", please explain here or use additional pages, if necessary:

Check here if additional pages used: _____

Seller certifies that seller has prepared this statement and certifies that the information provided is based upon the actual notice or actual knowledge of the seller without any specific investigation or inquiry on the part of the seller. The seller hereby authorizes any person representing any principal in this transaction to provide a copy of this report, and to disclose any information in this report to any person in connection with any actual or anticipated sale of the property.

Seller: _____ Date: _____
Seller: _____ Date: _____

PROSPECTIVE BUYER IS AWARE THAT THE PARTIES MAY CHOOSE TO NEGOTIATE AN AGREEMENT FOR THE SALE OF THE PROPERTY SUBJECT TO ANY OR ALL MATERIAL DEFECTS DISCLOSED IN THIS REPORT ("AS IS"). THIS DISCLOSURE IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THAT THE PROSPECTIVE BUYER OR SELLER MAY WISH TO OBTAIN OR NEGOTIATE. THE FACT THAT THE SELLER IS NOT AWARE OF A PARTICULAR CONDITION OR PROBLEM IS NO GUARANTEE THAT IT DOES NOT EXIST. PROSPECTIVE BUYER IS AWARE THAT HE MAY REQUEST AN INSPECTION OF THE PREMISES PERFORMED BY A QUALIFIED PROFESSIONAL.

Prospective Buyer: _____ Date: _____ Time: _____
Prospective Buyer: _____ Date: _____ Time: _____

765 ILCS 77/35

(**765 ILCS 77/**) **Residential Real Property Disclosure Act**

Sec. 5. Definitions. As used in this Act, unless the context otherwise requires the following terms have the meaning given in this Section.
"Residential real property" means real property improved with not less than one nor more than 4 residential dwelling units; units in residential cooperatives; or, condominium units, including the limited common elements allocated to the exclusive use thereof that form an integral part of the condominium unit.
"Seller" means every person or entity who is an owner, beneficiary of a trust, contract purchaser or lessee of a ground lease, who has an interest (legal or equitable) in residential real property. However, "seller" shall not include any person who has both (i) never occupied the residential real property and (ii) never had the management responsibility for the residential real property nor delegated such responsibility for the residential real property to another person or entity.
"**Prospective buyer"** means any person or entity negotiating or offering to become an owner or lessee of residential real property by means of a transfer for value to which this Act applies.

Sec. 10. Except as provided in Section 15, this Act applies to any transfer by sale, exchange, installment land sale contract, assignment of beneficial interest, lease with an option to purchase, ground lease, or assignment of ground lease of residential real property.

Sec. 15. The provisions of this Act do not apply to the following:
(1) Transfers pursuant to court order, including, but not limited to, transfers ordered by a probate court in administration of an estate, transfers between spouses resulting from a judgment of dissolution of marriage or legal separation, transfers pursuant to an order of possession, transfers by a trustee in bankruptcy, transfers by eminent domain, and transfers resulting from a decree for specific performance.
(2) Transfers from a mortgagor to a mortgagee by deed in lieu of foreclosure or consent judgment, transfer by judicial deed issued pursuant to a foreclosure sale to the successful bidder or the assignee of a certificate of sale, transfer by a collateral assignment of a beneficial interest of a land trust, or a transfer by a mortgagee or a successor in interest to the mortgagee's secured position or a beneficiary under a deed in trust who has acquired the real property by deed in lieu of foreclosure, consent judgment or judicial deed issued pursuant to a foreclosure sale.
(3) Transfers by a fiduciary in the course of the administration of a decedent's estate, guardianship, conservatorship, or trust.
(4) Transfers from one co owner to one or more other co owners.
(5) Transfers pursuant to testate or intestate succession.
(6) Transfers made to a spouse, or to a person or persons in the lineal line of consanguinity of one or more of the sellers.
(7) Transfers from an entity that has taken title to residential

SAMPLE

real property from a seller for the purpose of assisting in the relocation of the seller, so long as the entity makes available to all prospective buyers a copy of the disclosure form furnished to the entity by the seller.
(8) Transfers to or from any governmental entity.
(9) Transfers of newly constructed residential real property that has not been occupied.

Sec. 20. A seller of residential real property shall complete all applicable items in the disclosure document described in Section 35 of this Act. The seller shall deliver to the prospective buyer the written disclosure statement required by this Act before the signing of a written agreement by the seller and prospective buyer that would, subject to the satisfaction of any negotiated contingencies, require the prospective buyer to accept a transfer of the residential real property.

Sec. 25. Liability of seller.
(a) The seller is not liable for any error, inaccuracy, or omission of any information delivered pursuant to this Act if (i) the seller had no knowledge of the error, inaccuracy, or omission, (ii) the error, inaccuracy, or omission was based on a reasonable belief that a material defect or other matter not disclosed had been corrected, or (iii) the error, inaccuracy, or omission was based on information provided by a public agency or by a licensed engineer, land surveyor, structural pest control operator, or by a contractor about matters within the scope of the contractor's occupation and the seller had no knowledge of the error, inaccuracy, or omission.
(b) The seller shall disclose material defects of which the seller has actual knowledge.
(c) The seller is not obligated by this Act to make any specific investigation or inquiry in an effort to complete the disclosure statement.

Sec. 30. Disclosure supplement. If, prior to closing, any seller has actual knowledge of an error, inaccuracy, or omission in any prior disclosure document after delivery of that disclosure document to a prospective buyer, that seller shall supplement the prior disclosure document with a written supplemental disclosure.

Sec. 40. Material defect. If a material defect is disclosed in the Residential Real Property Disclosure Report, after acceptance by the prospective buyer of an offer or counter offer made by a seller or after the execution of an offer made by a prospective buyer that is accepted by the seller for the conveyance of the residential real property, then the prospective buyer may, within 3 business days after receipt of that report by the prospective buyer, terminate the contract or other agreement without any liability or recourse except for the return to prospective buyer of all earnest money deposits or down payments paid by prospective buyer in the transaction. If a material defect is disclosed in a supplement to this disclosure document, the prospective buyer shall not have a right to terminate unless the material defect results from an error, inaccuracy, or omission of which the seller had actual knowledge at the time the prior disclosure document was the completed and signed by the seller. The right to terminate contract, however, shall no longer exist after the conveyance of the residential real property. For purposes of this Act the termination shall be deemed to be made when written notice of termination is personally delivered to at least one of the sellers identified in the contract or other agreement or when deposited, certified or registered mail, with the United States Postal Service, addressed to one of the sellers at the address indicated in the contract or agreement, or, if there is not an address contained therein, then at the address indicated for the residential real property on the report.

Sec. 45. This Act is not intended to limit or modify any obligation to disclose created by any other statute or that may exist in common law in order to avoid fraud, misrepresentation, or deceit in the transaction.

Sec. 50. Delivery of the Residential Real Property Disclosure Report provided by this Act shall be by:
(1) personal or facsimile delivery to the prospective buyer;
(2) depositing the report with the United States Postal Service, postage prepaid, first class mail, addressed to the prospective buyer at the address provided by the prospective buyer or indicated on the contract or other agreement; or
(3) depositing the report with an alternative delivery service such as Federal Express, UPS, or Airborne, delivery charges prepaid, addressed to the prospective buyer at the address provided by the prospective buyer or indicated on the contract or other agreement.

For purposes of this Act, delivery to one prospective buyer is deemed delivery to all prospective buyers. Delivery to an authorized individual acting on behalf of a prospective buyer constitutes delivery to all prospective buyers. Delivery of the report is effective upon receipt by the prospective buyer. Receipt may be acknowledged on the report, acknowledged in an agreement for the conveyance of the residential real property, or shown in any other verifiable manner.

Sec. 55. Violations and damages. If the seller fails or refuses to provide the disclosure document prior to the conveyance of the residential real property, the buyer shall have the right to terminate the contract. A person who knowingly violates or fails to perform any duty prescribed by any provision of this Act or who discloses any information on the Residential Real Property Disclosure Report that he knows to be false shall be liable in the amount of actual damages and court costs, and the court may award reasonable attorney fees incurred by the prevailing party.

Sec. 60. No action for violation of this Act may be commenced later than one year from the earlier of the date of possession, date of occupancy, or date of recording of an instrument of conveyance of the residential real property.

Sec. 65. A copy of this Act, excluding Section 35, must be printed on or as a part of the Residential Real Property Disclosure Report form.

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"Unknown" Defects

Obviously, a seller can't be expected to know about every potential latent defect. If an item on a disclosure form is unknown or unavailable, the seller must complete the form based on the best information available. In this instance, the seller would be obligated to note that the disclosure may be based on incomplete facts.

A seller is not obligated, however, to do any specific inspection or investigation to complete the form. For example, it's not necessary for a seller to hire a pest control expert to prove that there is no termite infestation behind walls or in subflooring. The seller simply has to truthfully indicate that, to the best of his knowledge, there's no evidence of current or previous infestation.

Real Success

If there is a change to the property's condition after a seller completes the seller disclosure statement, the seller is obligated to **update** the form. For example, let's say a buyer is preparing to make an offer, but first hires a home inspector, who finds some problems with the house. The buyer and seller negotiate about repairs, and can't come to an agreement. The buyer refuses to make an offer. Now, where does that leave the seller? The seller is now aware of new material defects as a result of the home inspection. If the seller refuses to fix those problems, he will have to disclose the known defects to all future buyers. The seller will likely be in position of choosing to either fix the problems for this buyer, for the next buyer, or adjust the asking price to account for the fact that defects need to be fixed.

Listing Agent Responsibility

You may ask yourself, "If the sellers have signed the state-mandated property disclosure form, what should I worry about?" There are two potential problems: Was the seller fully aware of a potential problem? Is the seller willing to honestly disclose the extent of a known problem?

These questions are pertinent to all property problems. As an agent, since you do share some liability with the seller, you need to take some responsibility, too. When you're on your first walk-through with a seller, in addition to obvious problems such as stains or cracks, you should be on the lookout for:

- Rotted trim wood at the base of the siding that appears to have scoring marks and powder residue.
- Peeling, chipped, and cracking paint in every room.
- A musty, mildew odor emanating from the basement.

In order to be liable, however, an agent must have **actual knowledge** of a material defect that was **not disclosed** to the buyer or be aware of any **misrepresentation** related to a material fact. As an agent, the law says you're responsible for three things: What you know, what you should know, and any positive statement that you make. What you know is obvious, if you know it, you know it. What you should know is determined by the court of law.

Material Facts

As you've seen, disclosure of property conditions is a basic tenet for all real estate professionals. Rarely does one find any argument over whether something is a defect and whether or not it should be disclosed. If an owner asks not to disclose a leaky roof, window, or basement, a licensee should feel comfortable saying, "Not an option. We must disclose this defect."

Determining what facts are **material** and **must be disclosed** may not be as straightforward as we would like to think, unfortunately. In real estate terms, material facts generally refer to the **condition of the property**. In its broadest definition, however, a material fact could also be considered a truth that would **change the individual's actions if it were known.** Material adverse information that is intentionally withheld is the classic definition of **fraud**.

Licensee Disclosure

Full disclosure of material adverse facts by a licensee to a buyer about the condition of the property being offered would **not** be grounds for disciplinary action even if a seller claimed that such disclosure violated their agency relationship and the fiduciary obligations of loyalty, obedience, or confidentiality.

For example, seller broker Bob tells buyer Brenda that the basement of the property being sold has had water damage twice in the past year, even though seller Stan had asked Bob to keep that information quiet. Although Bob went against his client's wishes, his disclosure of that material fact about the condition of the property would *not* get Bob in trouble. Note, however, that Bob is not necessarily protected from civil liability. Stan could try to sue Bob for breach of fiduciary duties if he wanted to, though he would be unlikely to win.

Nondisclosure

Nondisclosure is generally not an option. However, when dealing with someone purchasing or leasing property, a licensee **cannot** disclose that a former occupant has or is suspected of having a disability as defined by fair housing laws. For example, telling a potential buyer that the seller has AIDS or is HIV positive would constitute unlawful discrimination and would **not** be allowed.

Real estate professionals are sometimes challenged with various **stigmas** or other issues unrelated to the condition of the property that can affect the sale of real property. What if a defect is not considered material by the seller? If the home for sale was the site of a homicide nine months ago, is this something that needs to be disclosed? What if it is believed by many neighbors that the house is "haunted"? While a seller might argue that these are not issues that affect the value or usability of the home, a buyer might argue that they are indeed material issues.

Illinois law explicitly protects a real estate licensee who does not disclose whether a home has ever been the site of a murder, suicide, or other occurrence that, by law, has no material effect on the condition of the property. Of course, such information may be disclosed with the seller's consent.

If you ever have a question about whether or not information is material and should therefore be disclosed, you need to consult your managing broker and your client to ensure that you are meeting your fiduciary obligation to your client and your ethical duty to all parties in the transaction.

Other Property Disclosures

Sellers and agents have other federal and state-mandated property-related disclosure obligations in addition to the Residential Real Property Disclosure Report.

Radon

Radon gas, you should recall, is a naturally occurring radioactive gas that emanates from rocks, soil, and water because of the decay of uranium. Since it is radioactive, it has been identified as a cancer-causing agent. Radon enters a home from the ground, usually through cracks or holes in the foundation, but can also creep in from uncovered sump pumps and crawl spaces. Radon testing is becoming more common, and can trigger some sort of remediation. It is recommended that every house in a radon-prone zone have a radon test every two years.

Illinois Radon Awareness Act *420 ILCS 46/1*

The **Illinois Radon Awareness Act** became effective on January 1, 2008. This Act states that prior to entering into a residential real estate transaction, the **seller** is required to provide the prospective buyer with these two documents:

- A pamphlet entitled "*The Radon Testing Guidelines for Real Estate Transactions*," which is available from the Illinois Emergency Management Agency—Division of Nuclear Safety
- The Illinois Disclosure of Information on Radon Hazards form

The disclosure form includes a section for the **real estate agent to sign and initial**, acknowledging that the agent has properly **informed the seller** of these disclosure obligations under Illinois law. The Act does not require the seller to test for radon. If any of the disclosures required by the Illinois Radon Awareness Act occur *after* the buyer has made an offer to purchase the residential real property, the seller shall complete the required disclosure activities prior to accepting the buyer's offer and allow the buyer an opportunity to review the information and possibly amend the offer.

While new construction is *not* exempted, there are some real estate transactions that do not require a seller to provide this information, such as property transferred to a mortgagee through foreclosure, transfers between co-owners, spouses, or heirs, or condominium and cooperative units that are **three stories** or higher above ground level.

Mold

Mold is *a fungus that can grow anywhere and on any organic material.* In order to grow, mold requires moisture, oxygen, and a food source. Neither the federal Environmental Protection Agency (EPA) nor the Illinois Environmental Protection Agency (IEPA) specifically require mold disclosure or set standards to measure contamination. However, sellers in most residential real estate transactions in Illinois include a mold disclosure form with other required property disclosures.

Because agents are responsible for disclosing any latent defects of which they are aware, a thorough visual inspection of properties for the existence of mold may be advised. Look for signs of moisture that could indicate the likelihood of mold, such as:

- Plumbing leaks.
- Leaking roofs or windows.
- Strong, musty odors.
- Water stains on ceilings, walls, or floors.
- Warped wood.
- Cracked or peeling paint.
- Peeling dry-wall tape.
- Clogged gutters.

Case in Point

Licensee Ken has a buyer client, Amy, who is interested in Cliff's house. Cliff, who is not Ken's client, tells Ken that the house has never been flooded. Ken sees no signs of flood damage and tells Amy what Cliff said. Amy buys the house and when she removes the carpet and paneling while renovating the basement, she can see significant amounts of water damage that more than likely were the result of multiple floods.

Ken is not liable to Amy for the information he shared from seller Cliff if he had no reason to believe that Cliff was lying to him. But what if Ken knew before the house sold that it sits in a flood plain and that floods in that area of town are not uncommon. Might Ken be liable for telling buyer client Amy that the home had no flood damage? Should he have known that the information Cliff told him might be false? Could Ken's actions rise to the level of negligence? At the very least, Ken should have urged his buyer client to hire a qualified home inspector.

Let's say that Cliff had told his listing agent, Vera, that the house had been flooded, but that he had covered up all damage with carpet and paneling. He further directed Vera that this information was to be confidential. Was Vera obligated to disclose this information to buyer's agent Ken and his client Amy? Yes, she was. The flood damage could be considered a material fact that may have impacted buyer Amy's decision. Vera was obligated to share what she knew. However, is doing so, seller Cliff could not accuse her of breaching her statutory obligation of confidentiality to her client.

DISCLOSURE OF INFORMATION ON RADON HAZARDS
(For Residential Real Property Sales or Purchases)

Radon Warning Statement

Every buyer of any interest in residential real property is notified that the property may present exposure to dangerous levels of indoor radon gas that may place the occupants at risk of developing radon induced lung cancer. Radon, a Class-A human carcinogen, is the leading cause of lung cancer in nonsmokers and the second leading cause overall. The seller of any interest in residential real property is required to provide the buyer with any information on radon test results of the dwelling showing elevated levels of radon in the seller's possession.

The Illinois Emergency Management Agency (IEMA) strongly recommends ALL homebuyers have an indoor radon test performed prior to purchase or taking occupancy, and mitigated if elevated levels are found. Elevated radon concentrations can easily be reduced by a qualified, licensed radon mitigator.

Property Address: _____

Seller's Disclosure (initial each of the following which applies)

(a)_____ Elevated radon concentrations (above EPA or IEMA recommended Radon Action Level) are known to be present within the dwelling. (Explain)

(b) _____ Seller has provided the purchaser with all available records and reports pertaining to elevated radon concentrations within the dwelling.

(c)_____ Seller either has no knowledge of elevated radon concentrations in the dwelling or prior elevated radon concentrations have been mitigated or remediated.

(d) _____ Seller has no records or reports pertaining to elevated radon concentrations within the dwelling.

Purchaser's Acknowledgment (initial each of the following which applies)

(e)_____ Purchaser has received copies of all information listed above.

(f) _____ Purchaser has received the IEMA approved Radon Disclosure Pamphlet.

Agent's Acknowledgment (initial) (if applicable)

(g) _____ Agent has informed the seller of the seller's obligations under Illinois law.

Certification of Accuracy

The following parties have reviewed the information above and each party certifies, to the best of his or her knowledge, that the information he or she provided is true and accurate.

Seller _____ Seller _____
Printed Name *Printed Name*

Seller _____ Date _____ Seller _____ Date _____
Signature *Signature*

Buyer _____ Buyer _____
Printed Name *Printed Name*

Buyer _____ Date _____ Buyer _____ Date _____
Signature *Signature*

Agent _____ Agent _____
Printed Name *Printed Name*

Agent _____ Date _____ Agent _____ Date _____
Signature *Signature*

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REALTOR®

ILLINOIS ASSOCIATION OF REALTORS®

MOLD DISCLOSURE

EQUAL HOUSING OPPORTUNITY

Printed Name(s) of Seller(s) _____

Printed Name(s) of Buyer(s) _____

Property Address _____

1. **SELLER DISCLOSURE.** To the best of Seller's actual knowledge, Seller represents:

   a. The property described herein ❑ **has** ❑ **has not** been previously tested for molds, fungi, mildew and similar organisms ("molds");

Note: If answer to a. is "has not," then skip b. and c. and go to Section #2.
If answer to a. is "has," then complete b. and c.

   b. The molds found ❑ **were** ❑ **were not** identified as toxic or harmful molds;

   c. With regard to any molds that were found, measures ❑ **were** ❑ **were not** taken to remove those molds.

Buyers Initials

❑ ❑ 2. **MOLD INSPECTIONS.** Molds, fungi, mildew, and similar organisms may exist in the property of which the Seller is unaware and has no actual knowledge. These contaminant's generally grow in places where there is excessive moisture, such as where leakage may have occurred in roofs, pipes, walls, plan pots, or where there has been flooding. A professional home inspection may not disclose molds. Buyer may wish to obtain an inspection specifically for molds to more fully determine the condition of the Property and its environmental status. Neither Seller's agents nor Buyer's agents are experts in the field of mold. The Buyers are strongly encouraged to satisfy themselves as to the Property condition.

3. **RECEIPT OF COPY.** Seller and Buyer has read this Mold Disclosure and by their signatures hereon acknowledge receipt of a copy thereof.

Seller: _____ Date: _____

Seller: _____ Date: _____

Buyer: _____ Date: _____

Buyer: _____ Date: _____

Form 348 9/2003

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Lead Paint

The **Residential Lead-based Paint Hazard Reduction Act** or **Title X** requires sellers (or seller's agents) and landlords to disclose known lead paint hazards for homes built **before 1978.** A summary of Environmental Protection Agency (EPA) and Housing and Urban Development (HUD) regulations issued to implement these disclosures are:

1. Sellers and landlords must disclose any known lead-based paint hazard in homes and must give buyers and tenants any reports available from prior lead tests.
2. Sellers (or seller's agents) and landlords must give buyers and renters a pamphlet about how to protect families from lead in homes.
3. Home buyers have a 10-day period (or other mutually agreed on time) to conduct a lead paint inspection or risk assessment at their own expense.
4. Sellers, landlords, and real estate agents must include certain language in sales contracts and/or leasing agreements to ensure that disclosure and notification actually take place. This is included in most standard real estate contracts.

Compliance with Lead Paint Act

Sellers aren't required to remove lead paint, correct hazards, or do any testing. The contingency language in a purchase contract should explain what happens if lead paint or lead paint hazards are found. For example, the contract may allow a buyer or tenant to rescind the contract if unacceptable levels of lead are found, or a seller or landlord may have the right to remove the lead. Other times, lead hazards are negotiated (as a price reduction) like any other property defect or contingency.

Sellers and their agents do share responsibility for ensuring compliance with lead paint disclosure rules, however. The written disclosure and pamphlet must be given *prior* to a seller accepting a buyer's written offer to purchase.

You may choose to provide the lead-based paint disclosure, even if you're selling a house that's of newer construction. Although it's unlikely, consider this scenario: A homeowner cleans out his garage, finds an old can of paint and paints the window sills in his 20-year-old house with it. What if it happened to be old lead-based paint? Even though the house was built after 1978, it could have lead-based paint. If you provide the pamphlet and there's no lead-based paint in the home, there's no harm done. You have simply informed a consumer of the dangers of lead-based paint.

Distressed Properties

So-called "distressed properties" could include homes that are in foreclosure or pre-foreclosure, real estate owned (REO), or short sales. A **short sale**, or short payoff, is when ***a lender agrees to accept less than the loan balance when real property is sold.*** Many lenders require that the homeowner be several months behind in mortgage payments before considering a short sale, but others are willing to make a short sale to offset a potential loan default. One of the issues related to selling distressed property is that every stakeholder—the lender(s), loan servicer, lien holders, mortgage insurers, securities investors, and possibly others—must decide whether or not to approve the short sale. Since the time required to sell such a property is usually extended, most sellers will insist on including a short sales contingency with the purchase agreement that allows the seller to cancel without breach in case the stakeholders refuse the short sale or offer terms unacceptable to the seller.

While such a contingency would certainly serve notice to the potential buyer that the property was over-encumbered, selling distressed properties does raise some questions about a seller's obligations related to disclosure and confidentiality. Is a seller's agent obligated to disclose the status of the home with an underwater mortgage? Does such a disclosure breach the agent's duty of confidentiality or obedience to the seller client? The fact that the seller may not be able to go through with the sale if the lender did not agree to it could certainly be considered a **material adverse fact.** Therefore, a seller's agent ***may indeed*** be obligated to disclose this information with or without the tell-tale short sales contract contingency.

Short sales, as you can see, provide their own set of unique challenges. You should work with a broker who has experience with all of the issues inherent in these transactions and even advise your client to work with a short sales counselor.

Showing Property

If you're representing the seller, you should be familiar with the property before showing it. You may or may not be around when the property is shown, depending on the wishes of the seller and the buyer's agent, but you should **always make sure that the seller is not around when the property is being shown**. The seller can meet the buyers but then should make an excuse to leave. The seller needs to understand that he or she has hired you as the professional to deal with prospective buyers and cooperating brokers.

Whether you are working with the buyer directly or through a cooperating broker, you need to get an honest assessment of the buyer's intent and perception of the property. It is critical to get a clear understanding of the buyer's position in order to respond effectively to their concerns. If the seller remains on site during the showing, buyers tend to be reserved in their comments and questions in order to avoid offending the seller.

Regardless of whether the property is residential or commercial, it needs to be presented to the buyer in the best possible format. In simple terms "stage" the property. That means **well-lit** rooms and environments show off the features that make the property more desirable. In a residential environment this might include a fire burning in the fireplace, aromas emanating from the kitchen, a dishwasher free of dirty dishes, walk-in closets organized to show sufficient space, etc.

When possible, confirm with the seller prior to the showing that the space has been organized to remove as much clutter as possible. It's okay for the property to look lived in, but the space—including garages, basements and storage areas—shouldn't look cramped or messy. Also, furniture should be moved closer to the walls. Rooms look smaller with furniture in them, so this gives buyers a better perspective on how big the rooms really are. It's not necessary for the seller to paint something just to change the color to something more saleable (unless the wall needs paint anyway) because you never know what buyers will like.

Summary

1. Licensees have certain disclosure obligations related to the condition of the property they are contracted to sell. **Patent** defects are **plainly observable**. **Latent defects** are *not* plainly observable or would not be discovered in a reasonable inspection. A seller's agent **must always disclose latent physical defects** to buyers. **Material facts** generally refer to the condition of the property but could be any truth that would **change the individual's actions if it were known.** Material facts should be disclosed. Material information that is intentionally withheld is considered **fraud**.
2. While licensees do have certain disclosure obligations related to the physical condition of a property, **no cause of action** may arise against a licensee for the failure to disclose an occupant of the property was afflicted with Human Immunodeficiency Virus (HIV) or any other medical condition, the property was the site of an act or occurrence that had no effect on the physical condition of the property (for example, murder or suicide), fact situations on property that is not the subject of the transaction, or physical conditions located on property that is not the subject of the transaction that do not have a substantial adverse effect on the value of the property being sold.
3. **Lead** is a bluish-white metal added to exterior and interior paint as a drying agent and for pigmentation. The **Residential Lead-Based Paint Hazard Reduction Act,** or **Title X**, requires disclosure of known lead-based paint dangers. For houses built before **1978**, a lead paint brochure must be given to buyers and tenants; buyers must be given time to conduct lead tests if they desire.
4. **Radon** is a naturally occurring, odorless, colorless, and tasteless radioactive gas that emanates from rocks. Radon can build up to dangerous levels in homes due to inadequate ventilation; prolonged exposure to the gas can cause cancer. The **Illinois Radon Awareness Act**, which went into effect in 2008, requires sellers of **one to four units** to give buyers a copy of the "Radon Testing Guidelines for Real Estate Transactions" pamphlet as well as the Illinois Disclosure of Information on Radon Hazards.
5. **Mold** can have a serious impact on the value and health of a home. Lawsuits regarding mold issues have branched beyond builders and insurance companies to include sellers, brokers, management companies, and licensees. In Illinois, a **mold disclosure form** is typically included in real estate transactions, though it is not required.
6. A **short sale**, or short payoff, is when a lender and any other stakeholders in the loan agree to accept less than the loan balance when real property is sold. This can be a time-consuming process that includes many issues for real estate brokers to consider. There is no hard-and-fast rule regarding whether the condition of the sale is a material fact that must be disclosed. Cautious guidance from an experienced managing broker is critical.

Quiz

1. ***Your client Rob is selling his lakefront cottage. On one side of the property, Rob tells you, he discovered an old underground storage tank when doing some landscaping. He left it alone and planted ground cover in that part of the yard. What type of defect would this be considered, and is Rob required to disclose it?***
   a. latent defect; must disclose
   b. latent defect; not required to disclose
   c. patent defect; must disclose
   d. patent defect; not required to disclose

2. ***During a listing appointment, the sellers confide that their 15-year-old son accidentally hanged himself in his bedroom. The sellers instruct you not to tell any buyer about the accident. What should you do?***
   a. If you take the listing, you must include this information in the MLS entry as it is a material fact.
   b. If you take the listing, you must inform the sellers that if a buyer specifically asks, you must tell them about it.
   c. If you take the listing, you should assure the sellers that you will not disclose this information.
   d. You should refuse the listing since the sellers are asking you to do something illegal.

3. ***When is the Residential Real Property Condition Disclosure Report form usually completed?***
   a. when an appraiser provides an estimate of the property's value
   b. when a buyer submits an offer to purchase
   c. when a mortgage lender evaluates the property to secure a loan
   d. when the property is listed for sale

4. ***Which of these do you think would LEAST likely be considered a material fact?***
   a. loud neighbors
   b. nearby sewage treatment plant
   c. property taxes are going up 25% at the end of the year
   d. the well water is undrinkable

5. ***Jason is selling his50-year-old farm house. It has a full basement, a two-car garage, four bedrooms, and two full bathrooms. Which of the following is NOT a mandated seller disclosure?***
   a. Disclosure of Information on Radon Hazards
   b. Lead Paint Disclosure
   c. Residential Mold Disclosure
   d. Residential Real Property Disclosure Condition

6. ***The first thing you notice when you walk into a home on a listing appointment is a large section of the carpet that is torn up, revealing the subflooring. What is the basic rule regarding disclosure of such defects?***
   a. Disclosure of defects is the responsibility of the seller and not the seller's agent; most agents require the seller to sign a waiver attesting to this.
   b. Patent defects such as this are typically considered the responsibility of the buyer.
   c. Regardless of whether a defect is patent or latent, having an "as is" clause in the purchase agreement will protect the seller.
   d. The torn carpet is considered to be a latent defect and must be disclosed in the disclosure statement to avoid liability.

7. ***A seller instructs her listing broker NOT to disclose the old carpenter ant damage that she painted over. The broker must***
   a. file a complaint with the State Attorney General's office.
   b. follow all commands of the principal.
   c. not follow the instruction of the principal and consider voiding the listing.
   d. turn the seller in to the appropriate real estate licensing authorities.

8. ***Dave and Wanda are underwater with their mortgage. They have been negotiating with their lender to see if it will accept whatever they can get for the house on the open market to discharge their mortgage obligation. This is an example of***
   a. equitable redemption.
   b. foreclosure.
   c. loan modification.
   d. short sale

9. ***Broker Ellie takes a listing for Jay's large home with a big yard and in-ground pool. It's January and the pool is empty. Ellie doesn't think to ask Jay about the pool. After buyer John and Jay agree to terms, Jay reveals that an engineer told him when he drained the pool in August that the walls are close to caving in. The sales agreement is signed. What should you do?***

   a. At this point, it's too late to do anything because you would be interfering with a legal contract.
   b. You should just be quiet because you're only six days away from a huge commission.
   c. You should inform the buyer's agent of what you learned and let the buyer decide what to do.
   d. You should do nothing because Jay told you this in confidence.

10. ***Houses built before 1978 do NOT require a seller to***

   a. disclose known lead paint hazards to buyers.
   b. give buyers the opportunity to conduct their own lead paint inspections.
   c. give a lead paint booklet to buyers.
   d. mitigate any lead paint used on the property.

11. ***Who is required to complete the Residential Real Property Disclosure Report?***

   a. listing broker
   b. seller
   c. seller with guidance from the listing broker
   d. seller's attorney

12. ***You're representing Roger, who is selling his condo to Jessica. Due to a recent hail storm, the patio door off the kitchen has a huge crack. Because he doesn't want to spend the money to replace the door, Roger just put some duct tape on the crack to stabilize it. What type of defect would this be considered, and are you required to disclose it?***

   a. latent defect; must disclose
   b. latent defect; not required to disclose
   c. patent defect; must disclose
   d. patent defect; not required to disclose



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Marketing and Communication

By now, you should be rather familiar with the role that the real estate professional plays in the sale of property. As you know, seller's agents work in the seller's best interest, using their knowledge of the current real estate market to determine the asking price for the home. A buyer's agent previews and shows homes based on buyer wants and needs and is responsible for preparing an offer to purchase the home. When the offer on the home is presented, the seller's agent will review that with the seller, giving recommendations and helping to explain the offer. All of these steps can be facilitated with good communication. In this chapter, we'll review some requirements related to communicating the assets of the property and services you're promoting and at requirements for communicating offers to sellers. We'll also spend a little time looking at good communication skills in general. Knowing how to communicate effectively will give you a great advantage in recognizing and correcting problems that can arise from mistrust and miscommunication.

You will learn:

- Strategies for promoting property.
- Obligations for presenting offers.
- Tips for communicating effectively.
- Record-keeping requirements.

Key Terms

Blind Ad
Counteroffer
Meeting of the Minds
Multiple Listing Service
Offer
True Picture

Promoting the Property

One of the primary obligations for a listing broker in fulfilling the terms of the listing agreement is to promote the property for sale. Your methods for doing this are, as you know, **negotiable with the client** and should be included in the listing agreement. For example, you might:

- Place yard signs.
- List the property in the MLS.
- Hold open houses.
- Contract with cooperating brokers.
- Advertise in local media.
- List the property on Internet websites.

Remember that you're not only marketing the property to potential buyers, but to **other brokers** who might have a ready, willing, and able buyer.

Real Success

Before you begin promoting the property on behalf of the seller, make sure you explain to the seller, as their representative, you will be communicating specific facts and attributes of the property to prospective buyers. In doing so, you **may or may not be creating a dual agency**.

If you elect to communicate the attributes of the property to potential buyers as a clerical task on behalf of the seller, you are **not** undertaking any responsibility for the interests of that buyer. If, however, you do undertake a representation role with the buyer, the seller must be aware that if the buyer is not interested in the seller's property, you are permitted by law to show that buyer alternative properties without violating your agency responsibilities.

Permission to Promote

You might assume that if someone lists property for sale with you, he or she is giving you the implied authority to do whatever you can to find a ready, willing, and able buyer. That would typically involve the placement of a sign in the yard, an ad in the paper, an addition to a Multiple Listing Service, etc. But this is not the case. You may **not** advertise a property nor solicit for prospective buyers or tenants without the **express written consent** of the owner of the property.

Why would someone choose to skip the benefits of advertising?

Well, perhaps a couple is going through a divorce and they don't want their neighbors to know about it yet. A "For Sale" sign in the front yard can certainly lead to a lot of questions. Perhaps the property is in an exclusive neighborhood with very strict regulations that prohibit yard signs. There are a lot of reasons why a client may choose to limit the promotion of their property. You need to discuss this with the client and get permission in writing in the listing agreement before you do any solicitation.

Marketing Strategy

While most listing agreements will provide a broker the rights to undertake various marketing activities, it is important that you review with the seller exactly what marketing activities you intend to use on the seller's behalf. Although there is a sense of consistency with regards to marketing activities from listing to listing, take the time to review each activity and judge its effectiveness with regards to that specific property. For example, putting together a successful marketing strategy might involve include any of the following activities:

- Take photos of the property, interior and exterior
- Prepare details about the listing for inclusion in the MLS
- Update appropriate Internet websites
- Prepare signs
- Disseminate the listing information to cooperating brokers
- Disseminate listing information to current and past buyer clients and customers
- Prepare marketing presentation package for prospective buyers
- Design/write classified or other ads; determine content, size, placement, etc.
- Schedule, oversee ad placement
- Design and proof secondary marketing materials, for example, brochures, flyers, postcards, announcements, etc.
- Follow up on inquiries emanating from ad or sign placement
- Summarize comments, reactions from prospective buyers
- Plan a review of marketing strategies and re-frame the strategy if necessary

If the listing is for commercial property, a marketing strategy would likely involve additional tasks, for example:

- Obtaining income statement(s)
- Gathering a list of tangible assets of the building for use in the marketing campaign
- Confirming zoning restrictions and/or conditions
- Preparing financial reports
- Identifying competition and acquiring details
- Distributing marketing materials to a database of logical purchasers
- Acquiring names of purchasers of similar properties during previous 12 months
- Scheduling distribution times for back-up marketing material
- Executing a personal fax campaign to selected purchasers

Real Success

In your zest for finding potential home sellers—and buyers for those listings you win—don't neglect your legal obligations related to advertising. For example, you should recall that sponsored licensees cannot advertise under their own names. Advertising for property and services must be placed under the direct supervision of a sponsoring or designated managing broker and must include the sponsoring broker's business name. Otherwise, the ad could be considered an illegal blind advertisement.

Remember also that deceptive and misleading practices are prohibited by both state and federal law. Ads should present a true picture of the property or services and should not include—or omit—any information that could mislead a reasonable consumer.

Presenting Offers from Buyers

You've listed the house, you've marketed the house, and now there's a potential buyer who is making an offer. The first thing a seller is likely to ask when an agent calls to announce an offer is, "How much?" Presenting an offer over the telephone is not the best strategy if it can be avoided. It's best to meet with the seller to present the offer face to face so that you may:

- Explain the terms of the offer, including any contingencies related to the buyer's financial qualifications.
- Identify anything in the offer that could be problematic so that you continue to protect the seller's best interest by offering alternatives.
- Discuss settlement costs.
- Ask the seller to sign the offer if it's acceptable.
- Explain the next steps to the seller, including what it means to present a counteroffer.

Disclosure of All Offers

Remember that one of your fiduciary obligations is disclosure. We've looked at disclosure as it relates to agency disclosure and to seller disclosure, now let's review an agent's **fiduciary obligation to disclose all offers.**

Even if an offer seems unacceptable, the agent must present it to the seller client. The seller, not the agent, decides if an offer is acceptable. The agent must present an offer to the seller even if its acceptance would mean a smaller commission, because the agent's first loyalty is to the client. Of course, if the seller explicitly told his agent not to present any offers less than a certain base amount, the agent could legitimately not present a buyer's offer. In such a case, however, the listing broker should have the seller client put this direction **in writing as evidence of the authority granted to the listing broker** in order to avoid potential complications with prospective buyers who submit offers below the indicated base.

What happens if an offer comes in after a seller has accepted a previous offer? Does that fiduciary obligation to present all offers end once an offer is accepted? No, it does not, which is why your listing agreement may contain a clause that releases you from the legal requirement to present all offers under certain circumstances.

Real Success

One of the biggest problems facing both a buyer and seller is: Can they **trust** their agent? Or, better stated, how do they find an agent they can trust, who will give them the service they want and need, and who will give them the truthful facts so they can make an informed decision about the transaction? How do they find an agent who will put their needs above that of the agent's own? And how can they avoid getting involved with an agent who will pressure them to perform some task or accept some result they really don't want or that doesn't fit their needs, or that costs more than they want to pay? How can they avoid getting involved with an agent who will convince them to sell their home for less than fair market value?

Trust is something that can take time to establish but can be lost very quickly. It is the little things that add up. It starts with the very **first contact** with the customer. If you say you are going to do something, then do it, no matter how small. Show up on time or five to ten minutes early.

If you do not know something, say so. If you are not sure, make note of it and set a time and date to contact them to give them an answer. Then contact them at that time. You may only be able to let them know that you are still working on getting an answer. If that is the case, set another follow-up time and do the same again until you get the answer to their question.

Have all your business materials in order. That means being **organized**. Have all the disclosures and listing information in hand. Listen to what their needs are and take notes. Then repeat it back to them to confirm what you thought you heard. This is the start to developing trust with them.

Communication

Communication is defined as the **transfer of information** and its **comprehension** through the use of common symbols and language. Most people feel the words we use define how we communicate with each other, although words we use are actually just a small part of the communication process between people. This means that what is spoken to a client matters, but other forms of communication will send an unspoken message to the client about how you may feel about them, the property, or the situation. That perceived message may be true or untrue.

Activity Updates

Real estate is a team effort between you and your clients, and communication is the key to making the "team" successful. Your clients will expect to hear from you regularly, whether there is anything new to report or not! That is why documentation is so important. You can relay even the tiniest piece of information and, usually, clients will be appreciative of your effort.

You should regularly update clients on the market activity of their home, as well as information on competing homes. Also, communicate how you are marketing their home. Keep them informed regarding any broker open house you had, and the remarks or suggestions from other agents. Remind them of the need for other agents to help sell the home. After any public open houses you have, give them feedback on what, if anything, the customers said to you. Stay in touch with the agents showing the property and ask for their feedback from their buyers, and relate this to your owners.

Keeping your owners abreast of the market activities surrounding their home and any advice you feel is important to market the property better will only make you look and sound like the professional you are. Always listen before you speak, this way you will learn much more. There's an old adage in business: If you don't take care of your clients, someone else will. Maintaining regular scheduled communication with your client is part of your statutory obligation of reasonable care. Plan to contact each client at least once a week, at a day and time that is convenient for them. Schedule that in advance, and do not neglect it, even if you have nothing to report.

Keeping Marketing Materials Current

Another example of reasonable care that you owe to a seller client is making sure that you update all listing information for your client's property. For example, if the client lowers the asking price, make sure all of your advertising materials reflect that. If the property has been on the market for awhile, make sure that you update the photos in the MLS and on any Internet sites. It certainly does not present a home in the best light if the photo in the MLS shows the home with snow on the ground and it's now August. Not only does that indicate that the home has been on the market for a long time, but it is a clear indication of the agent's lack of reasonable care.

Electronic Communication

Technology can be both a blessing and a curse. Cell phones, text messaging, FAX machines, e-mail, social media, instant messaging. All of these tools can make communicating with co-workers and customers faster and easier. But we know, too, that technology can intrude into our own personal space. As a professional, you expend a great deal of energy in nurturing relationships with your clients, and the last thing that you would want to do is jeopardize that relationship by annoying them. Establish up front with your seller what level and means of communication they're most comfortable with.

Keeping Records

It's very important to keep good records of your communications with clients. A log of all activities should be kept from the time the relationship begins. For example, you should record:

- Conversations that occur on the phone,
- Copies of e-mails,
- Any forms used to determine the specifications,
- Records of appointments or cancellation of appointments, and
- Information provided regarding lenders, inspectors, and other professionals.

Good records illustrate the natural flow of events that lead to a real estate transaction. If there's ever a dispute, an agent with reliable records is better protected. A lack of detailed records may imply that the relationship was not maintained and perhaps statutory obligations were breached.



Remember: Illinois Real Estate License Law also requires a brokerage firm to maintain copies of all transaction records for **at least five years**.

Summary

1. Advertising must contain all information necessary to communicate to the public in a direct, accurate, and understandable manner; advertising cannot be "fraudulent, deceptive, inherently misleading, or proven to be misleading in practice;" **blind advertisements** may not be used by any licensee; a **broker's name** and **sponsoring broker's business name** must be in included on all advertising, including business cards; sponsored licensees cannot advertise under their own name; advertising must be placed under the **direct supervision** of a sponsoring or managing broker.
2. Offers should preferably be presented in person. Explain the terms of the offer, including any contingencies related to the buyer's financial qualifications. Identify anything in the offer that could be problematic so that you continue to protect the sellers' best interests by offering alternatives. Ask the sellers to sign the offer if it's acceptable to them. Explain the next steps to the sellers, including what it means to present a counter offer. **All offers** should be presented, even if the agent thinks it unacceptable.
3. Tips for gaining and keeping a client's trust include: Don't use high pressure sales tactics; demonstrate a willingness to perform your fiduciary obligations; follow through on promises; behave professionally in all situations; do your homework and be prepared; avoid double standards; don't become buddies with the client.
4. Communication guidelines include: Be aware of *how* you say things, not just what you say; recognize how your body language can send messages about attitude and attentiveness; provide the appropriate amount of information for the situation; address issues and concerns promptly; ask questions and follow up until everyone is clear on what's being communicated.

Quiz

1. ***Otis shows a property to his buyer client. Jan, the listing agent, calls Otis to ask for feedback. She asks, "Is the buyer interested in making an offer?" Otis tells Jan his client is still in the process of looking at other properties. Jan replies, "I can tell you, my seller is really desperate for an agreement." At this point, Jan is violating the duty of***
   a. confidentiality.
   b. disclosure.
   c. accounting.
   d. obedience.

2. ***Broker Bill, who represents a seller under an exclusive listing agreement, receives two offers for the seller's property at the same time: One from an agent in his office, and one from an agent of a cooperating broker. What should Bill do?***
   a. submit both offers at the same time, allowing the seller to make a decision after looking at all the facts
   b. submit the higher offer first; if it is not acceptable, look at the other one
   c. submit the offer from his agent first, and let the seller decide on it before looking at the other offer
   d. submit the offer from the cooperating agent first, and let the seller decide on it before looking at the other offer

3. ***If the seller changes the terms proposed by the buyer in the sales contract, he creates a(n)***
   a. alternative offer.
   b. counteroffer.
   c. modification agreement.
   d. notification of acceptance.

4. ***You and your seller client Homer are reviewing an offer to purchase. What are you, as the sellers' designated agent, permitted to do to the document directly?***
   a. fill in the commission amount that the prospective buyer left blank
   b. change language in the pre-printed contract because Homer was unsure about what it meant
   c. sign the document on behalf of Homer and return the original to the buyer and give Homer a photocopy
   d. strike out the offer price and write in Homer's counteroffer at his direction

5. ***Broker Sam takes an exclusive right to sell listing on a home, even though he thinks the seller's asking price was too high. Later, he urges the seller to adjust the listing price, but to no avail. Just as the listing is about to expire, Sam advertises the property at a price below the listing and immediately receives an offer, which the seller accepts. Sam's action***
   a. constitutes a breach of the agency agreement.
   b. is an acceptable practice.
   c. proves the listing price was too high all along.
   d. would be acceptable, since the seller signed and accepted the offer.

6. ***Patricia contracts with broker Ben to market her house through the Multiple Listing Service only. Ben has found great success selling homes in Patricia's neighborhood by placing ads with photos in the local weekly newspaper. The following Thursday, Patricia was surprised to open her paper and see a photo of her house. What authority, if any, did Ben have to publish a photo of Patricia's home?***
   a. absolute authority
   b. express authority
   c. implied authority
   d. He did not have authority to publish the photo.

7. ***Your buyers, the Johnsons, are late for an appointment to view a property for sale. What should you do?***
   a. show them other properties as they are clearly not interested in this home
   b. listen to what they say when they show up; then determine what to do
   c. wait 10 minutes, then leave
   d. tell them that if they cannot be on time, you cannot work with them

8. ***Harold Beech is the owner of High Flying Realty in Evanston. His mother wants him to list her home in Springfield. Since the Beech name is familiar in his old neighborhood, Harold decides he might have better luck if he advertises the home under the name Beech Realty. Can he do this?***
   a. Yes he can, as long as he doesn't accept commission.
   b. Yes he can, as long as the sign says "broker-owned."
   c. No, Harold cannot practice outside of High Flying's geographic market territory.
   d. No, he must advertise under the name High Flying Realty.



UNIT 11

BUYER RELATIONSHIPS AND COUNSELING

Chapter 34 – The Buyer's Agent

Chapter 35 – Qualifying the Buyer

Chapter 36 – The Buying Process



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The Buyer's Agent

For many years in the real estate industry, the concept of agency representation was reserved for sellers, and buyers were left to fend for themselves. Even when a buyer contacted a broker to assist with finding a home, the buyer's interests were likely not represented. This fact may not have been clear to the buyer, who probably assumed that the broker they contacted represented them. All that has changed in today's real estate environment. In this chapter, we'll look at the obligations and issues related to being a buyer's agent, including the way in which such an agency relationship is created and how a buyer's agent may be compensated. We'll also review the important topic of dual agency.

You will learn:

- Agency disclosure obligations.
- Statutory duties owed to a buyer client.
- The purpose and content of a buyer brokerage agreement.
- Ways in which a buyer's agent is compensated.

Key Terms

Buyer Brokerage Agreement
Client
Compensation
Contemporaneous Offers
Customer
Designated Agent
Dual Agency
Informed Consent
Meeting of the Minds
Non-Agency

Implied Concept of Representation

When a buyer consumer first contacts a broker to assist in the purchase of a home, the buyer may initially be looking for someone who can simply open the door and show them a house in which they are interested. Most brokers today can see the advantages in providing specific representation to buyers, however, and buyer's agency is more and more common. As a matter of fact, licensed real estate brokers in the State of Illinois work under what could be called the "implied" concept of agency representation.

Article 15-Agency Relationships of the Illinois Real Estate License Act indicates that licensees are ***"... considered to be representing the consumer they are working with as a designated agent..."*** In simple terms: You represent the person whom you are counseling. That being the case, once buyers approach you and ask you to give them insight about available properties within the market that meet their expectations, they may consider you to be their agent of record even though no specific words or contracts were used to create the relationship.

Agency Disclosure

Because of the presumption of agency in Illinois, it's critical that licensees be very clear when first meeting with consumers about the available options for agency representation. Potential buyers must be made aware who a licensee represents **before** they might make comments about the property or about their financial situation that could be considered confidential information. Licensees must explain that if a buyer chooses not to enter into a contractual relationship, the agent cannot offer guidance and recommendations in negotiating the purchase of property. Without an agency agreement, a licensee will simply play an administrative role, performing clerical tasks only. To protect yourself and to avoid misinterpretation in the future, it is wise to obtain a signed **non-agency disclosure** if the buyer chooses not to sign an agency agreement.

Statutory Duties to a Buyer Client

225 ILCS 454/15-15

Obviously, buyer's agents owe **all fiduciary duties to the buyer** in a real estate transaction. When representing a buyer in a written agency relationship, the licensee must acknowledge and perform the same level of service on behalf of the buyer as they would on behalf of the seller. In fact, when representing a buyer, buyer's agents should perform this task as diligently as if they themselves were personally buying the property.

Section 15-15 of the Illinois Real Estate License Act requires a licensee acting under an agency relationship to faithfully undertake the duties and obligations established under the terms of the representation agreement:

- Promote the best interest of the client by **seeking a transaction** at the price and terms acceptable to the client.
- Present all offers, counteroffers, and other forms of communications in developing a contract **in a timely manner** to protect and preserve the best interests of the client.
- **Disclose material facts** concerning the transaction and the property about which you may have actual knowledge. This is common sense. Remember you are working in the best interests of the buyer, so any knowledge you acquire that can affect his negotiating position must be conveyed to him in a timely manner.
- **Account** for all money and property placed in your possession in a timely manner. This may be funds for a down payment, for example, or there may be instances when a buyer provides you with documentation of a personal nature, such as a divorce decree, that you must safeguard.
- **Obey** the specific directions of your client that are not otherwise contrary to applicable statutes, ordinances, or rules.
- Act in a manner consistent with promoting the client's **best interests**. The first obligation in the fiduciary relationship is that of "care." This is a simple concept that mandates you care for the interest of your client **above and beyond your own**.

- Keep confidential all **confidential information** received from the client. Although you many have a fiduciary obligation to your client, confidential information acquired about your client or another party must remain confidential. If the information was acquired directly from the person it affects, and that information may have an adverse impact on that person's negotiating position, it is to be considered confidential. If the information is provided to you from a third party source without any indication it is considered confidential, then you have an obligation to communicate that information to your client to enhance his negotiating position.
- **Comply** with all federal, state, and local requirements, applicable statutes and regulations, including, without limitation, **fair housing and civil rights** statutes.

These duties will be visited in more detail throughout this unit on buyer relationships.

Representing Multiple Buyers

There are instances where you may represent multiple buyers simultaneously. Are you negligent if, while representing multiple buyers, you present the same property to all parties? A licensee representing a client does not breach a duty or obligation to the client by showing properties in which the client is interested to other prospective buyers or tenants. There is an obligation, however, that if you are representing the interests of multiple buyers on a single parcel of land, you will advise all the parties in writing of your situation, as it could be considered a conflict of interest. When handling such contemporaneous offers, you must consider your obligation to each of your buyer clients if asked by the listing broker to present multiple offers and explain the differences and assets that each presents.

Buyer Brokerage Agreement

An agency relationship between a buyer and a licensee in a real estate transaction can be created with a document such as a **buyer brokerage agreement**. Such a contract—which may also be called a buyer agency agreement, a buyer relationship agreement, or a buyer listing, among other things—is a written agency contract between a real estate buyer and a **sponsoring broker** stipulating the sponsoring broker will be **paid compensation** for services, typically when the buyer purchases real estate and the transaction closes. This "employment contract" primarily does two things:

- Grants the designated broker the right to represent the buyer in the purchase or lease of property.
- Makes the buyer responsible for seeing that the sponsoring broker is compensated.

This contract could take many forms. Your sponsoring broker may have created a basic form or might use a standard form from a local board of REALTORS®. If your sponsoring broker accepts buyer clients, make sure that you familiarize yourself with the form in use.

Open for Discussion

Mark and Sarah, a young couple looking to acquire their first home, have come into your office seeking information about available properties. After having obtained the specifics of what they're looking for, you offer them an opportunity to enter into a buyer representation agreement. They seemed a little confused and indicate that last real estate agent they spoke with did not ask them to sign any sort of contract. ***As a licensee, what would you say to Mark and Sarah to convince them to sign a buyer representation agreement? What obligations, if any, would you have to Mark and Sarah if they choose to decline agency representation?***

Exclusive and Open Agency Agreements

Just as there are two types of exclusive listing agreement with sellers, an **exclusive buyer brokerage agreement** may provide for compensation to the sponsoring broker if the buyer acquires a property through the efforts of:

- The buyer's designated broker or any other real estate brokerage.
- The buyer's designated broker, any other real estate brokerage, or any other third party.

An exclusive buyer brokerage agreement **must be in writing**.

A **non-exclusive buyer agency agreement** or **open buyer agency agreement** is one in which *a sponsoring broker is paid compensation only if the buyer's designated broker is the agent who introduces the buyer to the property he or she purchases.*

Sample buyer agency agreements may be found in Chapter 15: Brokerage Agreements.

Required Elements Review

To review, all written buyer brokerage agreements, whether exclusive or non-exclusive, must contain the following elements:

- The agreed basis or amount of **compensation** and time of payment
- The **duration** of the buyer brokerage agreement clearly set forth (automatic renewals are prohibited)
- The **names** of the sponsoring broker, the designated agent, and the buyer client(s)
- The **signatures** of the buyer(s) and an authorized signator on behalf of the sponsoring broker
- The **minimum services** of the buyer's broker

Failure to include language in a brokerage agreement providing for **minimum services** as defined or language in the brokerage agreement **waiving** those minimum services will result in the brokerage being considered to be **non-exclusive**. Since disclosure of the potential for **dual agency** is required in Illinois, buyer brokerage agreements may also contain this disclosure, or it may be disclosed in a separate document.

Real Success

The buyer's incentive to sign a buyer brokerage agreement generally is to have someone dedicated to finding a qualifying property and to protecting the buyer's interests throughout the purchase process. Still, some buyers must be convinced of the value of signing a contract for buyer representation. Since compensation has traditionally been the responsibility of the person *selling* a house, buyers may not be on board with the idea that *they* should compensate a broker.

As a buyer's agent, you should not feel uncomfortable about establishing the value that you, as a professional, bring to the transaction. Think about it: If you went to work for someone on a salary basis, would you go to work every day not knowing what you're getting paid? Who would work for six weeks and then ask, "Gee, I haven't gotten a paycheck yet; wonder what I'm going to make for all my hard work?" Working as a buyer's agent is not a volunteer job, and you have a right to establish what you're worth.

What if a buyer simply does not want to sign a buyer brokerage agreement? You can remind her that you owe the duty of confidentiality only to those with whom you have a signed agency relationship. If she is going to reveal financial information and other confidential information to you, you can share that with the seller. Unless she is your client, you are not obligated to act in her best interest when it comes to negotiating the terms of purchase agreement.

Compensation for Buyer's Agents

A signed buyer brokerage agreement provides that the sponsoring broker will be compensated in accordance with the terms specified. It is critical to note that the fee must be **negotiated** between the buyer and the broker. It could be a flat fee, a percentage of the sales price, or any other form of compensation agreed to by the buyer and the broker.

A buyer who is contractually obligated to pay compensation could negotiate to have the seller pay all or a portion of compensation owed by the buyer to the buyer agent's sponsoring broker. For example, the buyer brokerage agreement might state that the buyer will get a credit for any commission received by the buyer's sponsoring broker from the seller through an MLS **offer of compensation**. If the buyer agreed to pay the buyer's agent 4%, and the listing broker agrees to pay 3% to a buyer's agent, the buyer would be obligated to pay only the 1% difference.

Caution: It's important to note, however, that such a clause in the agreement does **not** create an agency relationship between the buyer and the listing agent, nor does it create a subagency relationship between the listing agent and the buyer's sponsoring broker.

Open for Discussion

Frank is a designated buyer's agent, and he has a contract with client Gail indicating that she will pay 3% of the sales price for finding her the house of her dreams and negotiating good terms.

Do you think that Frank is required to disclose his commission from Gail to the listing agent?

What if the listing broker offers a commission split to a buyer's agent. Would Frank be obligated to disclose that to his client Gail?

Let's say Gail falls in love with a house, but the listing broker is not offering a commission split. What are Gail's options?

Timing of Compensation

Payment of a broker's compensation may be dependent on any lawful condition. A buyer brokerage agreement may specify that compensation is due when the buyer makes an offer, or only when the seller accepts the offer, or only when the transaction closes. If the compensation is paid by the seller, the listing agreement between the seller and the listing broker may specify when the compensation is due. Of course, when the seller is paying, this is a negotiable point in the listing agreement between the seller and the listing broker. Unless otherwise agreed, however, the traditional consensus is that a buyer's broker is entitled to compensation when an appropriate property is found and a **meeting of the minds** between the buyer and the seller on the terms has occurred.

Open for Discussion

Mike has a signed exclusive buyer brokerage agreement with Nan. After showing Nan one house, he leaves on vacation. Frustrated, Nan calls another agency and finds Joy. Joy shows her several houses, helps with pre-qualifying, and submits the offer, which the seller accepts. The day before closing, Mike returns and pulls out his signed contract, claiming the commission. ***What are some of the issues to consider with this scenario?***

Dual Agency Review

What happens when your buyer client shows an interest in a property you have personally listed? By now, you should know that Illinois law allows for real estate licensees to act in the capacity of a **dual agent**, that is, represent both parties to a transaction simultaneously with **informed written consent of both parties**. Before you enter into a dual agency role, you need to ensure that both your buyer and seller clients are fully aware of the implications and complications inherent in dual agency. You must acknowledge, for example, that in a dual agency situation, the buyer and seller would receive **administrative services** and that you would be prevented from providing any consultation or recommendation as to the position each should take in negotiating the transaction.

Open for Discussion

You are the listing broker for Dan's house. Your buyer client, Megan, expresses an interest in his house. Although they acknowledged the possibility of dual agency when they signed their agency contracts, you sit down with both Dan and Megan separately and again discuss the implications of dual agency. According to Section 15-45 of the Illinois Real Estate License Act, there are five specific things that you cannot disclose to either Dan or Megan as negotiations for this transaction proceed. ***What are they? What can you do for Dan and Megan as a dual agent? How many of the nine permissible activities can you name?***

Required Consent

In order to legally act in the role of dual agent, recall that you need to obtain **three specific written evidences** of the buyer's and seller's consent.

1. First, both buyer and seller must sign a document that establishes they understand the role you would undertake as a dual agent. This consent to dual agency must be executed **before either party inadvertently provides you with confidential information** that you would be legally obligated to reveal to the other party. At this point, however, this is simply an acknowledgment of the **possibility** that a dual agency situation could arise and that the clients understand its implications. This initial consent is generally obtained in the **agency agreement**—the seller's listing agreement and the buyer brokerage agreement.

2. When a dual agency situation does occur, you must have a separate written authorization from both buyer and seller, again acknowledging that they understand the nature of dual agency and have **granted consent** for you to act in a dual agent capacity.
3. Finally, there needs to be **reaffirmation of consent to dual agency** by both buyer and seller as a part of the **sales contract**.

While standard residential forms provide for all three levels of consent, commercial forms are typically created as needed. If the forms used by your brokerage do not cover all three levels of consent, it may be necessary to require buyers and sellers to execute additional documentation to establish your right to dual agency.

Open for Discussion

What happens if your buyer client denies consent for you to undertake the role of dual agent? Let's continue the previous scenario. Let's say that client Megan is a nervous first-time home buyer and she is really counting on your help and experience to guide her through the negotiation process. She is uncomfortable with the whole back and forth of offer and counteroffer, and she wants to be sure that she's not over-paying for Dan's property. Bottom line: She changes her mind and refuses to sign the consent to dual agency because she's afraid of making a mistake. This poses a very interesting dilemma. Your relationship with buyer Megan is certainly at risk. Without her informed written consent, you cannot act as a dual agent in this transaction—even if Dan agrees to dual agency—so you need to make a decision regarding representation. ***Do you terminate your relationship with seller Dan so that you can continue to represent Megan? Or do you terminate your relationship with Megan and continue to represent Dan? What factors should you consider, and what complications could arise when determining how to handle this situation?***

Summary

1. **Article 15** of the Illinois Real Estate License Act indicates that licensees are considered to be designated agents of the consumer they are working with unless, after disclosure of agency relationships, another form of relationship or non-relationship is agreed to. **Disclosure of an agency relationship** by the agent should be provided at the **first substantive contact** before any confidential information is shared. The agency disclosure may be made as part of a brokerage agreement or may be made in a separate document. This provides affirmation that the agency relationship was disclosed to the consumer and that informed consent of the party for a specific relationship has been given.
2. When a licensee is **not performing the minimum services** required under an exclusive brokerage agreement and is, therefore, not acting as the customer's agent, that licensee must disclose this fact **in writing** to the customer. This situation is referred to as **non-agency**. Signing a non-agency disclosure does not create an agency relationship.
3. A buyer's broker in Illinois owes the following **statutory duties** to his or her buyer clients: Promote the buyer's best interests, which includes seeking acceptable terms; timely presentation of offers; disclosure of material facts; accounting; obedience; loyalty; reasonable skill; confidentiality (which survives the termination of agency); and following the law.
4. A licensee representing a buyer client does **not** breach a duty by showing properties in which the client is interested to other prospective buyers. If multiple offers are to be considered by the seller simultaneously, the broker must present a notice of contemporaneous offers to both buyers and allow them to decide how to proceed with representation.
5. A **buyer brokerage agreement** is considered an employment contract and creates an agency relationship. These contracts can be exclusive or non-exclusive. Exclusive contracts **must be in writing** and must list the **minimum services** related to offers, counteroffers, notices, and contingencies. The fee for a buyer's broker must be **negotiated** between the buyer and the broker. Buyer's brokers may be compensated as a result of the listing broker's offer of compensation. A broker's buyer client would be required to make up the difference. A buyer's broker is generally entitled to compensation when an appropriate property is found and a **meeting of the minds** between the buyer and the seller on the terms has occurred.
6. **Dual agency** is a situation where the buyer and the seller in the same real estate transaction are both clients of the same designated agent. Both parties in the transaction must consent to the dual agency, in writing, and acknowledge that they understand that certain duties in the relationship cannot be delivered. When a brokerage allows dual agency, that fact must be disclosed to the client at the time the brokerage agreement is entered into even if a dual agency situation does not yet exist. Written confirmation of **prior consent** for dual agency must be obtained before entering into any offer or contract.

Quiz

1. ***During a family gathering, your brother-in-law mentions a desire to see a property that you personally have listed. You make arrangements to show him the property. Which statement is FALSE?***
   a. You must have him sign a dual agency disclosure and consent prior to showing him the property.
   b. Since you listed the property before your brother-in-law inquired about it, you cannot represent him because it's too late to disclose the family relationship to your seller.
   c. You can represent him and the seller with proper disclosure, but your relationship may create an ethical issue that could jeopardize your relationship with the seller.
   d. You must get a signed consent to dual agency from your seller client before showing the property.

2. ***Paul has a buyer brokerage agreement with Mary, who agreed to pay him 2.5% commission for finding her a house. He showed her 16 different houses, but when she settled on the one she wanted, she submitted her offer directly to the listing agent, bypassing Paul to avoid paying his commission. What is Paul's best recourse?***
   a. record a lien against Mary's property
   b. submit to an arbitration hearing with the local board of REALTORS®
   c. sue the listing agent for his 2.5% of the sales price
   d. sue Mary for breach of contract

3. ***Lucy went to listing agent Jake's open house, where she signed a non-agency disclosure form. What duty does Jake owe to buyer Lucy?***
   a. honesty
   b. loyalty
   c. obedience
   d. none, he is not her agent

4. ***Agent Sally executes a buyer brokerage agreement with buyer Brad. Sally reads an ad placed by an FSBO seller, offering 3.5% commission to the broker who brings the buyer. What is the seller considered to be to Sally if Brad makes an offer on the house?***
   a. agent
   b. client
   c. customer
   d. principal

5. ***What should be the first thing an agent discusses with a potential buyer client?***
   a. agency disclosure
   b. amount of money the buyer has to spend
   c. neighborhoods the buyer is interested in
   d. number of bedrooms the buyer needs

6. ***The listing agreement provides that the listing broker may offer cooperating fees to area brokers to assist in finding buyers willing to purchase the seller's property. A buyer's agent accepts this offer on behalf of his client. In this case, the cooperating broker represents the***
   a. buyer.
   b. buyer and the seller.
   c. listing broker.
   d. seller.

7. ***Lisa has a buyer brokerage agreement with Doug. In that contract, Lisa agrees to compensate Doug 3% of the sales price for his services if the seller refuses to do so. She finds a home she likes and makes an offer. The listing broker indicates that 3.5% of the sales price will be paid to a buyer's broker at closing. How much will Lisa owe Doug?***
   a. 3%
   b. 3.5%
   c. 6.5%
   d. nothing

8. ***Buyer Ray contracts with agent Debra, guaranteeing Debra's sponsoring broker will receive a 3% commission for finding him a house, regardless of who pays. Debra finds a house, and the MLS indicates that the listing agent will pay 2% of the sales price to a buyer's agent. How much will Debra's sponsoring broker earn?***
   a. 2% from the seller and nothing from the buyer
   b. 2% from the seller and 1% from the buyer
   c. 2% from the seller and 3% from the buyer
   d. 3% from the buyer and nothing from the seller

9. ***Patrick's home is listed for sale on the MLS by listing broker Abe. There is no mention of compensation due a buyer's broker. Buyer's broker Jane has a client who is interested in Patrick's home and presents an offer, which Patrick accepts. Patrick is paying 7% commission. How much of the commission must Patrick pay Jane's sponsoring broker?***

    a. 7%
    b. 3.5%
    c. nothing
    d. impossible to tell

10. ***Lester lists his house with Jessica of Top Realty, offering 3% of the 7% commission to any broker who brings him a ready, willing, and able buyer. Broker Kevin, who works for Ace Realty, is a buyer's broker for Lisa. Lisa makes a successful offer for Lester's house. Once the transaction is complete, how will Kevin receive his earned commission?***

    a. Lester pays Ace Realty, who pays Kevin.
    b. Lester pays Kevin directly.
    c. Lester pays listing broker Jessica, who pays Kevin.
    d. Lester pays Top Realty, who pays Ace Realty, who pays Kevin.

11. ***You are a dual agent in a real estate transaction. What are you NOT allowed to share with your clients?***

    a. closing costs that each should expect to pay
    b. real estate terms
    c. recommended offer price
    d. sale prices of comparable properties

12. ***Your colleague at Ace Realty asks you to sit an open house for his listing for an hour because his car broke down. Buyer Susan comes in and wants to look at the property. You must tell her that you***

    a. can represent her as a designated buyer's agent.
    b. cannot show her the property since you are not the listing agent.
    c. represent the seller as his designated agent.
    d. will be acting in the capacity of a dual agent.



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Qualifying The Buyer

When you first meet a potential buyer, it's okay to have a bit of healthy uncertainty as to whether or not they are serious. Remember the three components necessary for a successful real estate transaction: Someone who is **ready** to buy, **willing** to buy, and **able** to buy. Before you spend precious time and energy researching and showing property, you need to spend an adequate amount of time qualifying the prospect. Such qualification typically occurs on three levels: Emotional (ready to buy), needs and wants (willing to buy), and financial (able to buy). In this chapter, we'll look at each of these. Finally, we'll conclude with a quick look at the tax benefits of home ownership.

You will learn:

- The difference between pre-qualification and pre-approval.
- How to calculate the maximum monthly mortgage payment a buyer can afford.
- Critical questions to ask prospects to determine their wants and needs.
- How to listen and communicate effectively.
- Strategies for finding and showing properties.
- The tax benefits and deductions available to residential real estate owners.

Key Terms

Appraisal
Conventional Loan
Credit History
Credit Scoring
Debt
Debt-to-Income Ratio
Housing Expense Ratio
Income
Loan-to-Value Ratio
Mortgage
Multiple Listing Service
PITI
Pre-Approval
Pre-Qualification

Financial Qualifying Review

It is assumed that buyers know what they can afford and what sort of loan they might be able to qualify for. Unfortunately, many brokers discover—after showing properties, purchasing meals, and spending inordinate amounts of time—that the buyer's debt is too high or the buyer wants to look at property that is out of range for what they can really afford.

Pre-Qualification or Pre-Approval

Pre-qualification is *the process of pre-determining how much a buyer **might** be eligible to borrow.* It looks at factors such as the buyer's income, available cash for down payment, as well as their housing requirements and desires. Pre-qualification may be done by a real estate broker or a mortgage broker. It does *not* guarantee approval and it is *not* binding on the lender.

Pre-approval, on the other hand, is *the process by which a lender determines if potential borrowers can be financed through the lender, and for what amount of money.* The lender is rendering a credit decision. A real estate broker or mortgage broker *cannot* pre-approve a borrower. Getting a pre-approval is critical not only because it is a powerful negotiating tool, but, in most cases, it is a requirement of contract acceptance.

Consulting with an MLO

Recall that your duty as an agent is to present a buyer who is ready to buy, willing to buy, and **able to buy**. If your buyer client has not already contacted a mortgage loan originator (MLO), you should advise him to do so early in the process. While a real estate agent can theoretically judge the buyer's financial capability to some degree, the complexity of the financial climate today demands that you **care for the interest of your clients** by ensuring they have access to various professionals to assist them in purchasing real estate. The financial insights gained by your client from consulting with a loan originator will save you time and money when researching appropriate property and, subsequently, by allowing you to focus on and show only properties that are within the range of what the buyer is financially able to afford. Also, since your right to compensation is directly tied to the purchaser's ability to fulfill the purchase contract, financial qualification is critical.

Appraisals and Loan-to-Value

Financial institutions are profit oriented institutions. Their incentive to grant mortgage loans is predicated on their need to earn a profit. In order to protect its interest, a lender presumes that if borrower defaults on the loan and it's necessary to initiate a foreclosure proceeding, the property is worth at least the amount of the outstanding loan balance. Before loaning money to purchase real estate, a lender will require a qualified **appraiser** to provide an **objective opinion of value**.

Conventional loan programs are classified by the **percentage of down payment** the borrower pays to get the loan. The **loan-to-value ratio** (LTV), then, refers to *the amount of money borrowed (the loan amount of a first mortgage) compared to the value of the property.* Lenders use LTV to determine how much they are willing to loan on a given property based on its value, using the *lesser* of the appraised value or the sales price in order to protect its interest. The lower the LTV, the higher the borrower's down payment, which means the loan is more secure.

Credit History

The first step in helping your buyers evaluate their potential buying power is typically to pull a **credit report**. A credit report provides a snapshot of the borrower's **credit history**, including the numbers and types of open accounts, outstanding balances, history of repayment, and other potential risk factors such as late payments, bankruptcy, foreclosure, judgments, etc. A strong indicator of a potential borrower's creditworthiness is his or her **credit score**, the *numeric representation of the borrower's credit profile compiled by assigning specified numerical values to different aspects of the borrower's credit history*.

Caution: A real estate broker should obtain **written permission** from the buyer client before pulling a credit report for that buyer.

Income, Assets, and Debts Review

The primary factors that a lender considers about a borrower's ability to meet the obligations of a mortgage are the borrower's income, assets, and debts.

Stable Monthly Income. *Monthly income that can reasonably be expected to continue in the future*, is generally meant to include the gross base income of the borrower(s) from primary jobs. A **quality** source of income is one that is *reasonably reliable,* such as income from an established employer, government agency, interest-yielding investment account, etc. Self-employment income generally requires two years of income tax returns for verification. A **durable** source of income can be *expected to continue for a sustained period*. Predictable earnings from acceptable secondary sources—such as part-time jobs, regular bonuses, consistent overtime, stock dividends, interest income, alimony, or child support—are considered if a lender's thorough analysis determines they can be substantiated and are durable. Remember that the federal **Equal Credit Opportunity Act** prohibits lenders from discriminating on the *source* of a borrower's income.

Assets. *Items of value*. The lender will want to verify the nature and value of assets held by a borrower to determine if the borrower has sufficient liquid assets to make the **cash down payment** and pay the closing costs and other expenses incidental to the purchase of the property. The source of the down payment is also important. A legitimate **gift** is acceptable if it can be shown (usually with a **gift letter**) that the borrower does not have to repay it, while **borrowed funds** are generally **not** acceptable. A lender also wants to see that the borrower has sufficient assets in **reserve** (generally at least two months of PITI) to handle emergencies.

Debts. *Financial obligations owed by a borrower.* Generally, a lender considers as debt any recurring monetary obligations that will not be canceled, plus any installment debts with 10 or more payments left. If there are student loans currently in deferment, these need to be calculated as debt regardless of how soon the loans will be repaid.

Housing Allowance

When qualifying a borrower for a mortgage, the lender must know the anticipated cost of ownership. This so-called **housing allowance** is actually comprised of different components that contribute to a borrower's monthly payment:

- **Principal.** That portion of each monthly payment used to reduce the original amount borrowed from the lender.
- **Interest.** The profit the lender is entitled to by allowing the buyer use their money to purchase real estate.
- **Taxes.** Since property taxes are generally paid first in the event of foreclosure, lenders frequently require borrowers to put 1/12 of the annual tax bill into an escrow account every month to protect their lien interests.
- **Insurance.** To protect their interest in the collateral property, lenders require property hazard insurance (and sometimes flood insurance), generally for at least 80% of the replacement cost of the improvements. Like taxes, some lenders will escrow 1/12 of the annual insurance payment each month.

Together, these first four components are known as **PITI**. In addition to PITI, some properties may incur other costs that must be included into the monthly housing expense:

- **Homeowners Association Fees.** When the collateral property requires **association fees** as a condition of ownership, for example, as with a condominium, that monthly amount must be added to PITI to get the complete housing allowance. Since failure to pay required association fees can result in a lien against the property, lenders must take that amount into account to protect their interest.
- **Private Mortgage Insurance (PMI).** When the loan-to-value on a conventional loan exceeds 80%, the lender generally requires a borrower to pay private mortgage insurance as a way to protect its interest in the event of default and loss on any subsequent sale of the property. PMI is automatically discontinued when a loan is paid down to 78% LTV.

Qualifying Standards

Determining the buyer's financial constraints is a relatively simple process that should precede any property search. When agents first meet with a buyer client, they may perform an analysis of the current or allowable monthly housing expense based on the buyer's income and debt. This provides the agent and the buyer with a realistic understanding of the price range of homes the buyer may be able to afford. To review, there are two qualifying standards considered in mortgage underwriting:

- Housing expense ratio
- Total debt-to-income ratio (sometimes called total expense debt ratio or total debt service ratio)

When the lender considers both ratios, the borrower must generally qualify under **both**.

You can review the formulas for calculating these ratios in Chapter 22: The Mortgage Lending Process.

Because of the dependence on the national secondary market, the majority of lenders have incorporated the standards set by the major secondary market investors, specifically Fannie Mae and Freddie Mac, into their own conventional loan underwriting procedures. Of course, if the loan is to be made through FHA or VA financing, those underwriting standards must be applied.

	Housing Expense	Debt-to-Income
Conventional Loans	28%	36%
FHA-Insured Loans	31%	43%
VA-Guaranteed Loans	Not applicable	41%

Caution: The qualifying standards discussed here could change. Always check for the most current information.

Mortgage Qualifying Scenario

Todd and Linda are interested in purchasing a $365,000 home. If they are able to put 20% down and get a loan for $292,000 with a fixed 6% interest over 30 years, the monthly loan payment of principal and interest would be $1,750. The annual property taxes are estimated to be $8,820, and property insurance will be $101 every month. ***What is the total PITI for this house?***

After examining all of the available income streams they can offer, you calculate their gross annual income to be $117,000. ***Does their income qualify them for this purchase under the housing expense ratio qualifying standards for a conventional loan?***

Further inquiry finds that Todd and Linda have the following pre-committed expenses that must be recognized as part of their debt obligation:

$400 Auto Payment

$274 Monthly Credit Card Payments

$250 Deferred Student Loan

Will Todd and Linda qualify for the purchase of this home?

Real Success

As a buyer's agent, you want is to provide top-notch professional service for your clients. It is not productive to just be a "chauffeur" to shuttle around those folks who simply want to look at various properties, but never seem to commit to a purchase. This is a common mistake many novice licensees make. One seasoned agent tells a story about taking buyer clients out to look at houses every Saturday morning for weeks, only to hear them discussing how nice a particular window treatment would look in their current home. As it turns out, they were really just looking for decorating ideas!

Before you spend time taking buyers through any property, residential or commercial, spend time qualifying them. Verify that they are ready to buy, willing to buy, and able to buy property in the price bracket that you are presenting. Top agents who make well over a million dollars a year will consistently qualify the parties they work with before any services are rendered. They meet potential clients in the office to define their needs and desires, and to evaluate if these two elements coincide. Before you start talking with potential clients about confidential financial matters, however, you need to convince them of the value of your services as a buyer's agent and get them to sign a buyer brokerage agreement. Without that in place, while you may technically be their agent of record, you are working under an **implied relationship** that is unenforceable and may result in you not receiving compensation upon the close of the sale.

Understanding Your Buyer

Remember that selling real estate is about working with people. The financial part means nothing if clients don't feel you're taking care of their personal needs as well. You can impress clients with what your brokerage has to offer or by demonstrating a thorough understanding of real estate finance as you help them qualify for a particular type of loan, but you'll impress clients even more by demonstrating a thorough understanding of people by uncovering and addressing their needs and wants.

One of the first things you need to understand about your buyer is his or her particular sense of **urgency**. For example, a residential buyer may be looking at a lease termination or a pending closing on his current home; a commercial buyer may be anticipating a deadline under a 1031 exchange. The timing required by the buyer to complete a real estate transaction is important because it impacts so many aspects of the sales process. Knowing the time limitations you're faced with will help you meet your client's needs.

Uncovering Needs and Wants

Unless you have worked with the buyer in the past, don't walk into a meeting with a presumption that the buyer knows exactly what he or she is looking for. Frequently, it requires an exchange of ideas to solidify exactly what the buyer's objectives are. One of your primary challenges is to differentiate between what a buyer wants and what a buyer needs. They are not always the same, nor are they always compatible.

When meeting with a buyer client for the first time, you shouldn't interrogate. The conversation should flow back and forth with give and take, questions and answers on both sides. Start out with the easy questions pertaining to likes and dislikes, needs and wants, then roll into the qualifying procedure slowly. Asking the proper question helps you differentiate between any unrealistic expectations the buyer may have and the realities of today's market. Frequently, a buyer's needs and a buyer's wants are at opposite ends of the spectrum. Your job is to help them focus on the characteristics and amenities that are important to them and to prioritize them.

Real Success

You must be especially careful when qualifying a buyer's needs and wants.

For example, in the discussion of the client's needs and wants, the issue of school districts may arise. It's natural for people to ask what you think as a real estate professional, especially if they're unfamiliar with the area or they want a second opinion. A positive or negative assessment of the school district can set you up for a lawsuit. The best approach is to direct people to sources for **objective answers** to their questions. This might be the public library, superintendent of the school district, or other similar authoritative source, but it should **never** be your personal opinion.

Questions

The most direct way to determine a buyer's needs and wants is to **ask questions**. To be thorough, you need to use a variety of question types. This strategy allows you to cross-check your communication and to confirm what your buyers are expressing. Questions may generally be categorized as follows:

Question Category	Anticipated Outcome
Open-ended	• Does not require a definitive fact or yes/no response • Minimized the defenses • Used to solicit information • Words: Who, what, when, where, why, and how
Close-ended	• Seeks a definitive response • Restricts or focuses the intention on a specific factor • Words: Did, would, is, have, could, do, don't, couldn't, wouldn't, and can
Direct or linked	• Relates to an earlier comment • Directs conversation to a targeted point
Expanders	• Communicates interest and understanding • Encourages continuation • Words: Uh huh, I see
Restatement	• Allows others to react to their own statements • Clarifies a message • Words: You think, you feel, and you believe
Reflection	• Focuses on feeling and emotion • Encourages expression of feeling that could block communication
Silence	• Provides an opportunity for the one being questioned to review and refine the response • Puts pressure on the individual to make a decision or speak

Questions can be very basic and fact-based, such as:

- What size is your present home and do you own it?
- How many bedrooms do you really need?
- What style of house or building material do you prefer?
- Have you decided on a specific community, a certain school district?
- Is public transportation a concern?
- What size yard do you think is adequate?
- What size payments do you think would be comfortable for you?

Questions may also be more complex and open-ended, such as:

- What services or features are important to you?
- What specific qualities or characteristics are you seeking in your new property?

For your own benefit, you might also want to ask the buyer client this important question: What are your expectations of me and the services I'm going to render to you as your agent? Ask what they're looking for, listen attentively, and follow through with customized service based on that knowledge, while honoring your fiduciary obligations to your client.

Real Success

Silence can be golden. Many times when you arrive at a decision point with a client or customer, silence is deafening. But resist the urge to fill the silence. Give the buyer a chance to think and respond. Consider the concept of "He who speaks first, loses." If a licensee fails to give a buyer time to think by speaking first, it could give the buyer cover to take the opportunity to back up and talk himself out of a decision.

Tools for Gathering Data

Most brokerages will have some sort of data sheet that an agent can use to gather all of the pertinent information from a buyer client. At a minimum, you need to take very specific notes about what the buyer is saying as he or she defines specific needs and wants. In addition, as the buyer responds to specific questions, you should be building a mental image of what the buyer is describing. Many times, especially with new buyers, the mental image of what they want is not truly in sync with what they are describing.

Another effective way to ensure that you address all of the physical characteristics of the property that are important to your buyer is to actually use a **Multiple Listing Service listing worksheet**. Although you're obviously not listing property for the buyer, you can use such a worksheet as a tool to ensure that you are gathering the right data to make a search for property in the MLS meaningful.

Using the same data-gathering tool for every buyer—whatever strategy you choose to use—also provides consistency and shows that you treat all of your buyers with the same level of detail and attention.

Real Success

Specific data about the characteristics and physical features that a buyer is looking for may not tell the whole story. You may have heard the old adage that "buyers are liars." It's not a derogatory statement, rather, a reaction to the fact that buyers may not fully understand the difference between what they ***think*** they want and what they ***really*** want. For example, most agents can tell stories about buyers who expressed a desire for one thing—a ranch house, for example—and ended up buying a two-story. Or they said that a big yard was a must, and then they end up buying a condominium. Well, buyers are ***not*** liars; agents may just be asking the wrong questions.

Also, if buyers tend to purchase property based on emotion, you need to do more than ask them logical questions, you need to get down to the emotional need. Here's a bit of advice: Once you get past the number of rooms and the size of the lot, tell your buyer you have one more question. "If you had to buy a one-room house, what room would that be?" A buyer may actually be buying a kitchen, for example, and getting the rest of the house with it. If that kitchen happens to be in a two-story house and not the ranch she said she wanted, was she a liar? No, the agent just did not get down to the emotional level.

ILLINOIS ASSOCIATION OF REALTORS
BUYERS INFORMATION CHECKLIST

1. Name: _____
2. Address: _____
3. Telephone No.: _____ Fax No.: _____
4. Area(s) requested: _____
5. Approximate possession date: _____
6. Specifications:
   a. Bedrooms _____
   b. Baths _____
   c. Garage _____
   d. Basement _____
   e. Style _____
   f. Lot Size _____
   g. Features: _____
   h. Remarks: _____
7. Price range: _____
   How was this determined:
   - ☐ Broker Pre-qualification
   - ☐ Lender
   - ☐ Other
8. What do you consider a comfortable monthly mortgage payment?
   $_____
9. How much do you plan to invest in the down payment?
   $_____ Source: _____
10. Do you have a preference for any particular lender or mortgage broker?
    _____
11. Other than the maximum price which you might be willing to pay for the property, is there any other information which you deem confidential and would not want disclosed?
    ☐ Yes ☐ No
    If yes, please state:_____
12. In order to assist us in monitoring our commitment to Fair Housing, we request the following information. Your providing this information is completely voluntary and will not be made known to any sellers.
    Race: ☐ Black ☐ White ☐ Other
    - ☐ Disabled
    - ☐ Family with children
    - ☐ Married

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Signatures:

Agent _____ Buyer _____

Date _____ Date _____

Buyer _____

Date _____

13. Source of Buyer:

☐ Personal referral ☐ Ad call
☐ Floor call/walk in ☐ Company referral
☐ Sign call ☐ Met at open house

14. How was property presented to Buyer?

☐ Buyer requested to see one specific home.
☐ Computer generated based on area stated by Buyer.
(If so, attach computer search)

Properties and/or Areas Shown	Price	Date	Buyers Comments	Printed Listing Given
				☐
				☐
				☐
				☐
				☐
				☐
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				☐
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				☐
				☐

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Effective Communication

We've established the importance of asking the right questions. Good communication requires not only the ability to **convey** information and emotion but also the ability to **receive** these from others. If you are not skilled at listening to and evaluating the client's responses, it does not matter what questions you ask. Therefore, one of the most critical skills that a successful buyer's agent can have is the ability to **listen** to what's being said. In fact, being a good listener is vital to all relationships, whether it's business or personal. Without truly listening to someone, all you are doing is telling them something; you are not having an open discussion about the matter at hand.

Effective communication actually occurs at three levels:

- The actual words being used
- The interpretation of the speaker's intent through tone of voice
- The recognition of body language and other visual cues

Caution: Listen to the words being used carefully. Words may have different meanings in different parts of the country or in different cultures. Be conscious that there may be a difference between what you perceive a word to mean and what your buyer perceives that word to mean.

Active Listening

It is necessary to first understand what the other person is saying, and that is done by really hearing what is being said. Not what we **think** we want to hear. Our minds can wander. We can start thinking about something else. This could be related to the task at hand, such as thinking about what else needs to be done. It could also be something completely different from the event we are seemingly engaged in; for example, we could start thinking about family or friends and what we need to do for them. The client or customer we are speaking with will be able to pick up on this as we start to drift out of the conversation. What are we really saying to this other person? *We don't care.* That is the real message sent. Because if we truly cared, we would be paying attention to what that person said.

How to Listen

How do we really listen? **Pay attention** and **tune in** to what is being said. This is done by **taking notes** and putting down anything else you are doing. When taking notes, bring up the topics covered and use everyone's names. If you cannot remember someone's name, write it down. You should know everyone's full name. When the clients see you taking notes, it will show that you care, and they will note that in their minds. They will assume you are taking the meeting seriously since it is important enough for you to write it down. This also will give you something to **review later** if you need to clarify something.

Pretending to Listen

Sometimes we would like to think we are listening because we are using "**word whiskers**." That is saying the same thing again and again back to the other person when they are speaking. Some examples are "I got it," "okay, okay," and "yeah, yeah." What are we transmitting to the other person? *We are not listening, and just finish what you are saying please; I have other things to do that are more important.* When this happens you need to remind yourself to start listening. This can be done by **focusing in** on what the person is saying and **clearing your own mind**. To do this, think of a clean blackboard and then start to fill in what the other person is saying. In most cases, we do not even know we are doing this.

Planning Our Next Utterance

Sometimes we start thinking about what we are going to say next and stop hearing what someone is saying to us now. How many times has it happened that you knew the answer to a question and could not wait to give it? Were you listening to what else the other person said after that question? In most cases, people do not. They get so focused on the answer, they don't want to forget it, and they don't hear anything else. There is a reason we have two ears and only one mouth: **We need to listen twice as much as we speak!**

Interrupting the Speaker

In the guise of showing that they are listening, many people will derail the speaker's train of thought. This is a common practice of sales people in general. The client may say something like "When I was in high school . . ." and the salesperson interrupts and says "What high school did you go to?" rather than letting the client finish his thought, ". . . I saw the home I always wanted to buy."

The best policy is to hold any and all questions and comments until the client is finished. If they pause for breath, this is the time to let them stop and reflect on what they said. They may clarify what was just said or reflect back on what was just said, giving you more information. If they are finished with their train of thought, ***then*** you may ask your follow-up question. An example would be, "What was it about that home you saw when you were in high school that made you think that?"

Make sure you ask **open-ended questions**. As discussed earlier, that is one without a simple "yes or no" answer. If they can only answer yes or no, your clients might then feel it necessary to defend themselves. You have lost a good chance for them to explain to you the home they want.

Hold Your Peace

Remember to *hold your peace*. No matter if you are busting at the seams to chime in about your own anecdotes or commentaries, keep the conversation **always focused on the client**. That is why you're there. Let clients feel that they have the time and space to speak their mind to you. Make sure that you do not offer any snappy judgments about what was said or any comparisons to other people. Avoid comments along the line of "You think that's bad, you should hear about the last seller . . ."

Take care that you **do not become defensive** or attack what was said by the client. Unless you want to end a meaningful conversation with the client, simply reflect back on what you heard. This technique works great in general conversions not only to ward off arguments but also to move away from potential conflicts. It also lets the clients give you more information about what was said and how they feel about the subject.

Ask for Feedback

Have you ever wondered if the people you are talking to truly understood the message *you* were intending to convey? Were they listening to you? The only true way of understanding whether or not your clients comprehend the message you are attempting to convey is to ask them for response "feedback." Take a step back and ask buyers a question that gives them the opportunity to restate what you said so you can understand if they understood the intention of your message.

Communicating Through Tone of Voice

Professional speakers understand that the quality and inflection of someone's voice are critical aspects to communicating any message. This includes the volume used, rate of speech, tone, and pitch. For example, angry people often speak loudly and more rapidly. The words they use may not betray their anger, but their voice may. Listen carefully to how you buyers communicate. They are going to provide you with additional unspoken direction as to their enthusiasm or disdain for a particular concept or property.

Communicating Through Body Language

A truly skilled communicator doesn't have to hear the words to know what the speaker is attempting to convey. It is very important that we understand this nonverbal way that we send and receive messages from each other. While it may be hard to read another person's body language, we have to control our own. The control of your body language will reduce your risk of sending the wrong message. For example:

- The failure to establish and maintain good **eye contact** or the tendency to stare at something else may show you as defensive or unfocused.
- **Nervous habits** like biting fingernails may suggest uncertainty.
- **Checking your watch** for the time frequently may show you do not value what is being said and you have other more important things to do.
- Speaking **quickly** or **mumbling** is sometimes viewed as being nervous or lacking confidence in what is happening.

- Leaning and **poor posture** may show that you seem disinterested or are very casual and don't really care about what is happening.

Although this is an area of academic study beyond the scope of this topic, the following chart provides a few examples of body language cues to be aware of:

Message	Gesture / Body Movement
Acceptance	Open eyed, steady gaze, limited blinking
Impressed	Happy, heads turn slow, limited fidgeting, slower movements
Concealment	Touching the nose
Dominance (veto power)	Sets the pace, takes the lead, negative gestures
Thinking	Touching face, rubbing the brow, scratching head
Needs space	Backs up, stands stiffly
Positive reaction	Leans forward, smiles, nods, tilts head slightly

Open for Discussion

Suppose a client asks you this: "What types of families live in this neighborhood?" ***How would you respond? What factors do you need to take into consideration?***

Finding Properties

Based on the client's responses to your questions, you can start tailoring the home search to those properties that will best suit the stated needs and are within the appropriate price range.

Analyzing Data

You should gather up all of the data you have collected about your buyer and **prioritize** the needs and wants before you research available properties. This strategy allows you to work systematically. The following are some critical areas to include when prioritizing data:

- **Geography.** The specific boundaries of the community or school district within which the buyer wishes to remain.
- **Neighborhood.** A preference for an established community or a new construction community and what amenities the community needs to have.
- **Structural Style.** The amount of physical space needed within the property and any specific requirements (stairs, basement, lot size, etc.).
- **Condition of Property.** How much work the buyer is willing to do.
- **Covenants and Restrictions.** Any restrictions and easements imposed upon ownership and use that could impact the buyer's decision.

Your first search should include **all of the buyer's wants**. If that search yields limited options, begin removing some of the "wants," starting with the least desirable to the most desirable. This will help buyers visualize which of their wants may have to be negotiable if they are truly ready to purchase.

Real Success

If you're representing the buyer, you must become familiar with the property or properties that you plan to show. When the buyer has a question, you'll appear professional and put the client at ease if you're able to answer it. If you don't have the answer, tell the buyer you'll find out. **Never guess or make up an answer.** If you've done your homework, there should be only a few questions you can't answer.

You may want to go through the home by yourself before showing it to a potential buyer if you're not the listing agent. **Being familiar with the home is a big advantage.** At the very least, you should talk with the listing agent to get as much information as you can before you show a home to a client or customer. Any problems with the home that are discussed with a prospective buyer ahead of time seem less ominous than those discovered later.

Finally, when bringing buyers to a home, you may want to take the **scenic route** if they aren't familiar with an area. It's also helpful to make note of the things that the buyer says are important to him or her. Then plan your route so that you can point out parks, schools, shopping, etc., on the way.

Evaluating Selected Properties

You might want to start by sitting down with your buyers in a setting that allows you to look at specific properties in the Multiple Listing Service that seem to match their stated needs and wants. You'll quickly learn if they were accurate in expressing what they thought they wanted as they respond to specific properties.

Every buyer is different. You may find the perfect house on the first try; you may have to show a dozen or more houses to the buyer before he finds what he's looking for. It may be necessary when working with a buyer to adjust his expectations based on his financial position. You may have to revisit your understanding of his stated needs. Every house you show gives you and the buyer an opportunity to clarify the buyer's needs and prioritize the buyer's wants. Here are some things to consider:

- **Organize the Order.** There are numerous philosophies as to which order you need to schedule the various properties in. Do you show the best property first and use the less desirable properties reinforce the strengths of the first? Do you save the best for last and build up to the property you feel best fits the buyer's needs? Every buyer is different, and the order of showing needs to reflect the buyer's personality.
- **Schedule the Showing.** The time of day can have a dramatic impact on the visual perception of the property. If you have flexibility in the timing of your showings, select that time of day that will provide the greatest visual impact on the buyers as they approach and walk through the property.
- **Walking Through the Property.** This is a science in itself. Where to do you begin? Where do you stand? How do you lead the buyer through the property? Do you let them lead you? What amenities of the property are important to the buyer? Do you show those amenities first or last? Again, like setting the order of the property to show, the method by which you walk the buyer through the property is just as critical. Try to find a positive feature to point out throughout the property as prospective buyers walk through. This makes the property more memorable and highlights things they might have missed. You can also create imagery that helps the buyers visualize their use of the property by pointing out how their furniture, artwork, etc., would look or work in a particular location.

Ask Questions

Ask questions! Watch the body language and remember that showing the property has two basic objectives:

- Gather more information about buyers and what they are actually looking for.
- Find the triggers that you can use to help close the deal.

Never assume buyers will immediately tell you if the property is "the one." You may need to help them realize that a property meets their criteria and they need to be proactive in acquiring it.

Tax Benefits of Home Ownership

While most will agree that buying property can be exciting, knowing there are excellent tax advantages that go along with home ownership can provide another incentive to make the decision to buy. There are several provisions written into the tax code to encourage home ownership:

- **Paid property taxes** are deductible if deductions are itemized.
- **Interest paid on a mortgage** is deductible.
- **Interest paid on home equity loans** used to improve property is deductible.
- Individual Retirement Account (IRA) funds can be tapped to help purchase a first home without any tax consequences. The Internal Revenue Code allows $10,000 toward the purchase without having to pay income taxes or early withdrawal penalties.

Property taxes and mortgage interest on a **second home** are also deductible. As long as the home is not rented for more than **14 days** during the year, any rental income can be excluded and taxes and interest can be deducted.

Home Acquisition Debt

Home acquisition debt is *a mortgage a taxpayer takes out to buy, build, or substantially improve a qualified home*. The loan must be secured by the home. The amount of the mortgage used to calculate qualified interest is limited to the **value of the home plus any substantial improvements**.

Mortgage interest paid by any property owner in any given tax year is deductible up to certain limits. On home acquisition debt, owners may deduct interest on up to $1 million when the homeowners are married filing jointly ($500,000 if married filing separately). An amount over those limits may qualify as home equity debt.

Discount Points

Discount points paid on a home loan to lower the interest rate may be fully tax deductible *in the year paid* if they meet all of the following IRS criteria:

1. The loan is secured by the homestead, defined as the principal residence.
2. Paying points is an established business practice in the area where the loan was made.
3. The points paid were not more than the points generally charged in that area.
4. The **cash method of accounting** is used. This means *income is reported in the year received and expenses are deducted in the year paid*. Most individuals use this method.
5. Points were not paid in place of amounts ordinarily stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6. The buyer paid the points at or before closing without using funds that were borrowed from a lender or mortgage broker.
7. The loan is used to buy or build a principal residence.
8. The points were computed as a percentage of the principal amount of the mortgage.
9. The amount is clearly shown on the Closing Disclosure settlement statement as points charged for the mortgage. The points may be shown as paid from either the buyer's or seller's funds.

The points paid to **refinance** a mortgage *are not fully deductible* in the year paid. However, if part of the refinanced proceeds are used to improve the primary home and meet the first six criteria, those points can be deducted and the remainder can be deducted over the life of the loan.

Home Equity Debt

Home equity debt is *a loan that does not qualify as home acquisition debt and is secured by a qualified home*. The amount of home equity debt on which interest is deductible is limited to the smaller of $100,000 if married and filing jointly ($50,000 if married filing separately) or the home's fair market value reduced by the amount of home acquisition debt.

The purpose of the home equity loan is not considered to qualify the loan. Individuals often take out home equity loans to pay for tuition expenses, medical expenses, or high credit card balances. When the amounts meet the threshold amount, interest is fully deductible. Interest on credit card debt is *not* deductible.

Other Considerations

After the first six IRS conditions are met, points and interest paid for financing **home improvements and new construction** are deductible. In the case of new construction, expenses incurred over a 24-month period are the only ones to qualify for the loan that generates deductible expenses.

If a **prepayment penalty** is imposed on homeowners who pay off mortgage loans early, the penalty can be deducted as home mortgage interest if it is not for a specific service performed or costs related to the mortgage loan.

Summary

1. Borrowers can get pre-qualified or pre-approved. **Pre-qualification** is when a real estate agent or lender reviews a borrower's history to determine if they're likely to get approved for a loan, and the approximate amount. Pre-qualification is not binding on the lender. **Pre-approval** is when a lender uses an application to determine that potential borrowers can be financed for a certain amount for a specific property. Neither a mortgage broker nor a real estate agent can pre-approve a borrower; only a lender can.
2. Monthly **income** must show stability, quality, and durability. Bonuses, commission, part-time earnings, and overtime all count if shown to be a consistent part of the borrower's income for the past few years. Lenders do not usually count temporary unemployment, welfare, and other income. **Credit history** is a record of debt repayment. **Credit scoring** is an objective means of evaluating credit. Lenders verify assets and will pull a credit report.
3. Conforming loans sold on the secondary market require income ratios of **28%** for housing expense and **36%** for debt-to-income (DTI). The **housing expense ratio** is the relationship of the borrower's total monthly housing expense (Principal, Interest, Taxes, Insurance or PITI) to income (stable monthly gross income), expressed as a percentage. PITI also includes required homeowners association fees and sometimes private mortgage insurance (PMI). Total **debt-to-income ratio** is the relationship of the borrower's total monthly debt obligations (including housing and debts that will not be cancelled and that have ten or more payments remaining) to income (stable monthly gross income), expressed as a percentage. A borrower must qualify under **both** ratios.
4. A key component of qualifying a buyer is uncovering **needs and wants**. This is usually accomplished through a series of questions, often using a standardized form. Buyer's brokers should categorize and prioritize the buyer's stated needs and wants to use when researching appropriate properties to match the buyer's criteria. **Effective communication** is essential during this information gathering process.
5. Mortgage interest paid by any property owner in a given tax year is deductible up to certain limits. Loans for reasons other than to buy, build, or substantially improve a home may qualify as **home equity debt**. Interest paid on home equity debt is also deductible up to certain limits. **Discount points** paid on a home loan may be fully deductible in the year paid if they meet all IRS criteria.

Quiz

1. ***Which statement about pre-approval of a buyer is TRUE?***
   a. Pre-approval can improve a buyer's negotiating position.
   b. Pre-approval is not binding on the lender.
   c. Pre-approval may be performed by a licensed real estate broker.
   d. Pre-approval must be performed before showing any properties.

2. ***Gordon wants to get a loan to buy a house. When evaluating his credit obligations, which would LEAST LIKELY be considered as debt?***
   a. alimony payments
   b. cable company payments
   c. credit card payments
   d. student loan with 6 payments left

3. ***Nicole has a stable monthly income of $3,200 and recurring monthly debts of $370. What is the maximum mortgage payment (PITI) she would qualify for under both ratios if getting a conventional loan?***
   a. $782
   b. $896
   c. $928
   d. $1,152

4. ***Laura fell in love with a house and is desperate to buy. The asking price is $235,000. She's making an offer of $230,000, and the house appraised for $225,000. If her lender is willing to give her a loan of 80% loan-to-value, how much of a down payment must she make if her offer is accepted?***
   a. $45,000
   b. $46,000
   c. $47,000
   d. $50,000

5. ***Of these mortgage-related costs, which would a homeowner LEAST LIKELY be able to deduct from income taxes?***
   a. discount points paid to purchase a second home
   b. interest paid on a home equity loan
   c. interest paid on a mortgage
   d. paid property taxes if itemized

6. ***Which of the following questions could NOT be construed as being discriminatory in nature when asked of a buyer?***
   a. Do you have children?
   b. How many family members will be living with you?
   c. What church do you attend?
   d. What type of house are you looking for?

7. ***What is the LTV if a property was appraised at $180,000, is being sold for $175,000, and the buyer is putting $25,750 down?***
   a. 82.9%
   b. 85.3%
   c. 86.3%
   d. 97.2%

8. ***Providing information about the quality of schools in an area and the demographic make-up of the students is okay as long as the***
   a. customer has purchased the property in the area.
   b. customer requests it.
   c. customer signs a waiver.
   d. information provided has been published by appropriate authorities and is available to anyone.

9. ***Of these, which mortgage-related activities could be handled by a licensed real estate broker?***
   a. origination
   b. pre-approval
   c. pre-qualification
   d. underwriting

10. ***As you're showing a buyer client through a property, you notice that she is constantly touching her face and rubbing her brow. What is this most likely to indicate about her state of mind?***
    a. She's concealing her true thoughts about the property.
    b. She's impressed with the property.
    c. She needs some space.
    d. She's thinking about the property.

11. ***Of these, which question will likely give you the best insight into the buyer's desires for the new house?***
    a. Do you have a preference between stone, brick, and siding?
    b. How many bedrooms do you need?
    c. What's your favorite room in the house and why?
    d. When would you like to close?

12. ***Your buyer, Opal, is a single mother of a toddler. As you're working with her to determine how much she might be able to afford, which income source should you ignore?***
    a. alimony payments
    b. child support payments
    c. occasional overtime
    d. welfare benefits



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The Buying Process

You have a signed buyer brokerage agreement, you've pre-qualified the buyer to know what sort of house he's looking for and what he might be able to afford, and the buyer has even worked with a mortgage lender to get pre-approved. You think you've found that perfect house for your buyer client, and now you're looking to close the deal. After you answer any objections to the property the buyer may have, you can begin the process of negotiating the sale. In this chapter, we'll look at offers and counteroffers, as well as the other tasks that must be addressed before your buyer can take ownership of the dream house you've managed to find.

You will learn:

- Disclosure responsibilities related to property.
- Strategies for responding to objections.
- Considerations for preparing and presenting offers.
- The purpose of a buyer's earnest money deposit.
- The value of a professional property inspection.
- Communication and coordination strategies for other parties to the transaction.
- Responsibilities related to closing.

Key Terms

Contemporaneous Offers
Contingency
Counteroffer
Earnest Money
Equitable Title
Good Funds
Latent Defect
Letter of Intent
Liquidated Damages
Material Fact
Offer
Patent Defect
Property Inspection
Purchase Agreement
RESPA
Settlement
Statute of Frauds
Stigmatized Property

Disclosure Obligations

Issues related to disclosure tend to be among the most challenging for new agents:

- "What am I *allowed* to tell?"
- "What am I *required* to tell?"
- "What am I *prohibited* from telling?"

By now, you should know that a real estate broker has statutory obligation to make complete disclosure of any **latent defect** known about the property. A latent defect is one that is *not plainly observable or that would not be discovered in a reasonable inspection*. Brokers should also be prepared to disclose **material facts**, which are those that would *affect a reasonable buyer's perception about the property if it were known*. Such disclosure obligations protect potential buyers, giving them the right to make an informed decision on the property.

A seller's agent is legally obligated to share known material facts and latent defects about the property with the buyer's agent. And you, as a buyer's agent, are legally obligated to pass that information along to your buyer client, even if that information may lead the buyer client to reject that particular property. Never forget that you must be loyal to your buyer clients and always work in their best interests, even if that means losing out on potential commission.

Case in Point

While walking through a home before showing it to your buyer client, you see a stain on the ceiling tile. Can you tell what caused it? Was it water from a leaky roof? Condensation on an air conditioning pipe or another pipe that leaked? Should it be there? No. So you need to ask the seller's agent what caused the stain. The seller's agent tells you, "Oh, the seller said that the idiot who put the ceiling tile in knocked a cup of coffee over. That was the last tile they had. They said they were going to come over and replace it; they never did."

So now, you're showing your buyer client through the house, and the buyer asks, "What's the deal with the stain on the ceiling tile?" What do you tell the buyer? "The seller said." If you say, "Oh, the idiot who put the ceiling tile in knocked a cup of coffee over," have you made a direct representation as to what caused that stain? Then you are responsible for that statement that you just made.

The seller is the one who has liability for that stain, so as an agent, you should leave it there. Your response should be, "The seller said the person who installed the ceiling knocked a cup of coffee over. I have no clue what caused that stain. You have every right to be concerned about it. What I'd recommend is you have a home inspection done to find out what really caused it, because I don't know."

Property Conditions

Although a seller is required to complete the Illinois Residential Real Property Disclosure Report, this does not absolve the buyer of all responsibility. A buyer should **always** inspect the property before agreeing to buy it since the seller and the seller's agent generally aren't required to tell the buyer about **patent defects** that are visible and would be discovered in a reasonably thorough inspection. This is true even if the buyer never actually inspected the property as long as he or she was given the opportunity. The rule also applies if the buyer inspects the property and sees the defect but doesn't recognize that it's a problem.

Still, in your professional capacity as a buyer's agent, you should carefully walk through the property with buyers, looking for subtle things that they may not perhaps recognize. You'll be better off in the long run if you raise issues early on than to wait for buyers to discover them after the transaction closes. Do you think you'll get a reference from a buyer who thinks you conspired with the listing agent to sell them a lemon just to get your commission?

"Stigmatized" Property

As you know, Illinois law does **not** require disclosure of any situation *outside of the property under consideration for purchase* that does not directly affect the property itself. So, for example, a seller's agent does not have to disclose that the house across the street has three teen-age boys who like to throw loud parties on the weekends. Nor does the law require real estate licensees to disclose whether a home has ever been the site of a murder, suicide, or other occurrence that, by law, has no material effect on the condition of the property. But what if you're the buyer's agent and your client asks you directly about the house or about the neighborhood? Are you obligated to respond with what you know? Illinois law protects seller's brokers who do not disclose such information, but what about your statutory obligations to a buyer client?

Here's an extreme example: You are a buyer's agent working with a couple from out of town. They are interested in a house where you know that a murder took place. They have not asked you if the home was the site of a murder, and you're not legally obligated to disclose that since it is considered to be immaterial under Illinois law. But to protect the sensitivities of your clients, you decide to gather up every article you can find about the incident to present to your buyer clients. Have you violated any of your fiduciary duties to your clients by disclosing this? What about any duties to the seller customer?

If you have reason to believe that the information may be material to your buyer client, you should disclose it. Some buyers might not care at all about an extreme event on a property such as a murder. They might even use their knowledge of the house's history to **leverage their negotiating position** with the seller. Others would not consider that house under any circumstances. What if you decided *not* to volunteer the information to your buyer client and six months after they moved in, a neighbor told them all the details? A murder, especially if it's a recent event, will not likely stay a secret for long.

Open for Discussion

You are showing a buyer client a parcel of land that you previously had listed. The buyer is extremely interested in the property; however, you are aware the neighbors to the west have a very peculiar home business. They are the largest provider in the state of fermented horse manure for use as fertilizer. Depending on wind direction, there are days when the aroma is less than desirable. Today is not one of those days. ***Do you tell your buyer client? If you fail to tell your client, can you be charged with negligence?***

Other Disclosure Issues

Obviously, the duties of loyalty and confidentiality mean that a buyer's agent cannot disclose any confidential information about his buyer clients that could damage their negotiating position. Can you think of anything, however, that would be considered a **material fact** that a buyer's agent would be obligated to disclose to a seller's agent? What if you knew that your buyer client lost his job two days after making an offer on a house? Is that a material fact, and should you share that with the seller's agent? Do you let the seller continue to believe that the deal is pending and, perhaps, turn down other offers that may be much more likely to close?

You can surely see that these issues can create some confusion, not only on the part of real estate clients and customers, but for real estate licensees, too. Make sure that you take advantage of the experience and advice of your managing broker in these situations.

Open for Discussion

In a recent county zoning board meeting you learn of a pending change in the zoning of a piece of commercial real estate you have been attempting to put under contract with your buyer client. You know for a fact that the intended use of the property may be denied if the zoning is enacted. Do you ignore this information, since this change is only pending and not a reality at this time? Do you tell your buyer client, knowing this may terminate the transaction? ***What are some strategies you can think of to address this? What are some issues to consider?***

Megan's Law

Megan's Law, adopted by the federal government in 1996, requires states to *develop a procedure to notify community residents of sexual offenders living in their area.* The information provided has always been available to the public, but the law makes it easier for people to access the information. The law is intended to help parents provide better protection for their children by arming them with information on potentially dangerous predators.

Several lawsuits against real estate licensees have resulted since the implementation of Megan's Law in which homebuyers sued sellers and real estate agents for not disclosing the presence of a convicted child molester in the neighborhood. Obviously, once an issue gets to court, the outcome is uncertain; however, courts have ruled that requiring full disclosure creates an unfair duty to impose on sellers and agents. Since the information is public and available to everyone, the concept of *caveat emptor* (buyer beware) is in place and, therefore, the responsibility falls on buyers to research the information. Once sellers have actual knowledge, however, if a prospective buyer specifically inquires about it, they should:

- Answer truthfully, or
- Direct them to local law enforcement.

Open for Discussion

Mark and Tammy, a young family with two small children, have asked for your help in finding their new home. You spend all afternoon showing them five different properties. A house on Elm Street has really captured their attention. Before they are willing to discuss making an offer, they have asked for your help in acquiring the answers to three specific concerns:

- The quality of education is extremely important to them. They need to know the current educational rating of the school district.
- Tammy's parents have warned them of the dangers of gang activity in many school districts in town. Tammy needs to have a level of knowledge that provides comfort that this school district is not plagued with gang activity. She asks for your opinion regarding known gang activity.
- Finally, they're interested in knowing the proximity of any convicted sex offenders who have a history of targeting young children.

How do you respond to their concerns? What are some issues to consider?

Closing a Sale

There really is no right or wrong time to close a sale, but you must take the initiative and **ask for the sale**. A good time to go for the close would be right after you've answered an important question or overcome a key objection. Many experienced salespeople ask for the close early and often. Watch for verbal or physical clues. If the prospect likes what he or she sees or hears, there is an opportunity to turn that enthusiasm into a sale. Remember, a prospect will rarely ask you for the offer or contract, but if you ask a prospect to sign at the right time, the sale has a good chance of succeeding.

Handling Objections

Objections do occur during a sale. This is true when you're selling yourself and your real estate brokerage firm's services to a prospective client, and it's true when you're selling a house to a prospective buyer. Being prepared to respond to these objections skillfully demonstrates professionalism. With more experience, objections can be overcome, and anticipating objections makes your client feel more comfortable.

Welcome objections, because they're an **opportunity to sell**. Theoretically, if you overcome the objections, you should make the sale. Objections don't mean that you've done a bad job or that the house isn't right for someone. Perhaps the person just needs more information. Objections during the sales process generally fall into one of three categories:

- **Invalid** objections are really excuses or stalls and often have nothing to do with the property. There's not much you can do if prospects are too busy or decide they aren't ready to buy now.
- **Valid** objections need to be addressed. If it's an *answerable objection*, such as the house needs a new roof, you should be prepared. Explain that the price has been discounted to reflect this fact. If the buyer doesn't think there's enough shopping nearby, list stores in the area and their distances from the property. If you don't have an answer or don't know, be honest about that and find the answer.
- If the objection is **not answerable**, for example, the house is in the wrong school district, there's not much you can do except admit that this is a valid objection. Find out if this is the only objection; then try to find out if there's room to compromise on this point and how high of a priority it is to the buyer. Don't ignore these concerns; just see if there's any chance to negotiate. You need to understand the objection and understand the prospect's reason for this objection.

Answering Objections

There are many ways you can answer objections, but here are a few general rules:

- **Rule 1.** Restate an objection before trying to answer it. This ensures that you truly understand the objection, avoids misunderstandings on both sides, and gives you a little more time to think.
- **Rule 2.** Never make a big deal out of an objection. Make your answer short and direct to the question at hand. If prospects need to hear more, they'll ask, but if you dwell on something too much, the objection may seem bigger than it really is.
- **Rule 3.** Respond to objections by asking questions. This helps you understand the objection, the prospect's thinking, and the real reason for the objection. In addition, it can help a prospect answer his or her own objection.
- **Rule 4.** No property is perfect. Every pro and con about the property must be weighed to find the best fit for a prospect. Sit down with the prospect, and write out this list, helping to focus on the positive things.
- **Rule 5.** Use third parties to support answers to objections, if possible. If a prospect is concerned about the basement leaking, having an expert's opinion is stronger than your opinion, and legal trouble may be avoided.

Closing Strategies

Feel confident that you're providing a genuine service to clients and customers, and realize that you're the one they're going to blame if they miss an opportunity. When in tune with the physical and verbal cues of people, you'll know how and when to close a sale. **Don't be pushy.** However, there's nothing wrong with a confident suggestion that if they like what they see, they should sign now before someone else does. You're the professional who's seen other houses slip away from people who hesitated or people who waited to list a house and missed buyers who couldn't wait to purchase.

Help your buyer clients feel at ease with making an offer or signing a contract to buy a house by sitting down with them and going through each part of the offer they are about to sign. This helps them understand what they're signing. Second, you'll show them that the contract has clauses to protect the buyer. And third, you'll impress people with your knowledge of the contract and real estate.

Another thing that many real estate brokers do is actually write the offer in the part of the house that impressed or interested their clients the most. If they liked the big family room, write the contract there. Try to **avoid any interruptions** that can derail everyone's train of thought. Let your prospects focus on signing the offer or contract. Finally, **encourage their attorney** to look over the documents.

Buyer's Remorse

Many people have been caught up in a moment and made a hasty decision. Later, after thinking about it, they wish they could undo this decision. Encouraging someone to make a hasty decision when buying or selling a home can be thought of as a **high-pressure** sales tactic. Telling potential buyers they have to decide now or lose the property is one example. Buyers caught up in this high-pressure tactic may later change their minds after they have had some time to think about the sales event they were just in and the pressure is off to buy something. We sometimes call this getting "cold feet."

Open for Discussion

Buyer's agent Penelope has been in contact with the listing agent, and she has a verbal confirmation that the sellers will accept her buyer's offer. Time is of the essence and she doesn't want to take the time to fill out all of the blanks on a standard agreement of sale. Instead, she types up a simple contract with just the basic information: Names, property, price. ***Is this OK if the buyer and seller both find it acceptable? Why or why not? What are some factors to consider?***

The Offer

Once you get that commitment, the next step will be to work with the buyer to prepare an offer. In this phase of the real estate transaction, a buyer's agent needs to be especially aware of the statutory duty to assist the buyer in developing, communicating, and presenting offers or counteroffers. Furthermore, Illinois licensing law mandates that all licensees involved maintain an **active and integral role** in the development, negotiation, and implementation of the contract right up to and including the point of closing.

This phase of the transaction is accomplished through the use of a **purchase agreement**. Purchase agreements, you'll recall, are *contracts in which a seller promises to convey title to real property to a buyer in exchange for the purchase price*. These are also called purchase contracts, sale contracts, sale agreements, purchase and sale agreements, or earnest money agreements, among other things. Normally, the purchase agreement serves three purposes:

- It's the buyer's **initial offer** (and subsequent counteroffers between seller and buyer).
- It's the **receipt** for the earnest money deposit.
- It's the **contract** between the buyer and seller that drives the settlement process.

A sample purchase agreement is available for review in Chapter 16: Contracts for Selling Property.

Preparing the Offer

In a residential property transaction, the real estate licensee usually prepares the documentation that will act as an offer from the buyer to the seller. Today, most residential purchase agreements are created under a cooperative relationship between the local bar association and the local REALTOR® association. In preparing the offer, you must ensure that the information is accurate as the buyer wishes it to be presented to the seller. Always keep in mind the limitations Illinois law has imposed upon you regarding the insertion of information. While, as a buyer's agent, you have the fiduciary obligation to advise the buyer and to protect his or her best interests, Illinois limits your participation in the completion of an offer to **"filling in the blanks of a pre-printed contractual form with factual information."** If buyers want any specialized language inserted into the standardized form, you must refer them to their attorney.

Note: Both Illinois license law and the code of ethics for attorneys prohibit a licensed attorney who is also a licensed real estate broker from acting in the capacity of attorney and broker in the **same transaction**. If the broker representing the buyer is a licensed attorney, that broker must inform the client that it's necessary to engage a different licensed attorney to represent him in the legal issues of the transaction.

When selecting a standardize form to use as the basis of the contract, make sure the agreement provides for an **attorney approval period**. If not, have the purchaser's attorney get involved *before* presenting the offer to the seller. The attorney's approval is a contingency in the agreement and not considered a mandatory clause in the creation and validity of a contract. If the contract includes such an **attorney review clause**, however, the buyer is excused from performing the obligations of the contract if attorney does not approve of the contract.

Since standardized forms generally include common riders or addendums, most residential purchase transactions can be handled at the offer stage without having to involve an attorney. Again, any special needs a buyer may have can be addressed with an attorney before the offer is tendered or addressed by the attorney under the attorney approval period as provided for within the contract.

Once the buyer signs the offer, you must provide the buyer with original signed copies of all documents immediately.

Buyer Contingencies

A **contingency** is a way for either party of a contract to get out of the contract due to some circumstance or condition. For example, some buyers make an offer to buy a home before they even list their own home for sale. However, they need to sell their present home in order to come up with the down payment to make the purchase. So, they make their offer "conditional" on the successful sale of their own home. Most pre-printed purchase contracts contain a **financing clause** that makes the offer contingent on the buyer being able to obtain financing upon agreeable terms, including the mortgage amount, the type of mortgage, the maximum interest rate, the minimum term, etc.

When representing a buyer, a real estate agent must also consider any other contingencies that may benefit his client, even if they don't appear on a standard purchase agreement. These types of contingencies are typically included with the original offer as addendum to the standard form, either as an approved addendum/rider or completed by an attorney. The seller is therefore alerted to these contingencies right away and can either accept or reject them early in the process. This also allows the buyer more flexibility in whether to maintain his or her interest in this home or find alternatives.

- **Condominium Review Clause.** Allows review and acceptance of the condominium association documents.
- **Inspection Clause.** Relates to systems such as electrical, plumbing, roofing, drainage, heating, air conditioning, etc. and specifies they are in adequate supply and working properly.
- **Walk-Through Clause.** Allows the buyer the opportunity to walk-through the home and accept (or not) the condition and, therefore, the purchase agreement.
- **Absent Party Clause.** Allows the buyer to accept an offer by telephone or other non-signatory method, and later sign within a fixed timeframe.
- **Wood Infestation Clause.** Gives the buyer the opportunity to have the property inspected for termites and provide options if there are problems.

- **Certificate of Occupancy Clause.** Puts the seller on notice that if the municipality requires a certificate of occupancy, the seller must provide it.
- **Approval of Another Clause.** Allows the buyer to rescind the offer if another named person does not approve, for example, an out-of-town spouse who has not yet seen the property.

Earnest Money Deposit

You can get some help from the buyers in convincing the seller to accept their offer. The more earnest money deposit the buyers put down, the better response you will likely get from the seller. Earnest money demonstrates that the buyers are serious. If the seller received two offers with otherwise identical terms, for example, but one buyer is putting down a $1,000 deposit and the other buyer is not putting down a deposit at all, which buyer is more likely to get the property?

The State of Illinois has no law that sets the appropriate amount of earnest money—if any—required for a given real estate transaction. Most brokerages like to get the largest deposit that a buyer is willing to commit because it usually holds the deal more tightly together. Still, the earnest money deposit is generally considered the **liquidated damages** paid to the seller if the buyer defaults and doesn't close. So, a buyer has a dilemma: A large deposit may induce the seller to accept the offer, but if deal doesn't go through because of something the buyer does (or does not do), the buyer could lose that money.

A broker can collect an earnest money deposit from the buyer, but it must be immediately turned over to the sponsoring broker and placed into the sponsoring broker's **escrow account** where it is kept until the transaction is settled or terminated. A buyer must be given a **receipt** acknowledging that deposit, although the purchase agreement could serve that purpose. An earnest money deposit is disbursed as stated in the contract.

Commercial Letters of Intent

When negotiating a sale on **commercial property**, the initial stage of creating an offer is most often the preparation of a **letter of intent.** Such a document is generally ***not*** considered to be a contract and, therefore, is **not binding** upon the parties. However, it is possible that a letter of intent may contain wording that implies a contractual relationship, which then creates an undisclosed contractual obligation upon the parties to the transaction. When drafting a letter of intent, an agent must ensure that it contains explicit language that all parties agree that the document is nothing more than a statement of facts intended to be used to create a formal written contract, for example:

> *"The purpose of this letter is to reach an understanding on the general terms of a proposed agreement before expanding the time and cost of preparing such an agreement. It is expressly understood and agreed that this letter is **not a contract** and that this letter creates **no legal rights or obligations** whatsoever between the parties. Nevertheless, it is the intent of the parties to cause an agreement to be expeditiously prepared incorporating the terms and conditions set out in this letter, together with other terms and conditions customarily contained in agreement for properties similar to the subject property and other terms and conditions which are applicable to this transaction. The parties agree that neither party shall have any rights, liability or obligations relating to the subject matter hereof in the event that they are unable or shall fail, for any reason, to reach an agreement on a mutually acceptable agreement and execute the agreement."*

Once all of the parties agree to the terms in the letter of intent, an attorney of the buyer or seller will then compose the final, legal agreement that is used to contractually bind both parties to the terms set forth in order to complete the transaction.

Presenting the Offer

After the buyer signs the agreement and receives copies of all signed contracts and documents, the buyer's agent must **promptly submit** the offer to the seller or to the seller's agent. This can be done via mail, in person, or electronically, if pre-approved. Note that if you're not the listing agent, you cannot talk directly to the seller. Recall that Section 20-20 of the Illinois Real Estate License Act states it is illegal to:

> *"… negotiate a sale, exchange, or lease of real estate directly with any person if the licensee knows that the person has a written exclusive brokerage agreement with another broker, unless specifically authorized by that broker."*

This means that when you have an offer to present to the seller, you cannot bypass the listing broker unless the listing broker gives you permission to deal directly with the seller. All negotiations must otherwise be presented through the designated agent or the sponsoring broker of that seller.

Here's another key statutory obligation of a buyer's agent: Not only must you present any offer to purchase or lease to the seller or seller's agent in a **timely manner**, but you must accept delivery of any counteroffers and present them to the buyer in a timely manner. This requirement must be followed **even if the property is subject to a contract of sale, lease, or letter of intent to lease.**

Supporting the Offer

Your task is to convince the seller to agree to the price and terms written in the buyer's offer. Many of the same techniques you used on the buyers can be used with sellers. Listen to what the seller wants in the transaction. Discover the seller's objectives. Determine how long the property has been for sale and try to gauge the seller's urgency. Be prepared to say ***why*** this is a good offer for the seller to accept. Obviously, even if you know that your buyer client is prepared to pay significantly more than he offered, you cannot suggest an acceptable counteroffer amount to the listing agent to close the deal more quickly. You owe your client the fiduciary obligation of confidence. You cannot disclose any information that could jeopardize your client's negotiating position.

Also, you must be prepared to defend your buyer client's offer no matter what. Let's say that they made an offer that was significantly below the asking price. Even if you feel uncomfortable presenting that offer to the seller's agent, you are obligated to obey the legal direction of your client. You cannot in any way indicate to the seller's agent that you think your client's offer is insufficient.

Open for Discussion

Buyer clients Steve and Mary have been looking for a new home for more than six months. You have been researching the marketplace diligently and have found very little that fits the criteria they've established for their new home. While driving to your office on a Sunday afternoon, Steve and Mary pass a home with a "for sale" sign in the front yard. They question why they haven't seen any information on that home before. After pulling the information from the MLS, you explain to them that the home is currently under contract and therefore it was not offered to them. At their insistence, you call the listing broker to inquire about the current status of the property. The listing broker tells you that the contract fell apart a week ago but he has not yet updated the status in the MLS. ***Do you think Steve and Mary could charge you with negligence in performing your statutory obligations as their agent for failing to provide them with information on all potential properties that fit their criteria? As a licensee and the lawful representative of the buyer, do you have an obligation to inquire about the stability of potential contracts for the purchase of any property should that property meet the buyer's objectives? What are some factors to consider?***

Open for Discussion

Mark and Loretta have been desperate to find a home because their lease is expiring very soon. You have shown them 14 homes, all of which they have rejected for various reasons. However, there's a new house on the market, 1515 Main Street, with everything they wanted. Perhaps the 15th time is the charm! Still, they are methodical individuals who do not make rash decisions. Therefore, they want to talk over the decision before committing to the property. They tell you they will call you later that afternoon. A couple hours later, another couple, Jim and Pam, come into your office looking to purchase a home. After talking to them about their needs and wants, you realize that the home on Main Street might be perfect, so you show it to them. Jim and Pam immediately make an offer on the property. ***Now what?***

Property Inspection

A **property inspection** is *a visual examination of the physical structure and systems of a property*. The inspector is inspecting the property for quality and condition. A good property inspector should have knowledge of the building process, building codes, parts of a home, and systems of a home. A home inspection will cover many areas of the home: Roof, mechanicals, and the foundation. There is a difference between a residential inspection and a commercial inspection in that a home inspector is not necessarily looking for code compliance, where a commercial structural inspector would. Code deficiencies will be pointed out, but this is not the primary focus of a home inspection since older homes do not necessarily have to be brought up to code.

The property inspection is geared towards finding items that are dangerous, items that are damaged, and items that don't work. The purpose of an inspection is not to find every possible imperfection in the home—even new homes have imperfections. By concentrating on potential problems, the property inspection is trying to help a buyer make intelligent choices. Structures cannot "fail" an inspection. The purpose of the home inspection is information and discovery. Upon completion of the inspection, the buyer should know the following:

- Repairs that need to be done immediately
- Potential future repairs that may be needed
- Recommended major/minor repairs
- Recommended preventive maintenance steps
- Significant deficiencies in the home
- Risks of hidden damage
- Unsafe conditions
- Areas that may warrant further investigation

Quality of Inspection

The best way to obtain a quality inspection is to use someone with a good reputation in the area. This can be done simply by asking around among other home owners or real estate brokers. A person can also seek out property inspectors that have some sort of certification or belong to a professional organization. This may indicate a level of training or expertise, and means that the inspector is adhering to the organization's guidelines and ethics:

- The **American Society of Home Inspectors**® (ASHI) is the oldest and leading non-profit professional association for independent home inspectors. ASHI members must pass two written technical exams and perform at least 250 home inspections, plus obtain continuing education credits.
- The **National Academy of Building Inspection Engineers** (NABIE) is a non-profit, professional society which accepts as members only state-registered professional engineers specializing in the practice of building inspections. In addition to standard home inspection analysis, licensed engineers are also allowed to evaluate overall structural soundness and mechanical system adequacy as of the date of the inspection.

Potential Liability

A property inspection is generally not warranted, and does not provide any type of guarantee on the items or systems inspected. The inspector provides a report to the buyer or home owner stating the condition as of the date of the inspection. Typically, though, a home owner can obtain a home warranty, purchased by buyer or seller, at closing. A home inspection company may offer this or make a referral, or the broker can refer the home owner to a home warranty company.

Where liability can become an issue, though, is if people pass themselves off as property inspectors, or others believe that they are property inspectors and rely on their opinion. Such misrepresentation or misunderstanding can get a person into serious trouble if a major defect in a home is missed. That's why it is very important for real estate agents to be careful so as not to be perceived as giving home inspection advice. The only advice that a real estate agent should give to potential buyers (or to sellers) is to urge them to have their own professional home inspection done.

Liability can also be a problem for home inspectors if they miss a serious problem with a home. Since property inspectors hold themselves out as having a higher level of competence, they are held to a higher standard of culpability. A property inspection must be thorough to avoid these types of problems.

Areas Covered by a Home Inspection

From the roof to the foundation, and all parts and systems in between, home inspections are designed to let buyers know what they're getting into. A standard ASHI home inspection includes a visual inspection and written report on:

- All home systems (heating, air-conditioning, plumbing, and electrical),
- The foundation, basement, and visible structure,
- The roof (including gutters and downspouts), attic, and visible insulation,
- Windows and doors,
- Interior and exterior walls, and
- Floors and ceilings.

Other items that are usually inspected as part of a home inspection include garages, sidewalks and driveways, cabinets and countertops, appliances, fireplaces, security systems, and telephone systems. Most inspectors also offer additional tests (often at additional cost) for wells, septic systems, drinking water, air quality, termites, lead, radon, and any number of other items.

Coordination of Other Parties

Real estate transactions frequently involve the use of multiple professionals, such as a property inspector, appraiser, or attorney. A valuable service that a buyer's agent provides to the process is the coordination of other parties who have a role to play in the transaction. Think of yourself as the hub of a wagon wheel, and the spokes are the individuals involved in closing a real estate transaction. Although there are a number of professionals involved, they don't always talk to each other. Someone must assume the responsibility to coordinate everyone's efforts.



A brief description of some of these roles follows:

Appraisers. A lender will order an appraisal to understand the value of the property in question, and buyers are entitled to a copy of any appraisal report that was used by the lender to determine the terms of a mortgage loan.

Lender/Loan Originator. Most residential sales agreements provide that the buyer will make application to a lender within a specified period of time following the acceptance of the agreement. Should the buyer fail to make application, it could be considered a breach of contract on the buyer's part, resulting in legal issues with the seller.

Inspectors. Whether residential or commercial, there will be some level of inspection undertaken on the property, whether structural, environmental. or pest. Regardless of the type of inspection, there is always a time frame granted in the contract under which the inspection must be completed. In addition, the contract should specify the implication and application of any negative results an inspection may have on the continued existence of the agreement.

Attorneys. The attorney for the purchaser typically doesn't get involved with the transaction until an agreement has been reached with the seller. In a residential environment, this would be after the contract is signed by both the seller and purchaser. In a commercial environment, this typically occurs after the seller and purchaser have agreed to the terms of their agreement in a letter of intent.



The law *does not* require a licensee to verify the validity of information acquired from what is believed to be a credible source. Therefore, a licensee cannot be held liable for providing false information to the client if it was provided by presumably a credible source, unless the licensee knew or should have known the information was false.

Settlement

You are a professional planning a long career in this industry. Your satisfied client has the ability to increase your reputation and your business. Although a broker is not typically involved in the actual closing process, your presence helps to give your clients comfort knowing that there is someone in their corner, continuing to advocate on their behalf. Besides, recall your statutory obligation to, within the scope of knowledge required for licensure, answer the buyer's questions regarding the steps needed to fulfill contract terms.

Your duties are not yet over just because your client has signed a contract. Should there be any snags that arise at the closing, you may be instrumental in smoothing them out to allow for the closing to continue. In addition, this is a good time to reaffirm their satisfaction with your services and offer to help their family and friends that may also be interested in acquiring or disposing of real estate.

Illinois Good Funds Act

215 ILCS 155/26

The lender brings the amount of the mortgage to settlement to pay the seller (which shows as a *credit* to the buyer), so your buyer client is usually only responsible for the down payment and closing costs. In Illinois, a buyer must present "**good funds**" at closing. Although a title agent would likely inform the buyers of the requirements for closing, it doesn't hurt for you to remind them of this so that they're prepared and the closing can go smoothly.

Lawful **cash money** of the United States is considered to be good funds. For other methods of money transfer, good funds are defined in 215 ILCS 155/26 as follows (although note that individual title companies may choose to impose more stringent requirements on what method of payment they will accept):

Amounts up to $5,000:

- A personal check or checks in an aggregate amount not exceeding $5,000 per closing, provided that the closing agent has reasonable grounds to believe that sufficient funds are available for withdrawal in the account upon which the check is drawn at the time of disbursement

Amounts less than $50,000:

- Cashier's checks, certified checks, bank money orders, official bank checks, or teller's checks drawn on or issued by a financial institution chartered under the laws of any state or the United States
- A check drawn on the trust account of any lawyer or real estate broker licensed under the laws of any state, provided that the closing agent has reasonable grounds to believe that sufficient funds are available for withdrawal in the account upon which the check is drawn at the time of disbursement

Amounts greater than $50,000 held by a single party:

- Wired funds unconditionally held by and credited to the fiduciary trust account of the closing agent
- A check issued by the State of Illinois, the United States, or a political subdivision of Illinois or the United States

- A check drawn on the fiduciary trust account of a title insurance company or title insurance agent, provided that the closing agent has reasonable grounds to believe that sufficient funds are available for withdrawal in the account upon which the check is drawn at the time of disbursement

This legislation protects closing agents from liability for closing transactions when funds may not actually be available.

Follow Up

One of the most common complaints that a client has about his or her real estate broker is the lack of follow-up. Call you clients a week to 10 days following the closing. Reaffirm that you are there to assist them in all their real estate needs. Set a reminder on your calendar to schedule your future follow-up calls. In fact, this should be a regular practice regardless of whether you are working with the buyer, the seller, or both.

Real Success

Success in the real estate industry is primarily about building relationships. Your ability to understand and anticipate the needs of your clients and customers is critical. You need to wear a lot of different hats, play a lot of different roles, and interact with a lot of different people. But the bottom line is that buyers and sellers want to have a complete assurance about the character, ability, and strength of the person they're depending on to represent them. Of course, you know that as a licensed real estate professional, you owe your clients specific statutory obligations. Nonetheless, you must be able to exhibit the spirit of those duties in all facets of your dealings.

In addition to recognizing your fiduciary duties, knowing the law, and complying with rules and regulations, here are several basic principles and techniques that you can follow in order to ensure that you are providing the best possible service you can in your dealings with clients, customers, and colleagues:

- Greet people cordially. Be sincerely happy to see them.
- When interviewing or talking to someone, use that person's name frequently.
- Have respect for the diversity of other people.
- Be sympathetic and understanding when a person turns to you for help.
- Act cheerful at all times, even if you don't feel cheerful.
- Do your best to suppress irritability toward other people.
- Don't bother others with your problems because they no doubt are trying to take care of their own problems.
- Don't make others nervous by discussing topics that might depress or anger them.
- Avoid controversial topics, such as politics or religion.
- Be aware of the moods of others. Choose your actions with regard to how the other person appears to be feeling at that particular moment.
- Be aware of how your body language and the tone of your voice may be interpreted by others.
- Keep confidential information to yourself.
- Never make a promise that you feel you won't be able to fulfill.
- Always be dependable and reliable

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Summary

1. Licensees are obligated to disclose any **latent defects** that are *not* plainly observable or would not be discovered in a reasonable inspection. The seller's Residential Real Property Disclosure Report does not absolve a buyer of the responsibility to inspect the property.
2. **Material facts** generally refer to the condition of the property but could be any truth that would **change the individual's actions if it were known.** Material facts should be disclosed. Material information that is intentionally withheld is considered **fraud**. Buyers who ask questions about schools, crime, etc., should be directed to local authorities such as law enforcement or school districts for answers. Buyer's agents should be very cautious about responding to such questions and should never offer an opinion.
3. No cause of action may arise against a licensee for the failure to disclose an occupant of the property was afflicted with HIV or any other medical condition, the property was the site of an act or occurrence that had no effect on the physical condition of the property (for example, murder or suicide), fact situations on property that is not the subject of the transaction, or physical conditions located on property that is not the subject of the transaction that do not have a **substantial adverse effect** on the value of the property being sold.
4. Objections to property may be invalid, valid, or not answerable. Buyer's agents should be prepared to address objections, involving third parties as necessary. When closing a sale, be confident but not pushy. High pressure sales can result in buyer's remorse.
5. Offers to sellers are usually accomplished with purchase agreements. Because of the **Quinlan and Tyson** ruling, Illinois licensees may fill in the blanks of a **pre-printed purchase agreement** that was developed by local bar associations and boards of REALTORS®. Anything beyond the specific blanks on these approved forms and **contingency addendums** requires the services of an **attorney**. Buyers must receive signed copies of all documents **immediately**. Offers on commercial properties may be accomplished with non-binding **letters of intent.**
6. **Earnest money deposits**, while not required, show the seriousness of a buyer and can help in negotiations. Earnest money is usually considered as **liquated damages** to the seller in the event a signed deal does not close successfully. Earnest money should be held in a broker's escrow account until distributed.
7. Buyer's brokers must present all offers to a seller or the seller's designated representative in **a timely manner**, even if the property is subject to a contract to sell. A licensee representing a client does not breach a duty or obligation to the client by showing properties in which the client is interested to other prospective buyers or tenants. If multiple offers are to be considered by the seller simultaneously, the broker must present a **notice of contemporaneous offers** to both buyers and allow them to decide how to proceed with representation.
8. A **property inspection** is *a visual examination of the physical structure and systems of a property*. The objective is to find items that are dangerous, damaged, or don't work. It is not an appraisal of value and it is not a guarantee of functionality or structural integrity. A property inspection helps a buyer make informed decisions.
9. A closing agent may not disburse funds at closing unless they are considered to be **good funds**. Legal cash money is considered good funds, as is a personal check for less than $5,000. Other forms may include cashier's checks, certified checks, bank money orders, official bank checks, or teller's checks, as well as wired funds, under certain circumstances.

Quiz

1. ***A licensee is working with a buyer client. The buyer has the agent complete a pre-printed purchase agreement. When must the agent give a copy of the offer to the buyer?***
   a. as soon as the buyer signs the offer
   b. when the buyer signs the agency disclosure form
   c. when the seller accepts and signs the offer
   d. whenever the agent has time to make a copy and deliver it to the buyer's home

2. ***A house is listed at $242,000 and your buyer client wants to offer $195,000. Which fiduciary duty are you following by presenting the offer to the seller or the seller's agent?***
   a. confidentiality
   b. disclosure
   c. obedience
   d. accountability

3. ***If a buyer brings up an objection to buying a house, you should***
   a. forget about this house and move to another one because he or she is not interested.
   b. ask questions to understand the objection, so you can respond to it.
   c. tell the buyer that he's making a mistake because this is a perfect house for him.
   d. let the buyer talk to the seller.

4. ***A buyer is paying $22,000 in cash for the lot he's purchasing. What would NOT be an acceptable form of payment for him to bring to settlement?***
   a. cash money
   b. a certified cashier's check
   c. a check issued by the City of Chicago
   d. a personal check, assuming the closing agent received a verification of deposit from the bank

5. ***Susan really wanted her children to go to a particular school, so she was not interested in looking at an otherwise perfect house in a neighboring district. How would you classify Susan's objections?***
   a. invalid but answerable
   b. invalid and not answerable
   c. valid but answerable
   d. valid and not answerable

6. ***A licensee is working with two clients who are interested in buying the same property listed by another brokerage. What disclosure may be required?***
   a. agency relationship disclosure
   b. disclosure of contemporaneous offers
   c. dual agency disclosure
   d. notification of non-agency

7. ***What is the common name of the court ruling that established a real estate licensee's ability to use a pre-printed purchase contract for the purchase of real property?***
   a. Buchanan v. Warley
   b. Jones v. Mayer
   c. Plessy v. Ferguson
   d. Quinlan and Tyson

8. ***Which is NOT considered a purpose of the real estate sales contract?***
   a. buyer's offer
   b. contract between the buyer and the seller
   c. contract between the seller and the broker
   d. receipt for the earnest money deposit

9. ***A buyer's broker has actual knowledge of structural damage to the floor boards of a home due to termite infestation. He informs his client that there are no termites in the home. The buyer signs a contract to purchase the property. Could the broker be susceptible to claims of fraud?***
   a. No because he is protected by the "as is" clause in the purchase agreement.
   b. No, because he said there were no termites, which could be true at present.
   c. Yes, because he knowingly made a potentially untrue statement that could be seen as an inducement to buy.
   d. Yes, unless there are visible signs of termites, the broker is justified in indicating that there are no termites within the property's structure

10. ***Which is NOT a purpose of a property inspection?***
    a. disclose repairs that should be done immediately
    b. guarantee that all major systems are functional
    c. indicate any conditions that are unsafe
    d. point out significant deficiencies in the home

11. ***If the buyers are ready to sign an offer but want to consult their lawyer first, the agent should***

    a. have his managing broker go over the contract with the buyers to make them feel more at ease.
    b. stress that time is of the essence with this sale.
    c. tell them normal procedure is for them to talk with a lawyer after signing the offer.
    d. tell them they should feel free to talk with their lawyer first.

12. ***Your buyer client wants to immediately submit an offer on a property that is currently under contract. Can you legally submit an offer to the seller's agent?***

    a. Yes, but the listing broker cannot give it to his client unless the contract falls through.
    b. Yes, but the listing broker is allowed to refuse to accept the offer.
    c. Yes, you have a fiduciary duty to present any offer to purchase.
    d. No, that would be contract interference.



UNIT 12

REAL ESTATE MATH

Chapter 37 – Real Estate Math

37

Real Estate Math

This section contains the basic formulas you need to know to answer the math questions on the real estate sales license exam. These formulas are organized as follows:

- General Formulas (fractions, percents, and decimals; measurements)
- Financial Formulas (loan-to-value, interest, points, qualifying ratios, net to seller)
- Valuation and Appraisal Formulas (appreciation/depreciation, capitalization rate, gross rent multiplier, net operating income, cost approach)
- Closing/Settlement Formulas (proration, property taxes, transfer taxes, commission)
- Property Management Formulas (profit and loss)

General Formulas

Fractions, Decimals, and Percents

As a real estate professional, much of the math you will encounter will require a working knowledge of fractions, decimals, and percents. Fractions, decimals and percents are all related and express a **part of the total** – only they express the same amount in a different way. For example, 20 is part of 100:

Fraction: 20 is 1/5 of 100

Decimal: 20 is .20 of 100

Percentage: 20 is 20% of 100

Converting Fractions, Decimals and Percents

To convert a fraction to a decimal you simply **divide** the numerator (the top number) by the denominator (the bottom number). Example: 4/5 = 4 ÷ 5 = .8

To convert this decimal to a percent, move the decimal point **two spaces to the right** and add a percentage sign. Example: .8 = 80%.

To convert this percent back to a decimal, move the decimal point **two spaces to the left** and drop the percentage sign. Example: 80% = .8.

And to convert a percent to a fraction, remember a percent becomes a fraction when placed over its denominator of 100. **Reduce the fraction whenever possible**. Example: 34% = 34/100 which can be reduced to 17/50 by dividing the numerator and denominator by 2.

Practice

In the chart below, enter the missing numbers in the form of a fraction, decimal or percent.

Percents	Fractions	Reduced Fractions	Decimals
40%			
	5/8	5/8	
	8/100		.08
55%			
	9/100	9/100	
			1.20

Calculating Part, Whole, or Percent

Part = Whole x Percent

Whole = Part ÷ Percent

Percent = Part ÷ Whole

The **Part** represents **a portion of the whole** and is always the **smaller number**. Examples of "part" include:

- Annual interest
- Loan amount
- Net income
- Monthly payment
- Agent's share of commission

Percents are always expressed as a **percent, rate or ratio.** Examples of "percent" include:

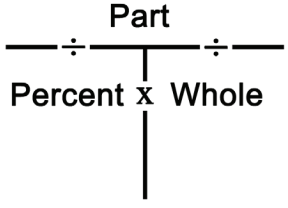
- Loan-to-value ratios
- Qualifying ratios
- Interest rate
- Capitalization rates
- Commission split

The **Whole** represents **the entire item** and is always a larger number (except in appreciation problems). Examples of "whole" include:

- Sale price
- Loan amount
- Total commission
- Gross rent
- Gross monthly income

T System

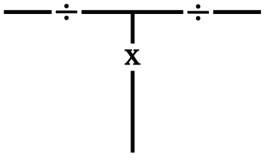
Some people like to use a memory device known as the **"T System"** (also referred to as **circle math or T math**) for solving problems dealing with percents or percentages. Though you can always use the straight line approach to solving mathematical problems, the T System is a simple way to break down math into a few easy steps. The T System can be used with **any three part formula** as illustrated here with the three factors common in all percent problems; **Part, Percent** and **Whole**.



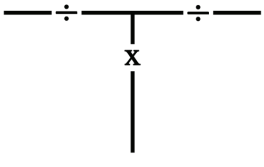
Note, the **horizontal line indicates division** and the **vertical line indicates multiplication**.

Practice

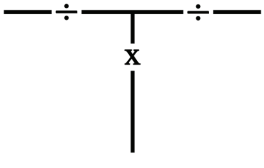
1. $150,000 is 30% of what dollar amount?



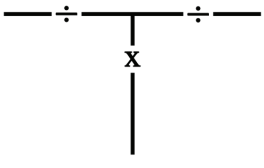
2. If 40% of the 1,200 houses in your neighborhood have garages, how many houses have garages?)



3. A homeowner sold his house a year after he bought it and paid off the $246,800 balance on his mortgage from the proceeds. If the lender charged a prepayment penalty of a half a percent of the loan balance, how much did he owe the lender?



4. Greg earned a commission of $1,020 on the sale of a $24,000 car. What was his commission rate?



Measurements

Questions on the state exam use different types of measurements relating to building lots, fencing, and concrete.

The five types of measurements you need to know are:

- **Front Feet**: The portion of the lot that faces the street. In a measurement, frontage is always the *first* number (a 65' x 150' lot has 65 front feet).
- **Square Feet:** Length multiplied by width (65' x 150' = 9,750 sq. ft.).
- **Acreage:** There are 43,560 square feet in an acre. Calculate the square feet of the lot, then divide that number by 43,560 (65' x 150' = 9,750 sq. ft. ÷ 43,560 = 0.2238 acre).
- **Linear Footage:** This is simply the length in feet around the perimeter (a 20' x 30' garden will take 100 linear feet of fencing).
- **Cubic Feet/Yards:** Length multiplied by width multiplied by depth equals cubic feet. Cubic feet divided by 27 results in cubic yards. (120' x 10' x 0.3333' = 399.96 cubic feet ÷27 = 14.8133 cubic yards).

Units of Measure and Conversions	
Linear Measurements	12 inches = 1 foot 36 inches = 3 feet = 1 yard 5,280 feet = 1 mile *- To convert inches to feet, divide inches by 12.* *- To convert feet to yards, divide feet by 3.* *- To convert yards to feet, multiply yards by 3*
Square Measurements	144 square inches = 1 square foot 1,296 square inches = 9 square feet = 1 square yard *- To convert square feet to square yards, divide square feet by 9.* *- To convert square yards to square feet, multiply square yards by 9.* *- To convert square inches to square feet, divide square inches by 144.*
Cubic Measurements	1,728 cubic inches = 1 cubic foot 46,456 cubic inches = 27 cubic feet = 1 cubic yard *- To convert cubic feet to cubic yards, divide cubic feet by 27.* *- To convert cubic inches to cubic feet, divide cubic inches by 1,728.* *- To convert cubic yards to cubic feet, multiply cubic yards by 27.*
Circular Measurements	360 degrees = a circle
Surveyor's Measurements	43,560 square feet = 4,840 square yards = 1 acre 640 acres = 1 square mile = 1 section 36 sections = a township 1 township = 36 square miles

All measurement must be in the same units before doing the calculations! For example, if given both inches and feet in a problem and you're asked to determine the square footage; you will need to convert inches to feet by dividing the inches by 12.

Calculating Rectangular Area

Length x Width = Square Inches or Square Feet or Square Yards

Example:

A 12 x 15 room requires 20 square yards of carpet.

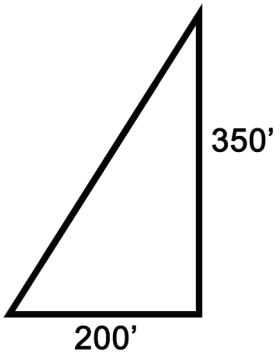
12 x 15 = 180 square feet

180 ÷ 9 = 20 square yards

Calculating Triangular Area

There are two common ways to figure the square footage of a triangle,

- Multiply **half** of the **base** measurement times the **height**, or
- Multiply the **base** times the **height** and divide by 2.



Example:

(200 ÷ 2) x 350 = 35,000 sq. ft.

(200 x 350) ÷ 2 = 35,000 sq. ft.

Calculating Volume

Length x Width x Height = Cubic Inches or Cubic Feet or Cubic Yards

Example:

A pool is 12' long, 8' wide, and 6' deep. The volume of the pool is:

12 x 8 x 6 = 576 cubic feet

To convert cubic feet to cubic yards, it's necessary to divide by 27:

576 cubic feet ÷ 27 = 21.33 cubic yards

Linear Feet

Length + Width + Length + Width = Linear Feet

Example:

A 75' x 50' back yard would require 250 linear feet of fencing.

75 + 50 + 75 + 50 = 250 linear feet

Sections

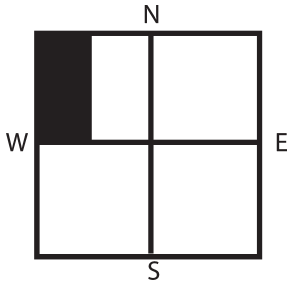
The rectangular (government) survey system is one method of legal property description. It uses terms such as **sections** and **townships**.

There are two types of math problems on sections:

1. You may be given a description and asked to calculate the number of acres in that particular area. Here, it is important to remember that the *total number of acres in a section is 640.*
2. You may be shown a diagram of a section and asked to write the description.

Examples:

1. Calculate the number of acres in the parcels described as the NW 1/4, NE 1/4 of section 32, and the NW 1/4, NE 1/4, NE 1/4 of Section 33.



640 ÷ 4 ÷ 4 = 40 Acres

640 ÷ 4 ÷ 4 ÷ 4 = 10 Acres

40 + 10 = 50 Acres

There are 50 acres total in the two parcels.

2. Write the description for the shaded area.

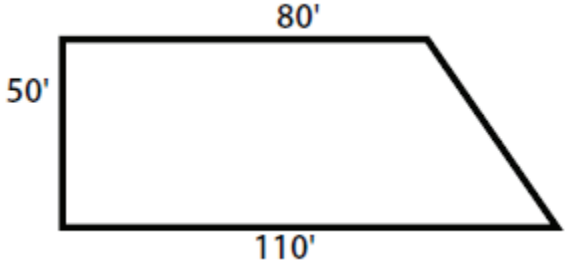
The description for the shaded area would read W 1/2, NW 1/4 of the section.

Practice

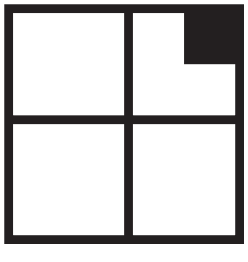
1. What would a commercial lot, 150' x 600', priced at $2,000 per front foot cost? What would it cost at $2.50 per square foot?

2. If a bag of concrete makes one cubic yard, how many bags will it take to pour a 60' x 4' x 4" sidewalk?

3. A lot measures 80' across the back, 50' deep, and 110' across the front. What is the sq. ft. of the lot?



4. Write a description for the shaded area:



5. Calculate the number of acres in the parcels described as the N 1/2, NW 1/4, and the SW 1/4, NW 1/4, NE 1/4 of Section 33.

6. A builder purchased a 10 acre parcel. He wants to divide the parcel into smaller lots. Before dividing the parcel, the builder must build an access road 20 feet wide and 840 feet long. How many lots will the developer be able to create with the remaining land if each lot measures 50 yards by 60 yards?

Financing Formulas

Down Payment and Loan-to-Value Ratio

Down Payment

The amount of money the lender requires a buyer to pay toward the purchase price of the property is called a **down payment**. The formula for down payment is:

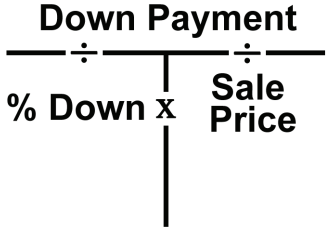
Down Payment (Part) = % Down (Percent) x Sale Price (Whole)

Depending on the information provided in the question, you may need to use a variation of this formula to calculate the answer:

Down Payment (Part) = % Down (Percent) x Sale Price (Whole)

% Down (Percent) = Down Payment (Part) ÷ Sale Price (Whole)

Sale Price (Whole) = Down Payment (Part) ÷ % Down (Percent)



If using the T System, the formula would look like this:

Example:

Your client wants to purchase a home selling for $117,900. The best financing available requires a 20% down payment.

.20 (Percent) x $117,900 (Whole) = $23,580 (Part)

Loan-to-Value (LTV)

The difference between the sales price and the amount the lender is willing to lend is known as the **loan-to-value ratio**. The LTV correlates to the down payment in that a loan with a down payment of 20% has a loan-to-value of 80%. The formula for loan-to-value ratio is:

LTV (Percent) = Loan Amount (Part) ÷ Sales Price (Whole)

Depending on the information provided in the question, you may need to use a variation of this formula to calculate the answer:

Loan Amount (Part) = LTV (Percent) x Sale Price (Whole)

LTV (Percent) = Loan Amount (Part) ÷ Sale Price (Whole)

Sale Price (Whole) = Loan Amount (Part) ÷ LTV (Percent)

Example:

The mortgage lender will qualify a borrower for a loan only if the loan-to-value ratio is less than 85%. The buyer wants to purchase a house that's selling for $215,000. He has $40,000 to put down, so he needs a loan for $175,000. Does this meet the lender's requirements?

$175,000 (Part) ÷ $215,000 (Whole) = 81.4%

Yes, the borrower meets the loan-to-value requirement.

Combined Loan-To-Value

The **combined loan-to-value** (CLTV) is the percentage of the property value borrowed through a combination of more than one loan, such as a first mortgage and a second mortgage home equity loan. The CLTV, sometimes called **total loan-to-value (TLTV)**, is calculated by adding all loan amounts and dividing by the home's appraised value or purchase price, whichever is lower.

Example:

Appraised Value: $100,000

First Mortgage: $80,000

Second Mortgage: $10,000

($80,000 + $10,000) ÷ $100,000 = 90% CLTV

Both loan-to-value (LTV) and combined loan-to-value (CLTV) can be used to determine the amount of home equity a borrower has. So, that borrower with 90% CLTV has 10% equity in the property.

Interest

Interest is the cost of using someone else's money. Interest is typically expressed as a percentage of the loan amount and is most often charged to the borrower on an annual basis, though interest can be paid monthly or at intervals greater than one year. The formula for calculating interest is:

Annual Interest = Annual Interest Rate x Loan Amount

Depending on the variables provided in a problem, you may be required to use a variation of the Interest formula. Remember, when two variables in the interest formula are known, the third can be calculated:

Annual Interest (Part) = Loan Amount (Whole) x Annual Interest Rate (Percent)

Loan Amount (Whole) = Annual Interest (Part) ÷ Annual Interest Rate (Percent)

Annual Interest Rate (Percent) = Annual Interest (Part) ÷ Loan Amount (Whole)

Example:

A savings account generates a monthly interest payment of $50. If the account balance is $1,600, what interest rate is being earned?

$50 (Part) ÷ $1,600 (Whole) = .03125 (Percent)

The interest rate being earned is 3.125%.

Practice

1. What is the annual interest earned by a bank on a $220,000 at 8% annual interest?

2. What interest rate did the borrower pay if she borrowed $52,800 and paid $693 in interest each quarter?

3. You are refinancing a $200,000 mortgage with a prepayment penalty of six months of interest at 6.5%. How much is the prepayment penalty?

Points

Points are really just a percent of the mortgage or loan amount (not the sale price). **One point equals one percent of the loan**. On the real estate exam, points may also be referred to as "**discount points**" or "**loan origination fees**." Regardless, they mean the same thing and are calculated the same way. The formula used for calculating points is:

Fee Owed (Part) = Points (Percent) x Loan Amount (Whole)

Example:

If a lender requires a borrower to pay 2 3/4 discount points on a $195,000 loan, what will the borrowers owe in points?

.0275 (Percent) x $195,000 (Whole) = $5,362.50 owed in points (Part)

Points may also be paid by a borrower at closing to lower the interest rate over the life of a loan. These are usually referred to as **discount points**. For example, a lender may offer to reduce the interest rate by 1/8% for every discount point the borrower is willing to pay upfront.

Example:

A borrower financing $180,000 was quoted an interest rate of 6.5% for a 30-year conventional loan. The payments on that loan would be $1,137.72 per month. At 6.25% for the same $180,000 30-year loan, the payments would be $1,108.29. So by paying two discount points up front to buy down the interest rate 1/4%, the borrower pays $29.43 per month less. What will the discount points cost the borrower?

.02 (Percent) x $180,000 (Whole) = $3,600 (Part)

With a monthly savings of $29.43 per month, this borrower must stay in the mortgage for at least 123 months to realize the advantages of the buydown:

$3,600 ÷ $29.43 = 122.3 months

Practice

1. Three discount points cost a seller $2,250. What was the amount of his loan?

2. If a seller paid $3,200 in discount points on a $160,000 loan, how many points were charged?

3. Jennifer is purchasing a property for $210,000 and will make a 20% down payment. She will be charged 2 ½ points. How much will Jennifer owe in points?

Loan Qualifying

Qualifying is the process of determining either the maximum monthly payment or maximum sales price a prospect can afford. This is accomplished through arbitrary ratios that vary based on loan type. One factor in such calculations is PITI (principle, interest, tax and insurance), the percent of the buyer's income that will be applied to the total amount of the payments on the requested loan.

Housing Expense Ratio

A buyer's housing expense ratio, also called the **front end ratio**, is the relationship of the buyer's **total monthly housing expense** to income, expressed as a percentage:

Total Housing Expense ÷ Gross Monthly Income = Ratio %

Conventional lenders consider a buyer's income adequate for a loan if the proposed total housing expense does not exceed **28%** of stable gross monthly income, for example:

Total Debt-to-Income Ratio

A buyer's total debt-to-income ratio (DTI), also known as the **back end ratio**, is the relationship of the buyer's total monthly debt obligations (including total housing expenses plus long-term debts) to income, expressed as a percentage.

(Total Housing Expense + Debt) ÷ Gross Monthly Income = Ratio %

Practice

1. Sam and Lacy want to obtain a loan to buy a new home. Their combined monthly income is $5,500. What amount of monthly payment can they qualify for if the lender uses 28/36 ratios and they have no other debt?

2. John and Libby Jackson earn a combined gross annual income of $90,000. They want to purchase a $250,000 home and plan to obtain a $225,000 conventional loan at 6.50% for 30 years. The monthly principal and interest payment will be $1,750, the hazard insurance premium is $51, the taxes are $125 and the financed private mortgage insurance premium is $38.25. Their only long term debt is a $350 per month car payment and a $300 loan payment. Can they qualify for a loan using 28/36 ratios?

3. Using the information in problem three above, what is the maximum monthly debt John and Libby can have and still qualify for the loan?

4. Seth and Kelly have been told that the monthly payment for PITI on the house they wish to buy is $970. If local lenders are qualifying prospective buyers at 28/36, what is the required monthly income for Seth and Kelly?

Net to Seller

As a real estate agent, there will be times when your client/the seller will want to net a certain amount on the sale of the property after expenses. This is often referred to as **seller pricing** or **net to owner.** Based on what the seller wants to make, you will be asked to determine the ultimate selling price (selling price may also be called listing price, sales price, or minimum offer). There are two steps to calculating the ultimate selling price:

1. Add up everything in the question, except the commission, to get the base price.

2. Build in the commission and use the percent formula.

The formula used in calculating net to seller is:

Gross Sales Price (Whole) = Net amount + Expenses (Part) ÷ 100% – Deductions (Percent)

Example:

Laney wants to sell her home. She must pay off her existing $35,000 mortgage and pay $3,200 in closing costs. She wants to have $40,000 left so she can buy another home. If she pays a 6.5% commission, what is the minimum offer she can accept?

$78,200 (Part) ÷ 0.935 (Percent) = $83,636.36 (Whole)

Laney must sell her house for a minimum of $83,636.36.

Practice

1. Mike and Melanie Patrick are considering an offer on their home. They must pay off a $145,500 loan; pay closing costs of 2,300 and a survey of $460. Their broker is charging a 6% commission. What is the minimum acceptable offer?

2. After deducting $4,200 in closing costs and a 5.5% brokerage fee, the seller netted $180,300. What was the selling price?

Valuation & Appraisal Calculations

Appreciation and Depreciation

Appreciation is the increase in value or worth of a property. In appreciation problems, you will be given three pieces of information:

1. The annual rate of appreciation
2. The number of years the property has appreciated
3. The current or original value of the property

The formula for calculating Appreciation ("A" for Add) is:

Original Value = Current Value ÷ (100% + Rate of Appreciation) OR

Current Value = Original Value x (100% + Rate of Appreciation)

The **rate of appreciation** in the formula above is the annual rate of appreciation multiplied by the number of years the property has appreciated.

Depreciation represents a loss in value or worth. The formula for calculating Depreciation ("D" for Deduct) is:

Original Value = Current Value ÷ (100% - Rate of Depreciation) OR

Current Value = Original Value x (100% - Rate of Depreciation)

The **rate of depreciation** in the formula above is the annual rate of depreciation multiplied by the number of years the property has depreciated.

This simple method of calculating depreciation can also be used for the purpose of determining income tax deductions for income-producing property. With this, the loss in value of commercial property is figured **equally** over the recovery period. Note, however, that **only the buildings** (called improvements) can depreciate, not the land on which the building sits. Federal income tax laws set the so-called recovery periods as follows:

- Residential income property – 27 1/2 years
- Commercial property – 39 years

So, to find the depreciation:

Improvement Value ÷ Recovery Period = Annual Amount of Depreciation

Example:

Richard is the owner of a four-unit apartment building. The property is valued at $375,000. If the land is valued at $75,000, the depreciation calculation is based on $300,000. Since recovery period on residential income property is 27.5 years, you can determine that Richard can deduct $10,909 of his taxes for depreciation:

$300,000 ÷ 27.5 = $10,909

Practice

1. Margaret's beach front property has depreciated 4% per year for 7 years. If the current value is $135,000, what did she originally pay for it?

2. An office building was purchased 10 years ago and is now worth $564,000. It has appreciated 3% per year in this time. What was the original value?

3. Seven years ago, an investor purchased a downtown condo complex and parking garage. The current value of the property is $1,200,000. Of the total, the current value of the condos is $950,000 and the current value of the parking garage is $250,000. Using the straight line method, assuming an average appreciation of 6% on the condos and an average depreciation of 5% on the parking garage, what was the original value of the property?

Net Operating Income

Net operating income (NOI) is the income *after expenses*. To find NOI, you would add total annual income from all sources, then subtract vacancy losses and expenses. The formula to find NOI is:

Gross Income – Vacancy Loss – Expenses = Net Operating Income

Capitalization Rate

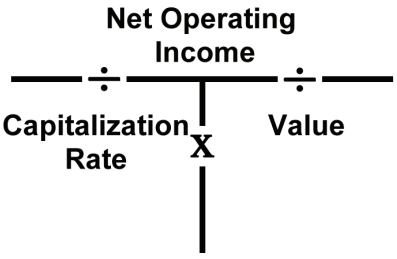
Capitalization rate is a percentage rate of return used by investors to calculate the present value of the property based on its ability to generate income. It is a method of estimating the value of a property by dividing the annual **net operating income (NOI)** produced by a property by the desired capitalization rate. Net operating income is the income available to the property owner after all operating expenses (taxes, insurance, etc.) have been paid. Capitalization rate is used in the **income approach** to appraisal and uses **net** income. You may be required to use different steps to find the net income, depending on the question. Be familiar with these terms:

- **Potential Gross Income.** The income a property would generate if every unit was occupied 100% of the time.

- **Effective Income.** Potential gross income minus vacancy and collection losses.
- **Net Operating Income.** Effective gross income minus annual operating and building expenses.

The formula for capitalization is remembered as **IRV** or:

(Net Operating) Income ÷ (Capitalization) Rate = Value



If using the T System, the capitalization formula would look like this:

Depending on the variables provided in a problem, you may be required to use a variation of the Capitalization Rate formula. Remember, when two variables are known, the third can be calculated:

Value (Whole) = Net Operating Income (Part) ÷ Capitalization Rate (Percent)

Net Operating Income (Part) = Capitalization Rate (Percent) x Value (Whole)

Capitalization Rate (Percent) = Net Operating Income (Part) ÷ Value (Whole)

Caution: Depreciation and annual debt service are **NOT** considered building expenses and should **NOT** be used if they are included in the problem. They are owner expenses.

Example:

A property could generate $200,500 in annual income. The building has an 8% collection loss, monthly expenses of $4,200, and the capitalization rate is 9%. What is the value of the property?

1. $200,500 (Potential Income) – $16,040 (Losses of 8%) = $184,460 (Effective Income)
2. $184,460 (Effective Income) – $50,400 (Annual Operating Expenses: $4,200 x 12) = $134,060 (Net Income)
3. $134,060 (Net Income) ÷ 9% (Rate) = $1,489,555.5555 (Value)

The value of the property is $1,489,556.

Practice

1. A property generates $325,000 in annual income. If monthly expenses are $6,500 and the capitalization rate is 8%, what is the value of the property?

2. The net operating income from a commercial building is $21,450. The estimated value of the property is $165,000. What capitalization rate did the appraiser use to arrive at this value?

3. An apartment complex has 8 units, each of which rents for $525 per month. The building has an occupancy rate of 95% and monthly building expenses are $800. An interested investor requires at least an 11% rate of return on her investment. What is the most the investor should pay for this property?

4. Applying a capitalization rate of 12.5%, what is the appraised value of a property that earns a monthly gross potential income of $45,600 and has a vacancy rate of 6% and operating expenses of 3%?

Gross Rent Multiplier

Gross rent multiplier (GRM) is used to compare the income-producing characteristics of **rental** properties in the sales comparison approach to appraisal. GRM refers to **rental income only.** Gross rent multipliers convert gross income into a market value. Unlike the capitalization rate formula, the GRM formula uses **gross income, not net income.** The gross rent multiplier formula is:

Value ÷ Gross Monthly Income = Gross Rent Multiplier

Expect the question to include information such as expenses that will attempt to direct you to net income – ignore it! Remember, use only gross income for gross rent multiplier. Also make sure you are clear on whether the figures presented represented monthly or annual income and adjust as necessary.

Example:

A property is valued at $195,000 and generates an annual income of $24,000. Building expenses run $1,100 per month, leading to a net income of $10,800. Calculate the gross rent multiplier.

$24,000 ÷ 12 = $2,000

$195,000 ÷ $2,000 = 97.5

The GRM is 97.5.

If the GRM derived above is applied to a subject property that generates $1,800 monthly, calculate the value of the subject property.

$1,800 x 97.5 (GRM) = $175,500

The indicated value of the subject property is $175,500.

Practice

1. Calculate the gross monthly rent multiplier on a property valued at $750,000 if the gross annual income is $81,000.

2. A property generates gross rents of $4,165 a month. It recently sold for $450,000. If it has a vacancy rate of 10% and expenses of $1,400 per month, calculate the gross rent multiplier.

3. The rental property being appraised rents for $7,680 a year. If the appraiser settles on a GRM of 132.5, what is the estimated value of the property?

4. Calculate the value of an apartment if the gross monthly income is $3,600 and the GRM is 108.

Cost Approach

The **cost approach** is a valuation method that develops an opinion of value for a property by calculating the cost of the land, site improvements and the cost to build the structure on the land. The formula for determining value using the cost approach is simple:

Cost of Improvements – Depreciation + Site Value = Final Property Value

Example:

An appraiser notes the following about the property: Replacement Cost=$465,000; Depreciation=$32,000; Site value=$85,000. What is the final estimate of value using the cost approach?

$465,000 - $32,000 + $85,000 = $518,000

Settlement Formulas

Prorations

Proration is when a cost or financial item is **divided between the buyer and seller** based on the amount of time they each owned the property, such as property taxes or homeowners association fees. There are two types of years used in proration:

1. **Calendar Year** = 365 days with actual number of days in each month.

2. **Banker's Year (Statutory Year)** = 360 days a year with 30 days in each month.

There really isn't a standard formula for calculating prorations, rather it is a series of steps which differ when calculating proration based on a calendar year vs. a banker's/statutory year.

Using a **calendar year**, calculating proration would follow these three steps:

Step 1: Take the financial item stated in the question (property taxes, interest, etc.) and divide it by 365 days to get a cost per day.

Step 2: Find the number of days for the seller or buyer.

Step 3: Multiply the daily rate times the number of days.

Using a **banker's/statutory year**, calculating proration would follow these three steps:

Step 1: Calculate a monthly rate by dividing by 12.

Step 2: Find the number of months in question. State exams usually will use simple closing dates like the 15th or 30th so you can use a whole or half month.

Step 3: Multiply the month rate by the number of months.

Follow these steps to find a prorated amount:

1. Determine who the expense belongs to (is the expense paid in arrears or paid in advance).
2. Determine if the expense is based on a calendar or statutory year.
3. Obtain starting and ending dates for the duration of the expense.
4. Calculate the number of days between those dates.
5. Calculate the cost for that amount of time.

Generally speaking, the following rules apply to prorations:

- Always use calendar year unless otherwise directed.
- Always do math to four places past the decimal until the final answer.
- Unless otherwise stated, seller is charged for the day of closing.
- If question doesn't use a closing date, use the sale date.
- Mortgage payments are due on the first day of each month.
- Debit the seller and credit the buyer the same amount and vice versa.

Example:

The sale of a property will close on May 30. Taxes are $2,500 per year and are paid through the last half of the previous year. Calculate the seller's share of taxes using a calendar year (365 days).

1. Calculate the cost per day ($2,500 ÷ 365 = $6.85).
2. Determine the number of days in which taxes haven't been paid (January 31 + February 28 + March 31 + April 30 + May 30 = 150).
3. Multiply the number of days for which taxes haven't been paid by the daily tax rate (150 x $6.85 = $1,027.50).

The seller owes $1,027.50 in taxes.

Practice

1. Property taxes on a home are $3,100 per year. They are paid through the first half of the year. The property has been sold and the closing date will take place on November 15 of the same year. What amount of prorated taxes will be due the buyer if using a banker's year?

2. The premium for two-year insurance coverage on a home is $620. If the policy was purchased and paid for July 1, 2009 and the closing takes place April 2, 2011, what credit is due? Use a 365 day calendar.

Property Taxes

As a real estate licensee, it may be necessary for you to calculate real estate taxes. When assessing taxes, taxing entities use the **ad valorem** system which means, "according to value." So, an ad valorem tax is based on the value of the property. To calculate the amount of taxes that will be imposed on a piece of property, you must know two things:

1. The percentage or ratio of assessment to market value used in the area.
2. The tax rate which can be expressed in any of four ways (all are equivalent):
   - Dollars/cents per hundred dollars of assessment, i.e., $5.50 per $100
   - Dollars/cents per thousand of dollars of assessment, i.e., $55 per $1,000
   - Percent, i.e., 5.5%
   - Mills, i.e., 55 mills (Note: 1 mill = $1 per $1,000. Per means divide so $1 ÷ $1,000 = .001)

You should be able to calculate the annual taxes, the tax rate, or the assessed value of a piece of real estate.

Assessed Value

Often, the first thing you will need to do is compute the **assessed value**. In some jurisdictions, this step isn't necessary because assessed value and market value are the same, in other words, property is assessed at 100% of market value. But other jurisdictions apply an assessment ratio to the property's market value before calculating the taxes. The formula for assessed value is:

Assessed Value (Part) = Assessment Ratio (Percent) x Market Value (Whole)

Example:

A lot is assessed at 45% of its market value of $60,000. What is its assessed value?

.45 (Percent) x 60,000 (Whole) = $27,000 (Part)

The assessed value is $27,000.

Annual Taxes

Once you have determined the assessed value, you can calculate the annual taxes by using this formula:

Annual Taxes (Part) = Tax Rate (Percent) x Assessed Value (Whole)

Depending on the information provided in the problem, you may need to use a variation of the tax formula as show here:

Annual Taxes (Part) = Tax Rate (Percent) x Assessed Value (Whole)

Tax Rate (Percent) = Annual Taxes (Part) ÷ Assessed Value (Whole)

Assessed Value (Whole) = Annual Taxes (Part) ÷ Tax Rate (Percent)

Example:

A property is appraised at $545,000 and assessed for tax purposes at 55% of value. Calculate the semi-annual taxes if the mills total is 59.

1. Calculate the assessed value: .55 (Percent) x $545,000 (Whole) = $299,750 (Part)
2. Use the tax formula: .059 (Percent) x $299,750 (Whole) = $17,685.25 (Part)
3. Find the semi-annual tax bill: $17,685.25 ÷ 2 = $8,842.63

The semi-annual taxes are $8,842.63.

Practice

1. What must a property's assessed value be if its taxes are $3,600 and taxed at 62 mills?

2. What tax rate would be used if a property assessed at $148,900 generates $8,200 in taxes?

3. Taxes are based on an assessment ratio of 45% of market value. This year, the school system collects 23 mills per $1 of assessed value. Calculate the annual school tax for a property valued at $325,000.

Transfer Taxes

A **transfer tax** (sometimes called **conveyance fee**, **auditor's transfer tax,** or **state documentary stamps**) is a tax charged to the seller based on the sale price of the property. The payment of the transfer tax is usually made by purchasing state documentary stamps and attaching them to the deed and having them canceled. The transfer tax charged and any exemptions from this tax differ from state to state.

Keep in mind, exam questions try to obscure the sales price by adding down payment, mortgage and other information to the question which you do not need. Use sales price ONLY. Note, however, if the buyer *assumes* the mortgage balance, it is not a taxable consideration.

Example:

A seller is selling his home for $205,600. The buyer will make a $25,000 down payment and borrow $180,000 from his bank. What is the transfer tax if the state tax rate is $.75 per $500 or portion thereof?

1. Determine the taxable units: $205,600 ÷ $500 = 411.2
2. Calculate the transfer tax: 412 (to account for the portion) x .75 = $309.00

The transfer tax is $309.

Practice

1. A property was sold in a state where the conveyance fee is $1.50 for each $1,000, or portion thereof, paid in cash at the time of the transfer. The property was appraised at $430,000 and sold for $422,500. What is the transfer tax?

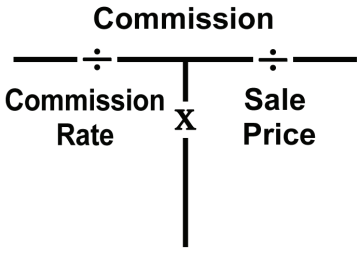
2. A seller is selling his home for $165,800. The buyer will make a $15,000 down payment and assume a $100,000 mortgage. What is the transfer tax if the state tax rate is $.75 for each $500 or portion thereof paid in cash at the time of the transfer?

Commission

When you sell or lease a property, your compensation is often paid in the form of a **commission** or a percentage of the sales price or lease. The formula used to determine commission is:

Commission (Part) = Commission Rate (Percent) x Sale Price (Whole)

If using the T System to calculate commission, it would look like this:



Depending on the information provided in a problem, you may need to use a variation of this formula:

Commission (Part) = Commission Rate (Percent) x Sale Price (Whole)

Sale Price (Whole) = Commission (Part) ÷ Commission Rate (Percent)

Commission Rate (Percent) = Commission (Part) ÷ Sale Price (Whole)

Example:

In the MLS, it states that the seller will pay 7% commission and the listing agent will pay 3% to a buyer's agent. Buyer's agent David earns a total of $5,340 commission. What was sale price of the property?

$5,340 (Part) ÷ .03 (Percent) = $178,000 (Whole)

The property sold for $178,000.

Commission Splits

Sometimes commission is split between the listing broker, selling broker, and individual agents. When commissions are divided, the total commission is calculated first, and then the broker and agent shares are determined. The formula for splitting commission is:

Share (Part) = Commission Split (Percent) x Commission (Whole)

Example:

A property sold for $149,500. The total sales commission is 6% and is divided as such: The listing brokerage will receive 40% of the sales commission; the selling brokerage will receive 60% of the sales commission; the selling agent will receive 60% of the selling brokerage commission. How much will the agent earn?

1. First, you have to convert the percents to decimals: 6% = .06; 40% = .40; and 60% = .60.
2. Now determine total commission: $149,500 x .06 = $8,970
3. Once you know the total commission you can calculate the percent that goes to the listing and selling offices.

   Listing brokerage: $8,970 x .40 = $3,588

   Selling brokerage: $8,970 x .60 = $5,382

   Selling agent: $5,382 x .60 = $3,229.20

The selling agent will earn $3,229.20.

Practice

1. Maxtown Realty sold a listing for $234,500. If they charged a 6.5% commission rate, what commission would they earn?

2. A real estate agent receives a commission of $11,268 as half of the total commission. The sales price of the property was $375,600. What rate of commission did the broker charge?

3. A property was sold for $236,400. The sales agent involved in the transaction received 40% of the broker's 7% commission. How much money did the sales agent receive?

Property Management Formulas

Profit/Loss

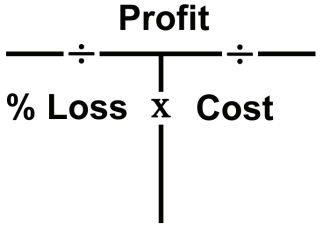
Profit or loss is the difference between the cost and the sales price of a property. Also called **return on investment** (ROI), profit can be calculated using this formula:

Profit (Part) = %Profit (Percent) x Cost (Whole)

And loss can be calculated using this formula:

Loss (Part) = %Loss (Percent) x Cost (Whole)

The profit/loss formula would look like this in the T System:



Another way to remember how to calculate percent of profit or loss is by saying this simple poem:

What you made divided by what you paid equals percent of profit (ROI)

What you lost divided by what it cost equals percent of loss

Example:

You have a home that you purchased for $90,000 and you sell it for $130,000. Using the numbers provided (excluding any interest, etc.) what is your profit? What is your percent of profit? What percent of your cost was the selling price? What percent of the selling price was your cost?

Profit is how much you make over and above your cost. It can be expressed as an amount or as a percent of the cost. The problem asks for both. To find the amount of profit you simply subtract the purchase price from the sale price:

$130,000 - $90,000 = $40,000

The percent of profit is asking what part of the profit is of your cost. This can be illustrated as a fraction $40,000/$90,000 which can be converted to a percent by dividing the numbers:

$40,000 ÷ $90,000 = .4444 or 44%

To find out what part the cost is of the selling price, you can illustrate this as a fraction $90,000/$130,000 which can be converted to a percent by dividing the numbers:

$90,000 ÷ $130,000 = .692 or 69%

Finally, to calculate what percent of the selling price was of your cost, you can illustrate this as a fraction $130,000/$90,000 which can be converted to a percent by dividing the numbers:

$130,000 ÷ $90,000 = 1.444 or 144%

Profit = $40,000

Percent profit = 44%

Percent of cost is the selling price = 69%

Percent of selling price was cost = 144%

Practice

1. A parcel of land is purchased for $222,000 and later sold for $245,400. What is the percent of profit?

2. Commercial Investments Inc. purchased an apartment complex for $620,000 and later sold it for $567,000. What percent of loss did Commercial Investments Inc. have on this property?

3. Melissa purchased a townhouse for $148,700 and wants to make a 12% profit on the original investment after paying a 6.5% commission. What must the property sell for to make this profit?

4. A house sold for $170,000, which was 85% of the original price. What was the original list price?

Test Taking-Techniques

Word Problem Solving Strategies

There is a strategy to solving math word problems and it consists of these five simple steps:

Step 1: Read the question, Read the question, Read the question – Carefully!

Example: A property sold for $100,000. The total commission received by the broker was $6,500. What was the rate of commission?

Step 2: Analyze the question, pick out the important information and restate it in a simplified question, eliminating unimportant information.

Example: $6,500 is what percent of $100,000?

Step 3: Choose the correct formula for the problem.

Example: Percent = Part ÷ Whole

Step 4: Substitute numbers for the known factors in the formula.

Example: $6,500 ÷ $100,000 = Percent

Step 5: Solve the problem.

Example: $6,500 ÷ $100,000 = .065 or 6.5% commission

Additional Math Pointers

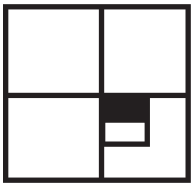
Here are some additional pointers that may help you with the math portion of the real estate exam:

1. Work problems from right to left using the given values.
2. Close counts on the exam. Don't spend 20 minutes to find 5 cents.
3. Use the % key on your calculator. It will set the decimal. Put % in last.
4. In simple math problems, words translate into symbols:
   a. Multiplication indicators: of, times, factor, product
   b. Division indicators: is, fraction, quotient, reciprocal
   c. Addition indicators: plus, more than, sum, increase, add, and
   d. Subtraction indicators: minus, less than, decrease, difference, take away
5. Ratios compare portions of a whole thing; they're simply fractions. To convert a fraction to a decimal, take the top number and divide by the bottom number. Example: 2/3 = 2÷3 = .6667
6. Loan-to-value ratio is the percent of the property value that a lender will loan a borrower. Loan is based on the appraised or market value, whichever is lower.
7. When in doubt, DIVIDE (÷)!

Quiz

1. ***A home is appraised at $125,000 and the assessment level is 35%. There are a total of 40 mills in the taxing area. What are the annual taxes?***
   a. $1,750
   b. $1,853
   c. $2,361
   d. $3,215

2. ***How many acres are there in the shaded area? What is the correct description for this section?***



   a. 10 acres; N 1/2, NE 1/4, SE 1/4
   b. 10 acres; N 1/2, NW 1/4, SW 1/4
   c. 20 acres; N 1/2, NW 1/4, SE 1/4
   d. 20 acres, N 1/2, NW 1/4, SW 1/4

3. ***Mr. and Mrs. Davis sold their home for $182,000 and it is due to transfer on August 13. The buyer, Miss Fairchild, took out a loan for $162,000 and is planning on moving in on August 15. Who pays the conveyance fee and how much is it if the rate is $1 per $1,0000?***
   a. Miss Fairchild; $20
   b. Miss Fairchild; $182
   c. Mr. and Mrs. Davis; $20
   d. Mr. and Mrs. Davis; $182

4. ***Bill expects a return of 8% on his investments and is considering a property with an asking price of $670,000. The records show a potential income of $6,200 a month, expenses of $1,500 a month, and a vacancy factor of 10%. With this information in mind, what would Bill's highest bid be?***
   a. $137,000
   b. $343,250
   c. $612,000
   d. $818,250

5. ***Arnold wants to net $132,000 for his home. He has to pay off an existing mortgage of $19,700. His closing costs will run $5,400 and he owes the broker a fee of 7%. For Arnold to get the net figure he wants, what must he sell the home for?***
   a. $141,935
   b. $157,100
   c. $163,118
   d. $168,925

6. ***Mr. and Mrs. Williams want to net $90,000 when they sell their home. They have to pay closing costs of $3,200 and the broker a 6% commission. What is the least the home can sell for to net $90,000?***
   a. $93,200
   b. $98,945
   c. $99,149
   d. $99,500

7. ***A house costs $200,000. The buyer is making a down payment of $32,000 and getting a $168,000 loan. If the lender is charging a total of 4 points, how much money will be paid out of the closing for the points?***
   a. $4,000
   b. $6,280
   c. $6,720
   d. $8,000

8. ***Mrs. Wilson got an interest-only loan for $12,500 at 8.75%. She has made 15 monthly payments of $91.15. What is her balloon payment?***
   a. $11,133
   b. $11,252
   c. $12,045
   d. $12,500

9. ***How many square feet are there in the S 1/2, SW 1/4, NE 1/4 of Section 28?***
   a. 136,125
   b. 435,600
   c. 720,480
   d. 871,200

10. ***Mr. and Mrs. Mason sold the lot adjoining their home for $15,000. If the lot measures 300 feet by 500 feet, how much did they get per front foot?***
    a. $30
    b. $50
    c. $300
    d. $500

11. ***A property has a gross monthly income of $12,600 and a vacancy and collection loss rate averaging 11%, with monthly expenses of $1,500 and depreciation of 6% a year. What would be the highest offer the prospective buyer should come up with if he insists on a 15% rate of return and the asking price is $850,000?***

    a. $723,293
    b. $730,493
    c. $777,120
    d. $833,293

12. ***A property is assessed at 50% with 11 mills and 7 mills. The annual taxes are $720. What is the market value of the property?***

    a. $40,000
    b. $80,000
    c. $90,000
    d. $130,909

13. ***The sale of a property closes on July 10. Taxes are $3,600 per year and paid through the first half of this year. What is the seller's share of taxes, based on a calendar year (assuming it's not a leap year)?***

    a. $97.83
    b. $195.65
    c. $1,716.16
    d. $1,883.84

14. ***In the MLS, it states that the seller will pay 7% commission and the listing agent will pay 4% to a buyer's agent. Buyer's agent Sue earns a total of $5,660 commission. What was sale price of the property?***

    a. $80,858
    b. $141,500
    c. $186,667
    d. $226,400

15. ***Broker Jeff earns $18,785 commission on a $289,000 sale. What was the commission rate?***

    a. 5.75%
    b. 6%
    c. 6.5%
    d. 7%

16. ***The market value of a property is $900,000 and is assessed at 35%. The annual taxes are $1,260. What is the tax rate?***

    a. $4.00/$1,000
    b. $4.20/$1,000
    c. $4.41/$1,000
    d. $7.14/$1,000

17. ***Appraiser Marla analyzes several rental properties in her town, determining their respective GRMs using gross monthly rent. She determines that the gross rent multiplier for her subject property should be around 114. The property currently rents for $17,400 annually. What would be Marla's approximate estimate of value?***

    a. $127,193
    b. $152,632
    c. $165,300
    d. $198,360

18. ***The Park Street Shops sold for $920,000. The four stores generate a total of $8,000 each month in rent; expenses run $2,500 each month. What is the gross monthly rent multiplier?***

    a. 28.75
    b. 41.82
    c. 87.62
    d. 115

19. ***Robert owns a building he leases to a software company, collecting monthly rent of $7,500. His expenses are $45,000 per year, and the building's depreciation is $10,000 per year. Robert wants to sell the building, and Hannah is interested in buying it if she can make a 12% return on her investment. Using the capitalization rate method, estimate what Hannah may be willing to pay.***

    a. $291,666
    b. $375,000
    c. $540,000
    d. $750,000

20. ***Lester is interested in a house you have listed, but he doesn't want the in-ground pool, which is 25' x 12' x 6'. He wants the sellers to agree to fill the pool with dirt, which costs $7.50 per cubic yard, delivered and dumped. How much will it cost the sellers to fill the pool if Lester buys the house?***

    a. $500
    b. $1,350
    c. $1,800
    d. $4,500

21. ***Ike bought two adjacent lots. Lot A is 50' x 100' and Lot B is 100' x 100'. He divided the two lots into three lots and is selling them for $2,800 per front foot. If he sells all three for his asking price, how much will Ike get?***
    a. $280,000
    b. $332,500
    c. $420,000
    d. $560,000

22. ***A local nature preserve takes up 42 acres of land. How many square feet is that?***
    a. 640 square feet
    b. 1,037.14 square feet
    c. 609,840 square feet
    d. 1,829,520 square feet

23. ***Mark wants to enclose his entire backyard with a fence for his dogs. The back yard is 70' x 50'. How many linear feet of fencing will he require?***
    a. 240
    b. 350
    c. 2,400
    d. 3,500

24. ***A 1.75 acre lot sells for 40 cents per square foot. What is the selling price?***
    a. $17,424
    b. $21,780
    c. $30,492
    d. $76,230

25. ***Kelly's gross stable monthly income is $3,500. What is the maximum monthly mortgage payment (PITI) she would qualify for using the payment-to-income ratio of 28% for a conventional loan?***
    a. $875
    b. $980
    c. $1,020
    d. $1,750

26. ***Abe's stable monthly income is $3,500. Every month he pays: $250 child support, $100 car loan payment, and $50 student loan payment. What is the maximum monthly mortgage payment he would qualify on a conventional loan (assume a payment-to-income ratio of 28% and a debt-to-income ratio of 36%)?***
    a. $860
    b. $910
    c. $980
    d. $1,260

27. ***What is the required down payment if the purchase price is $85,000 and the loan-to-value ratio is 80%?***
    a. $5,000
    b. $6,800
    c. $8,500
    d. $17,000

28. ***What is the loan-to-value ratio if the loan amount is $175,000, the appraised value is $205,000 and the sales price is $200,000?***
    a. 82.3%
    b. 85.4%
    c. 87.5%
    d. 97.6%

29. ***Jack is appraising a relatively new home and determines that the lot value is $14,000 and the home's replacement cost is $194,500. He also determines that the roof has been damaged by hail and needs to be replaced, which would cost $9,500. Using the cost approach, what might be Jack's final estimate of value?***
    a. $180,500
    b. $199,000
    c. $208,500
    d. $218,000

30. ***The rent for each unit of a ten-unit strip mall is $1,000 per month. The annual vacancy rate averages 5%. The expenses for the property come to $30,000 per year with depreciation of $15,000. What is the net operating income?***
    a. $49,000
    b. $54,500
    c. $84,000
    d. $96,000

Glossary

A

Abandonment The failure to occupy and use property, which may result in a loss of rights.

Abstract of Title A brief, chronological summary of recorded documents affecting title to a particular parcel of real property.

Acceptance Agreeing to the terms of an offer to enter into a contract, thereby creating a binding contract; taking delivery of a deed.

Acceleration Clause Contract clause giving the lender the right to declare the entire loan balance due immediately because of default, or other reasons stated in the contract.

Accessibility The relative ease with which customers can get to a retail establishment. *Also called:* **Ingress/ Egress.**

Accordion Clause A clause in a commercial lease that gives the tenant flexibility to expand and contract the amount of space occupied.

Accountability In an agency relationship, the agent's statutory duty is to account to the principal.

Accretion The gradual addition of land by the forces of nature.

Accrued Expenses Items on a settlement statement for which the cost has been incurred, but the expense has not yet been paid.

Acknowledgment The act of signing a document before a notary public, stating it was signed voluntarily.

Acre A measure of land area that is equal to 43,560 square feet. One square mile contains 640 acres.

Actionable Fraud Fraud meeting certain criteria, so a victim can successfully sue. Victim/plaintiff must prove the defendant concealed material facts or made false statements (intentionally or negligently) with intent to induce the victim to enter a transaction, and that the victim was harmed by relying on these misrepresentations.

Actual Eviction Using the legal process to make someone leave. *Compare:* **Constructive Eviction.**

Actual Fraud Intentional misrepresentation or concealment of a material fact; when a person actively conceals material information or makes statements known to be false or misleading. *Also called:* **Deceit.**

Actual Notice Actual knowledge; that which is known.

Acquisition Cost The total amount needed to purchase property, including down payment, loan amount, and any allowable buyer-paid closing costs.

Active Income Earnings received from any of the following: wages, salaries, commissions, bonuses, and other payments for services rendered; profit from a trade or business where the taxpayer is an active participant; gain on sale or disposition of assets used in an active trade or business; income from intangible property if the taxpayer played a significant role in creating the property.

Act of Waste When a possessor who holds less than fee ownership (i.e., tenant, vendee, and mortgagor) misuses or abuses the property.

Ad Valorem A Latin phrase meaning "according to value"; used to refer to taxes assessed on the value of property.

Adjustable Rate Mortgage A type of mortgage structure that permits the lender to periodically change or vary the interest rate charged, based on a standard index.

Adjusted Basis The original cost or other basis of property, reduced by depreciation deductions and increased by capital expenditures.

Adverse Action When a creditor denies credit, offers less favorable terms than those applied for, or changes the terms of an existing credit agreement.

Adverse Possession Acquiring title to someone else's real property through open, notorious, and hostile possession of it for the required statutory amount of time.

Advertisement The placement of public announcements in any medium with the intention of promoting or enticing a consumer into purchasing goods or engaging the services of someone.

Advisory Letters Communication from the Illinois Department of Financial and Professional Regulation to a licensee who requests clarification on points of law or administrative rule. Only the licensee requesting an advisory letter may rely on it as a defense against disciplinary action.

Affiliated Business Arrangement (AfBA or ABA) A situation where a person in a position to refer settlement services—or an associate of that person—has either an affiliate relationship with or a direct or beneficial ownership interest of more than 1% in a provider of settlement services and who then refers business to that provider or in some way influences the selection of that provider.

After Tax Cash Flow Cash flow from income-producing property, less income taxes, if any, attributable to the property's income. If a tax loss provides a tax savings from the shelter of income earned outside the property, that savings is added to the property's earned cash flow.

Agency A relationship in which a real estate broker or licensee, whether directly or through an affiliated licensee, represents a consumer by the consumer's consent, whether express or implied, in a real property transaction.

Agency Disclosure The legal obligation of a licensee to disclose the relationship that an agent has with a buyer or seller in a real estate transaction, if any.

Agent Generic term used to describe one person who is contracted to represent another person.

Air Rights The right to undisturbed use and control of airspace over a parcel of land (within reasonable limits for air travel); may be transferred separately from the land.

Alienation The transfer of ownership or an interest in property from one person to another, by any means.

Alienation, Involuntary The transfer of an interest in property against the will of the owner, or without action by the owner, occurring through operation of law, natural processes, or adverse possession.

Alienation, Voluntary When an owner voluntarily transfers an interest to someone else.

Alienation Clause A contract clause that gives the lender certain stated rights when there is a transfer of ownership in property. *Also called:* **Due-on-Sale Clause.**

Alluvion Solid material deposited along a shore by accretion.

Amenity Purchaser Person who values a property based on its ability to fulfill his specific business needs, unlike investors who value a property based primarily on its investment return.

Americans with Disabilities Act (ADA) Prohibits discrimination against people with disabilities in employment, transportation, public accommodation, communications, and governmental activities. The ADA also establishes requirements for telecommunications relay services.

Amortization When a loan balance decreases because of periodic installments paid on the principal and interest.

Anchor Tenant A retail store strategically located in a shopping center to generate traffic for smaller stores. *Also called:* **Magnet Store.**

Annual Percentage Rate (APR) A measure of the cost of credit, expressed as a yearly rate. It includes interest as well as other charges. Because all lenders follow the same rules to ensure the accuracy of the annual percentage rate, it provides consumers with a good basis for comparing the cost of loans, including mortgage plans.

Annexation Attaching personal property to land so the law views it as part of the real property. *See:* **Fixture.**

Anticipation An economic theory that says value is created by expectation of future benefits.

Anticipatory Repudiation When one party to a contract informs the other before the time set for performance that he does not intend to perform as agreed. *See:* **Tender.**

Antitrust An area of law concerned with maintaining competition in private markets by prohibiting any restraint on trade.

Appraisal A professional estimate or opinion of the value of a piece of property or parcel of land, as of a certain date, that's supported by an objective, or pertaining to appraising and related functions, such as appraisal practice or appraisal services.

Appraisal Report Any communication, written or oral, of an appraisal, appraisal review, or appraisal consulting service that is transmitted to a client upon completion of an assignment.

Appraiser A person who estimates the value of property, especially an expert qualified to do so by education and experience.

Appropriation The authorization of the expenditure of funds and the source of those funds.

Appropriative Rights Water rights allocated by government permit according to an appropriation system. It is not necessary to own property beside the body of water in order to apply for an appropriation permit. *Also called:* **Prior Appropriation.** *Compare:* **Littoral Rights, Riparian Rights**.

Appurtenance A right that goes along with ownership of real property; usually transferred with the property, but may be sold separately. This is a legal term referring to both physical and non-physical appurtenances.

Appurtenant Easement An easement that benefits a particular piece of property (dominant tenement). *Compare:* **Easement in Gross.**

Area Variance Permission to use land in a way typically not allowed by current zoning laws.

Assemblage Combining two or more parcels of land into one larger parcel.

Assessment 1. A government's valuation of property for tax purposes. 2. A special assessment.

Assets Items that are of value to the owner. Assets that are liquid, such as cash, stocks, or bonds, can be converted to cash quickly.

Assumption When one party takes over the primary liability for the loan of another party and the terms of the loan or note remain unchanged; usually lender approval is needed; also, a release is needed or original party remains secondarily liable for the loan.

Arm's Length Transaction A transaction that occurred under typical conditions in the marketplace, with each party acting in his or her own best interest.

Asbestos Fibrous material derived from a naturally occurring group of minerals commonly used in insulation. Asbestos fibers released into the air are carcinogenic.

"As Is" Clause Provision in a purchase agreement stating the buyer accepts the property in its present condition.

As of Right Zoning Prohibits discrimination among landowners in a particular zone.

Asking Price The price the seller asked for the property when it was first put on the market.

Assessed Value Value placed on property to which a local tax rate is applied to calculate the amount of real property tax.

Assign 1. To transfer a right or interest to another; 2. A tenant transferring his right of possession or other interest in leased property to another for the remainder of the lease term. *Compare:* **Sublease.**

Assignment One party (assignor) transferring rights or interests under a contract to another person (assignee).

Attachments Things connected to the land, whether natural or man-made; generally considered to be real property.

Attorney-in-Fact Any person authorized to act for another by a power of attorney (not necessarily an attorney-at-law).

Avulsion When real property is lost due to sudden acts of nature like tornadoes or earthquakes.

B

Bait and Switch A deceptive sales technique that involves advertising to a consumer with a particular product or rate to attract them, then persuading them to accept less favorable terms so that the loan originator can earn a higher fee. Most states have consumer protection laws that make this tactic illegal.

Balloon Payment A final payment at the end of a loan term to pay off the entire remaining balance of principal and interest not covered by payments during the loan term.

Bankruptcy A court process that cancels debt and provides some relief for creditors; Chapter 7, sometimes called a straight bankruptcy, it is a liquidation proceeding; Chapter 13, sometimes called a reorganization proceeding, is filed by individuals who want to pay off their debts over a period of three to five years.

Baseline Main east-west line designated and named throughout the country for use with the government survey system.

Basement Part of a house or building partially or entirely below grade (ground level) and used to support the rest of the structure.

Basis Accounting procedure used to determine the capital gain or loss after the sale of property. It is equal to purchase price, plus capital improvements, less depreciation.

Beneficiary Person designated to receive benefits from a certain act, such as one who benefits from a trust.

Bequeath The act of giving personal property to another by will.

Bequest A gift of personal property by a will.

Bilateral A contract in which each party promises to do something.

Bill of Sale A document used to transfer title to personal property from one person to another.

Blind Advertisement Any real estate advertisement that is used by a licensee regarding the sale or lease of real estate, licensed activities, or the hiring of any licensee that does not include the sponsoring broker's business name or, in the case of electronic advertisements, does not provide a direct link to a display with all the required disclosures. The broker's business name in the case of a franchise shall include the franchise affiliation as well as the name of the individual firm.

Block and Lot Description The type of legal description used for platted property. The description states only the property's lot number and block number in a particular subdivision, so to find out the exact location of the property's boundaries the plat map for that subdivision must be consulted at the county recorder's office.

Blockbusting The illegal practice of inducing owners to sell their homes (often at a deflated price) by suggesting the ethnic or racial composition of the neighborhood is changing, with the implication that property values will decline as a result. *Also called:* **Panic Selling** or **Panic Peddling.**

Blueprint A detailed building plan used to evaluate design, determine feasibility, and guide construction of a structure.

Boycott An agreement by two or more people who refuse to deal with a person or company.

Branch Office A sponsoring broker's office other than the sponsoring broker's principal office.

Breach Violation of a contract obligation, duty, or law.

Breach of Contract Failure to perform according to the terms of a contract.

Breakpoint The sales volume above which a retailer makes a profit; used to determine the amount of percentage rent due over and above the base rent on a retail commercial lease.

Broker An individual, entity, corporation, foreign or domestic partnership, limited liability company, registered limited liability partnership, or other business entity other than a residential leasing agent who, whether in person or through any media or technology, for another and for compensation, or with the intention or expectation of receiving compensation, either directly or indirectly: (1) Sells, exchanges, purchases, rents, or leases real estate. (2) Offers to sell, exchange, purchase, rent, or lease real estate. (3) Negotiates, offers, attempts, or agrees to negotiate the sale, exchange, purchase, rental, or leasing of real estate. (4) Lists, offers, attempts, or agrees to list real estate for sale, rent, lease, or exchange. (5) Whether for another or themselves, engages in a pattern of business of buying, selling, offering to buy or sell, marketing for sale, exchanging, or otherwise dealing in contracts, including assignable contracts for the purchase or sale of, or Buys, sells, offers to buy or sell, or otherwise deals in options on real estate or improvements thereon. For purposes of this definition, an individual or entity will be found to have engaged in a pattern of business if the individual or entity by itself or with any combination of other individuals or entities, whether as partners or common owners in another entity, has engaged in one or more of these practices on 2 or more occasions in any 12-month period. (6) Supervises the collection, offer, attempt, or agreement to collect rent for the use of real estate. (7) Advertises or represents himself or herself as being engaged in the business of buying, selling, exchanging, renting, or leasing real estate. (8) Assists or directs in procuring or referring of leads or prospects, intended to result in the sale, exchange, lease, or rental of real estate. (9) Assists or directs in the negotiation of any transaction intended to result in the sale, exchange, lease, or rental of real estate. (10) Opens real estate to the public for marketing purposes. (11) Sells, rents, leases, or offers for sale or lease real estate at auction. (12) Prepares or provides a broker price opinion or comparative market analysis.

Broker Price Opinion (BPO) The estimated or analysis of the probable selling price of a particular interest in real estate, which may provide a varying level of detail about the property's condition, market, and neighborhood, and information on comparable sales.

Broker Protection Clause Provides the broker is still entitled to commission if the property is sold during a certain time under certain circumstances.

Brokerage A business concept premised primarily on bringing parties together for the purpose of a transaction.

Brokerage Agreement A written or oral agreement between a sponsoring broker and a consumer for licensed activities to be provided to a consumer in return for compensation or the right to receive compensation from another. Brokerage agreements may constitute either a bilateral or unilateral agreement between the broker and broker's client depending upon the content of the brokerage agreement. All exclusive brokerage agreements must be in writing.

Browser The program used to access and display formatted pages on the Internet.

Building Codes A means of setting construction standards, requiring builders to use particular methods & materials; regulations establishing minimum standards for construction and materials. (There are different building codes for different systems: electric, plumbing, etc.)

Building Efficiency The ratio of usable square footage to rentable square footage.

Building Permit Official documents from a local government or other authority that allow the beginning of a construction or remodeling project.

Bundle of Rights All real property rights conferred with ownership, including, but not limited to, the right of use or possession, the right of enjoyment, the right of exclusion, and the right of disposal.

Buydown When additional funds, in the form of points, are paid to a lender at the beginning of a loan to lower the interest rate and monthly payments on the loan.

Buyer Agency Agreement An employment contract between a buyer and a broker that grants the broker the exclusive right to represent the purchaser in the purchase or lease of property and that makes the buyer responsible for paying commission to the buyer broker.

Buyer's Agent An agent representing the interests of the buyer of a property.

Buyer's Market A situation in the housing market giving buyers a large selection of properties from which to choose.

C

CC&Rs A declaration of **C**ovenants, **C**onditions, and **R**estrictions; usually recorded by a developer to create a general plan of private restrictions for a subdivision.

Capitalization Rate Rate of interest considered a reasonable return on investment; commonly used in the process of determining value based on net income.

Carbon Monoxide A colorless, odorless gas released when fossil fuels are broken down to produce heat.

Cash Flow Money available to an individual after subtracting all expenses.

Cash-on-Cash Return The bottom line of any investment expressed as a percentage by dividing the investment's cash flow by the deposit and settlement costs.

Cease and Desist An order or request to halt an activity (cease) and not to take it up again later (desist) or else face legal action. The recipient of the cease-and-desist may be an individual or an organization.

Certificate of Eligibility A certificate issued by the Department of Veteran's Affairs to establish status and amount of a veteran's eligibility to qualify for loan guaranty.

Certificate of Reasonable Value (CRV) A document issued by the VA which establishes the reasonable value of the subject property based on an approved appraisal. The VA loan amount cannot exceed the CRV.

Certificate of Title A document prepared by an attorney stating the attorney's opinion of the status of title to property after performing a title search and reviewing the public records.

Chain of Title Chain of deeds and other documents transferring title to land from one owner to the next, as disclosed in public records.

Chattel Personal property.

Civil Law Body of law concerned with the rights and liabilities of one individual in relation to another; includes contract, tort, and property law.

Civil Penalty When a state entity, government agency, or private party seeks monetary relief against an individual as restitution for wrongdoing by the individual.

Civil Rights Fundamental rights guaranteed to all persons by the law. The term is primarily used in reference to constitutional and statutory protections against discrimination based on race, religion, sex, or national origin.

Civil Rights Act of 1866 The first major legislation to directly affect equal rights to ownership of real property.

Civil Union A legal relationship between two persons, either of the same or opposite sex.

Class (A, B, C, D) A way to rate or categorize office buildings based on a combination of building characteristics, such as age, lease rates, architectural design, location, tenant profiles, management, building amenities. Such categories may vary from market to market according to local and regional standards.

Clean Air Act (CAA) Government Act requiring the EPA to develop air quality standards for existing pollutants, along with establishing air standards for new sources of pollution. Also regulates air pollutant emissions, determines acceptable levels for emissions, and sets deadlines for compliance.

Clear Title A title that is free of liens or legal questions as to ownership of property.

Clearspan Open distance between inside faces of support members.

Client A person being represented by a licensee. *Also called:* **Principal.**

Closing Transfer of real property ownership from seller to buyer, according to terms and conditions in a sales contract; the final stage in a real estate transaction.

Closing Costs Expenses incurred in the transfer of real estate in addition to the purchase price; (e.g., the appraisal fee, title insurance premiums, broker's commission, transfer tax, etc.)

Closing Disclosure Document prepared by the lender or closing agent itemizing all expenses and costs paid by the buyer and seller to close the real estate transaction as required for RESPA-related transactions**.**

Clouds on a Title A claim, encumbrance, or defect that makes title to real property unmarketable.

Cluster Zoning Allows developers to provide a varied selection of lot sizes and housing choices within a single area.

Coercion An act of force used to get a person to comply.

Collateral Property pledged as security for a debt.

Collusion Secret agreement or cooperation among people, especially for deceitful or fraudulent purposes.

Commercial Broker's Lien A lien that may be filed by a real estate broker on commercial real estate, or any interest in that commercial real estate, in the amount of commission the broker is due under a written agreement with either the owner of the property or the prospective buyer or tenant.

Commercial Property Land zoned and used for business purposes, such as warehouses, restaurants, and office buildings (as distinguished from residential, industrial, or agricultural property).

Commingling Illegally mixing money held in trust on behalf of a client with personal funds. *See:* **Conversion.**

Commission The compensation paid to someone in lieu of or in addition to his or her regular salary. Examples of commissions may be a flat rate or percentage of sales price.

Common Area Maintenance (CAM) A line item fee owed by most commercial tenants to pay for their share of cost of maintaining common areas or service areas such as the lobby, corridors, elevators, restrooms, and stairwells, which are used by two or more tenants and/or third parties and are not under the control of any one tenant.

Community Property In some states, the recognition that any property acquired during marriage is owned equally.

Comparables Other similar properties that have sold in a certain area. *Also called:* **Comps.**

Comparative Market Analysis (CMA) An analysis or opinion regarding pricing, marketing, or financial aspects relating to a specified interest or interests in real estate that may be based upon an analysis of comparative market data, the expertise of the real estate broker or managing broker, and such other factors as the broker or managing broker may deem appropriate in developing or preparing such analysis or opinion. *Also called:* **Competitive Market Analysis.**

Compensation The valuable consideration given by one person or entity to another person or entity in exchange for the performance of some activity or service. Compensation shall include the transfer of valuable consideration, including, without limitation, commissions; referral fees; bonuses; prizes; merchandise; finder fees; performance of services; coupons or gift certificates; discounts; rebates; chance to win a raffle, drawing, or lottery; retainer fee; or salary.

Compensatory Damages Award, usually money, intended to compensate the plaintiff for harm caused by the defendant's act or failure to act. *Also called:* **Actual Damages.**

Competent 1. Of sound mind, for the purpose of entering a contract or executing a will; not suffering from mental illness, retardation, or senility. 2. Of sound mind and having reached the age of majority.

Concrete Slab A foundation made from a layer of poured concrete reinforced with steel rods (called "rebar").

Concurrent Ownership Ownership by more than one person; co-ownership.

Condition 1. A provision in a contract, deed, law, regulation, guideline, etc., that makes the parties' rights and obligations depend on the occurrence, or non-occurrence, of a particular event. *Also called:* **Contingency Clause.** 2. A provision of a contract, law, regulation, guideline, etc., that allows, or does not allow, something else to occur based on whether or not certain other events occur or do not occur. 3. Other factors that reflect the general state of something as good or bad; (e.g., economic conditions of an area, property condition, etc.).

Conditional Fee A type of defeasible fee; title may be terminated by the former owner if conditions stated in deed are not met. Former owner has a power of termination. *Also called:* **Fee Simple Subject to a Condition Subsequent.** *Compare*: **Fee Simple Determinable.**

Conditional Use A land use that does not comply with the general zoning rules for the zone in which it's located, but is permitted there because it benefits the public; for example, a hospital in a residential neighborhood. *Also called:* **Special Use.**

Condominium A property developed for co-ownership, where each co-owner has a separate interest in an individual unit, and an undivided interest in the common areas of the property.

Confidential Information Any information obtained by a licensee from a client during the term of a brokerage agreement that (i) was made confidential by the written request or written instruction of the client, (ii) deals with the negotiating position of the client, or (iii) is information the disclosure of which could materially harm the negotiating position of the client, unless at any time, (1) the client permits the disclosure of information given by that client by word or conduct; (2) the disclosure is required by law; or (3) the information becomes public from a source other than the licensee. Note that material information about the physical condition of the property shall not be considered confidential information.

Confidentiality The protection of the client's confidential information.

Conforming Loans Loans that meet Fannie Mae/Freddie Mac standards and which can be sold on the secondary market. *Compare:* **Nonconforming Loans.**

Conformity A "rule" that says a particular home achieves maximum value when it's surrounded by homes similar in style and function.

Consideration Anything of value, such as money, goods, services, or promises, given to induce another person to enter into a contract. *Also called:* **Valuable Consideration.**

Construction Loan A temporary loan used to finance the construction of improvements and buildings on land.

Constructive Eviction When a landlord's act (or failure to act) interferes with the tenant's quiet enjoyment of the property, or makes the property unfit for its intended use, to such an extent the tenant is forced to move out.

Constructive Fraud A negligent misrepresentation or concealment of a material fact; when a person carelessly fails to disclose material information, or makes false or misleading statements. *Also called:* **Negligent Misrepresentation.**

Constructive Notice Provides protection to a landowner against all unrecorded titles.

Consumer A person or entity seeking or receiving licensed activities.

Contemporaneous Offers Offers to purchase or lease on behalf of two or more clients represented by the same designated agent for the same real estate parcel or unit that the designated agent knows, or has known, or has reason to know will be taken under consideration by the owners or owner's representative at the same time.

Contingency Clause A provision in a contract, deed, law, regulation, guideline, etc. that makes the parties' rights and obligations depend on the occurrence (or non-occurrence) of a particular event.

Contingency Provision in a contract or deed that makes the parties' rights and obligations depend on the occurrence (or nonoccurrence) of a particular event. *Also called:* **Condition.**

Contract An agreement between two or more parties to do, or not do, a certain thing. The requirements for an enforceable contract are: Capacity, mutual consent, lawful objective, and consideration. In addition, certain contracts must be in writing to be enforceable.

Contribution A value theory that says a particular item or feature of a home is only worth what it actually contributes in value to a piece of property.

Conventional Loan A loan that is not insured or guaranteed by the federal government.

Conversion 1. Misappropriating property or funds belonging to another. 2. Changing an existing rental apartment building into a condominium.

Conveyance An instrument that conveys a grantor's interest, if any, in real property, such as a deed.

Cooperating Broker A broker who works with a listing agent to sell property in a real estate transaction; the selling broker who found a buyer for the listed property. The cooperating broker could be a buyer's agent, or a cooperating broker could be a subagent of the seller, working as an agent of the listing broker. *Also called:* **Cooperating Agent.**

Cooperative A building owned by a corporation, where the residents are shareholders in the corporation; each shareholder receives a proprietary lease on an individual unit and the right to use the common areas. *Also called:* **Co-op.**

Coordinator The Coordinator of Real Estate created in Section 25-15 of the Illinois Real Estate License Act.

Corporation An association organized according to strict regulations, in which individuals purchase ownership shares; regarded by the law as an artificial person, separate from the individual shareholders.

Cost The dollars needed to develop, produce, or build something.

Cost Approach An appraisal method which estimates the value of real estate by figuring the cost of building the house or other improvement on the land, minus depreciation, plus the value of the vacant land. *Also called*: **Reproduction Cost Approach.**

Counteroffer A response to an offer to enter into a contract, changing some of the terms of the original offer; a rejection of the original offer (not a form of acceptance), and does not create a binding contract unless the new counteroffer is accepted by the original offeror (the counterofferee).

Covenant 1. A contract. 2. A promise. 3. A guarantee (express or implied) in a document such as a deed or lease. 4. A restrictive covenant.

Covenant of Quiet Enjoyment Guarantee that a buyer or tenant has the right to exclusive, undisturbed possession of a leasehold estate and will not be disturbed by the previous owner, lessor, or anyone else claiming interest in the property.

Credit History A record of debt repayment, detailing how a person paid credit accounts in the past as a guide to whether he or she is likely to pay accounts on time and as agreed in the future.

Credit Report A report of an individual's credit history prepared by a credit bureau and used by a lender in determining a loan applicant's creditworthiness.

Credit Scoring An objective means of determining creditworthiness of potential borrowers based on assigning specified numerical values to different aspects of a borrower.

Credits Money received for an obligation given.

Customer A consumer who is not being represented by the licensee but for whom the licensee is performing ministerial acts.

D

Debits An expense or money applied against a credit.

Debt Any recurring monetary obligation that will not be cancelled (e.g., monthly bills).

Debt-to-Income Ratio The relationship of a borrower's total monthly debt obligations, including housing and long-term debts with 10 or more payments remaining, to income, expressed as a percentage (Total Debt / Income = Ratio %). *Also called:* **DTI, Total Debt Service Ratio,** or **Back End Ratio.**

Debt Service Amount of money needed to meet the periodic payments of principal and interest on an amortized loan or debt. If the periodic payments are constant and equal, then a portion will pay off accrued interest with the remainder reducing principal.

Decedent A person who has died.

Declaration of Covenants, Conditions, and Restrictions *See:* **CC&Rs.**

Deed The legal document conveying title to a property.

Deed, Bargain and Sale A deed that implies the grantor owns the property and has the right to convey it, but does not carry any warranties.

Deed, General Warranty A deed in which a grantor warrants title against defects that may have arisen before or during the grantor's ownership.

Deed, Limited Warranty A deed in which the grantor warrants title only against defects arising during the time he or she owned the property, and not against defects arising before that time of ownership. Also called a **special warranty deed, or a grant deed**. *Compare:* **General Warranty Deed**.

Deed, Quitclaim Deed that conveys any interest in a piece of real property the grantor has at the time the deed is executed. A quitclaim deed makes no warranties regarding the title, if any, held by the grantor.

Deed, Sheriff's A deed issued by the court to a purchaser of property from a foreclosure sale.

Deed in Lieu of Foreclosure A deed given by a borrower to a lender to satisfy a debt, avoiding foreclosure. *Also called:* **Voluntary Conveyance.**

Deed of Trust In Illinois, a deed of trust functions the same as a mortgage.

Deed Restrictions Limitations on real property use, imposed by a former owner through language included in the deed. *Also called:* **Restrictive Covenants.**

Default Failure to fulfill an obligation, duty, or promise, as when borrower fails to make payments, tenant fails to pay rent, or party fails to perform a contract. Mortgage, note, or other document defines what constitutes default.

Defeasance Clause 1. Clause used to defeat or cancel a certain right upon the occurrence of a specific event (e.g., on final payment, words of grant in a mortgage are void and the mortgage is thereby cancelled and title is revested to mortgagor). 2. Clause used to give a borrower the right to redeem real estate after default on a note by paying the full amount due plus fees and court costs.

Deficiency Judgment A court order stating that the debtor owes money to the creditor when the collateral property does not bring enough at foreclosure sale to cover the entire loan amount, accrued interest, and other costs.

Demand The need or desire for a specific good or service; an essential ingredient in creating value.

Demographics Data published in a variety of sources that describes the population, age levels, and income levels of the people in a given area.

Density When referenced by zoning requirements, the number of building units per acre or the number of occupants or families per unit.

Department of Housing and Urban Development (HUD) Government agency that deals with housing related issues and is responsible for administration and enforcement of the federal Fair Housing Act.

Depreciate To decline in value.

Depreciation 1. A loss in property value for any reason. 2. For taxes, the expensing of the cost of business or investment property over a set number of years, determined by IRS to be an asset's useful life.

Derogatory Credit Credit history showing previous problems in meeting financial obligations.

Descent An operation of law when real property is transferred to an heir after the death of the owner who leaves no will (intestate).

Designated Agency A contractual relationship between a sponsoring broker and a client in which one or more licensees associated with or employed by the sponsoring broker are designated as an agent of the client. *See:* Illinois Real Estate Act, Article 1: Section 15-50.

Designated Agent A sponsored licensee named by a sponsoring broker as the legal agent of a client as defined in Section 15-50 of the Illinois Real Estate Act.

Designated Managing Broker A managing broker who has supervisory responsibilities for licensees in one or, in the case of a multi-office company, more than one office and who has been appointed as such by the sponsoring broker registered with the Department.

Devise The transfer of real property through a will.

Disability A physical or mental impairment that substantially limits or curtails one or more major life activities.

Discharge of Mortgage Refers to when the seller's mortgage on the property is paid off. The lender issues the discharge of contract, and the seller should record this document. *Also called:* **Release of Lien.**

Disclosures Points or facts in a real estate transaction that must be revealed.

Discount Points One percent of the loan amount. Discount points can be charged for any reason, but are often used for buydowns. Discount points are used to increase the lender's yield on a loan.

Discrimination Treating people unequally because of their race, religion, sex, national origin, age, or some other characteristic of a protected class, in violation of civil rights laws.

Do Not Call Registry National registry managed by the Federal Trade Commission that limits commercial telemarketers from phoning consumers who place their telephone numbers on a list.

Doctrine of Laches The loss of a right through undue delay or a failure to assert.

Domain Name The name that identifies a website, usually followed, for commercial purposes, by the .com suffix. Other common suffixes are .gov for government websites and .edu for schools and other educational institutions.

Domicile The state in which a person has a permanent home.

Dominant Tenant A person with easement rights on another's property; either the owner of a dominant tenement, or someone who has an easement in gross.

Dominant Tenement Property that receives the benefit of an appurtenant easement.

Donative Intent Intent to immediately and unconditionally transfer title to real property.

Down Payment The amount a buyer pays to obtain a property in addition to the money that the buyer borrows.

Dual Agency An agency relationship in which a licensee is representing both buyer and seller or both landlord and tenant in the same transaction. When the agency relationship is a designated agency, the question of whether there is dual agency shall be determined by the agency relationship of the designated agent of the parties and not of the sponsoring broker.

Dual Agent A licensee who represents both the buyer and the seller (or the landlord and the tenant) in a real estate transaction.

Due-on-Sale Clause A provision in a mortgage allowing the lender to demand repayment in full if the borrower sells the property securing the mortgage. *Also called:* **Alienation Clause.**

Duress Threatening violence against or unlawfully confining someone and forcing him to sign a document; or, threatening or confining a signer's spouse, child, or other close relative.

Dwelling Any building, structure, or portion thereof which is occupied as, or designed or intended for occupancy as, a residence by one or more families, and any vacant land which is offered for sale or lease for the construction or location of any such building or structure.

E

Earnest Money Deposit Money offered as an indication of good faith regarding future performance of a purchase agreement. *Also called:* **Earnest Money.**

Easement A right of way giving persons other than the owner access to or over real property for a particular purpose.

Easement Appurtenant An easement that grants access. *Compare:* **Right of Way.**

Easement by Condemnation 1. Taking private property for public use through the government's power of eminent domain. 2. A declaration that a structure is unfit for occupancy and must be closed or demolished.

Easement by Grant An easement granted to another in a deed or other document.

Easement by Express Reservation An easement created in a deed when a landowner divides property, transferring the servient tenement, but retaining the dominant tenement.

Easement by Implication An easement created by operation of law (not express grant or reservation) when land is divided, if there is a longstanding, apparent use that is reasonably necessary for enjoyment of the dominant tenement. *Compare:* **Implied Easement.**

Easement by Necessity A special kind of easement by implication that occurs when the dominant tenement would be useless without an easement, even without a longstanding, apparent use.

Easement by Prescription An easement acquired by prescription. *See:* **Prescription**.

Easement for Light and Air A view easement; considered a negative easement. In the case of negative easement, the dominant tenement can prevent the subservient tenement from doing something on the land because it could affect the dominant land.

Easement in Gross An easement that benefits a person instead of land; there is a dominant tenant, but no dominant tenement. *Compare:* **Appurtenant Easement.**

Economic Base Main business or industry supporting and sustaining a community. A good economic base is critical for strong home values.

Economic Rent The rent that would be possible to charge if adjusted to appropriate market levels. *Also called:* **Market Rent.**

Effective Age Age of a structure based on actual wear and tear, not necessarily its actual age.

Effective Demand The ability of a particular market to afford a property.

Effective Gross Income Potential gross income minus vacancy and collection losses.

Emblement A crop that is planted and cultivated through someone's labor and industry. Emblements are considered to be personal property. *Also called:* **Fructus Industriales.**

Eminent Domain The government's constitutional power to take (appropriate or condemn) private property for public use, as long as the owner is paid just compensation.

Employee 1. Generically speaking, someone who works under the direction and control of another. 2. When used to refer to or describe or delineate the relationship between a real estate broker and another real estate broker or residential leasing agent, the term shall be construed to include an independent contractor relationship, provided that a written agreement exists that clearly establishes and states the relationship. All responsibilities of a broker shall remain. *Compare:* **Independent Contractor.**

Employment Agreement The contract between a sponsoring broker and an affiliated licensee that defines the terms of the relationship.

Encroachment A physical object intruding onto neighboring property, often due to a mistake regarding the boundary.

Encumbered Property A property that has mortgages, liens or other restrictions against it, which prevent or restrict its transfer.

Encumbrance Non-possessory interest in property; a lien, easement, or restrictive covenant burdening the title.

Entitlement The dollar amount of loan guarantee to which an eligible veteran is entitled.

Environmental Hazard A situation that exists with potential for harm to persons or property from conditions that exist outside or within a property. *See:* **Internal Environmental Hazard, External Environmental Hazard.**

Environmental Impact Statement (EIS) Study required by the National Environmental Policy Act for all federal and federally related projects, which details a development project's impact on energy use, sewage systems, drainage, water facilities, schools, and other environmental, economic, and social areas.

Equal Credit Opportunity Act (ECOA) Federal law that prohibits discrimination in granting credit to people based on sex, age, marital status, race, color, religion, national origin, receipt of public assistance, or rights exercised under the Consumer Credit Protection Act.

Equitable Title An interest created in property upon the execution of a valid sales contract, whereby actual title will be transferred by deed at a future date (closing). Also, the vendee's (buyer's) interest in property under a land contract. *Also called:* **Equitable Interest.**

Equity An owner's unencumbered interest in property; the difference between the value of the property and the liens against it.

Equity Exchange When value in a property is traded for value in another property. Properties must be of like kind, held for use in trade or business, or as investment to qualify for tax deferment. An equity exchange can also be a delayed exchange, with a promise to provide a replacement property. To qualify for tax deferment, the replacement property must be located within 45 days and closed within 180 days of the first exchange. *Also called:* **Tax-Deferred Exchange, Tax-Free Exchange, Like Kind Exchange,** or **Section 1031** (from the section number of IRS law).

Equity Skimming Schemes that involve the stealing of a homeowner's equity.

Erosion Gradual loss of soil due to wind or water.

Errors and Omissions Insurance (E&O) Professional liability insurance that protects real estate professionals from mistakes or negligence.

Escalation Clause Lease clause that allows an increase in rent for increases in expenses paid by the landlord, such as real estate taxes, operating costs, and cost of living expenses.

Escheat When property reverts to a government entity, such as the state or county, depending on state statutes, after a person without a valid will and without heirs dies.

Escrow Account 1. An account maintained by a broker for the deposit of client's money (i.e., good faith deposits). *Also called:* **Trust Account.** 2. An account maintained by a lender for the deposit of borrowers' extra 1/12 monthly deposits to cover next year's insurance and tax payments. *Also called:* **Reserve Account.**

Escrow Closing A closing by a disinterested third party, often an escrow agent.

Escrow Moneys All moneys, promissory notes, or any other type or manner of legal tender or financial consideration deposited with any person for the benefit of the parties to the transaction. A transaction exists once an agreement has been reached and an accepted real estate contract signed or lease agreed to by the parties. Escrow moneys include, without limitation, earnest moneys and security deposits, except those security deposits in which the person holding the security deposit is also the sole owner of the property being leased and for which the security deposit is being held.

Established Business Relationship (EBR) A relationship that may allow a telemarketer or seller to call a consumer for up to 18 months after the consumer's last purchase, delivery, or payment (even if the consumer's number is on the National Do Not Call Registry).

Estate A possessory interest in real property.

Estate at Sufferance Possession of property by a tenant who came into possession of the property under a valid lease, but stays on after the lease expires without the landlord's permission.

Estate at Will A leasehold estate with no specified termination date and with no regular rental period.

Estate for Years A leasehold estate set to last for a specific period, after which it automatically terminates. *Also called:* **Term Tenancy.**

Eviction Dispossessing or expelling someone from real property.

Evidence of Title Evidence of title to real estate is provided through a title report or issuance of title insurance.

Exclusionary Zoning A zoning law that effectively prevents certain groups, such as minorities or the poor, from living in a particular community.

Exclusive Brokerage Agreement A written brokerage agreement that provides that the sponsoring broker has the sole right, through one or more sponsored licensees, to act as the exclusive designated agent or representative of the client and that meets the requirements of Section 15-75 of the Illinois Real Estate License Act.

Exclusive Right to Sell Listing agreement that entitles the broker to a commission if anyone, including the seller, finds a buyer for the property during the listing term.

Executed Contract Contract under which both parties have completely performed their contractual obligations.

Executor/Executrix Person named in a will to carry out its provisions, including disbursement of land.

Executory Contract A contract under which one or more parties have not yet completed performance of their obligations.

Exemption Provision holding that a law or rule does not apply to a particular person, entity, or group (e.g., a company with a property tax exemption does not have to pay property taxes).

Express Contract Contract that has been put into words, either spoken or written.

Expressed Agency Agency relationship based on an expressed agreement, either written or oral.

Extreme Lending Lending to a borrower who has extremely high debt in relation to income.

F

Face-to-Face Closing A closing conducted with all parties present. *Also called:* **Roundtable Closing.**

Fair and Accurate Credit Transaction Act (FACT Act or FACTA) Amendment to the federal Fair Credit Reporting Act intended primarily to help consumers fight the growing crime of identity theft; includes provisions for fraud alerts and credit freezes, as well as provisions known as Red Flag Rules.

Fair Credit Reporting Act (FCRA) Federal law dealing with the granting of credit, access to credit information, the rights of debtors, and the responsibilities of creditors.

Fair Housing Act Common name for Title VIII of the Civil Rights Act of 1968. A law that prohibits discrimination in all facets of the homebuying process on the basis of race, color, national origin, religion, sex, familial status, or disability.

Fair Market Value The price a property would sell for on the open market.

Familial Status A protected group under the federal Fair Housing Act and the Illinois Human Rights Act which make it illegal to discriminate against a person because he or she is the parent or guardian of a child less than 18 years of age.

Farming The process of working on a specific area over a period of time to identify prospects for services; encompasses a number of techniques, including cold-calling, mass mailing, door-to-door solicitation.

Fannie Mae *See:* **Federal National Mortgage Association.**

Federal Home Loan Mortgage Corporation (Freddie Mac or FHMLC) Federally chartered institution that functions as buyer and seller of residential mortgages.

Federal Housing Administration (FHA) Provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories since its inception in 1934. FHA insures mortgages on single-family, multifamily, and manufactured homes and hospitals. It is the largest insurer of mortgages in the world.

Federal National Mortgage Association (Fannie Mae or FNMA) As part of the secondary mortgage market, the nation's largest investor in residential mortgages.

Federal Reserve Banks Banks that provide services to financial institutions (e.g., check clearing), which have one main office in each Federal Reserve district. All nationally chartered commercial banks must join the Federal Reserve and buy stock in its district reserve bank.

Fee Simple The greatest estate one can have in real property. It is freely transferable and inheritable, and of indefinite duration, with no conditions on the title.

Fee Simple Defeasible A fee estate in real property that may be defeated or undone if certain events occur or conditions are not met. *Also called:* Defeasible Fee. *See*: Conditional Fee, Fee Simple Determinable.

Fee Simple Determinable A defeasible fee that automatically terminated if certain conditions occur. *Also called:* **Determinable Fee**. *Compare:* **Fee, Conditional**.

FICO Score Credit scoring where a number from 300–850 is assigned to a consumer's credit history. The lower the score, the greater the risk of default. Generally, above 660 is an acceptable risk, 620–660 is a marginal risk, below 620 is a high risk. Another type of credit score is a BEACON Score.

Fiduciary Person in a position of trust, held by law to high standards of good faith and loyalty.

Fiduciary Duties Obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care owed to all clients in an agency relationship.

Fiduciary Relationship A relationship of trust and confidence, in which one party owes the other (or both parties owe each other) loyalty and a higher standard of good faith than is owed to third parties.

Finance Charge The cost of consumer credit as a dollar amount.

Finance Instrument A written document used in the borrowing or lending of money. The most common type is a promissory note.

Firewall A system designed to prevent unauthorized access to or from a private network. Information in front of a firewall is public; information behind a firewall is private and is, therefore, not considered to be advertising.

First Substantive Contact Discussions about the needs of a consumer that might result in confidential information being exchanged; an event triggering agency disclosure.

Fixed Rate Loan A loan where the interest rate remains constant for the duration of the loan.

Fixture A man-made attachment; an item of personal property attached to or closely associated with real property in such a way that it has legally become part of the real property.

Flipping Purchasing a piece of property and immediately reselling it for a profit, usually after fixing it up.

Flipping, Illegal Property purchased at a low price, appraised at a high value without reason, and resold at the higher price.

Float An unlocked interest rate that could change between the time of application and closing.

Footer The underground base, usually concrete, that supports a foundation.

Forbearance A legally binding promise to refrain from doing a particular act.

Foreclosure When a lien holder causes property to be sold, so that the unpaid debt secured by the lien can be satisfied from the sale proceeds.

Foreclosure, Judicial A lawsuit filed by a lender or other creditor to foreclose on a mortgage or other lien; a court ordered sheriff's sale of the property to repay the debt.

Foreclosure, Non-Judicial Foreclosure by a trustee under the power of sale clause in a deed of trust, without the involvement of a court.

Foreclosure, Strict Foreclosure with a strict deadline, past which a mortgagor can no longer reclaim his or her interest in the real property out of the foreclosure proceedings by bringing the mortgage current and the court awards title to the mortgagee with no sale required.

Foundation The basic structure on which a house will sit. A foundation can be concrete slab, pier and beams, crawl space, or basement.

Framing The basic load-bearing skeleton of the house to which interior walls, exterior walls and roof are attached.

Fraud An intentional or negligent misrepresentation or concealment of a material fact; making statements that a person knows, or should realize, are false or misleading.

Freddie Mac *See:* **Federal National Home Mortgage Corporation.**

Freehold Estate A possessory interest of uncertain duration.

Frontage The dimension across the access side of a parcel of land. When referring to lot size, frontage is the first number. For example, if a lot size is 150' x 100', the frontage is 150'. *Also called:* **Front Foot.**

Fully Amortizing Mortgage A type of mortgage structure that requires regular payment of principal and interest calculated to pay off the entire balance by the end of loan term.

G

Guaranteed Sales Plan A real estate purchase or sales plan where a licensee enters in a contract to purchase property within a specific time and for a specific price in the event it is not sold in accordance with the terms of a subsequent brokerage agreement.

General Agent An agent authorized to handle all of the principal's affairs in one area or in specified areas.

Gift Letter A statement from someone who is providing funds for a down payment (e.g., friend, relative, employer) indicating that the money is not expected to be repaid.

Good Funds Collected funds in a bank account and usable immediately by the owner of the account.

Government National Mortgage Association (Ginnie Mae or GNMA) Government-owned corporation that guarantees payment of principal and interest to investors who buy its mortgage backed securities on the secondary market.

Government Survey System Legal description for land referencing principal meridians and base lines designated throughout the country. *Also called:* **Rectangular Survey**.

Graduated Lease A lease in which the rent changes throughout the lease term. The contract specifies how much as well as when the rent will change.

Grant To transfer or convey an interest in real property by means of a written instrument.

Grantee The person who receives a conveyance of real property in a real estate transaction.

Granting Clause Deed clause stating a grantor's intent to transfer an interest in real property. *Also called:* **Words of Conveyance.**

Grantor The person who transfers title to real property in a real estate transaction.

Gratuitous Agency An agency relationship where the agent not compensated for his or her services, but still owes the principal all statutory obligations due every client.

Gross Income Income before taxes and other expenses have been deducted.

Gross Lease A lease in which the lessor pays all operating and maintenance costs associated with the property.

Gross Living Area (GLA) Residential space that is finished, heated, and above grade. Garages, finished basements, and storage areas do not count in GLA.

Gross Rent Multiplier (GRM) A number derived from comparable rental properties in an area, which is then used to estimate the value of real estate. The GRM is only used for one- to four-unit residential properties.

Ground Lease A lease in which a tenant leases unimproved land on a long-term basis and typically includes a provision that provides the tenant will construct a building on the property, which he will own upon completion. The lessor retains the rights to the land. Essentially, ownership of the land and improvements (building) are separated. *Also called:* **Land Lease.**

Groundwater Naturally occurring water found in subterranean crevices or spaces.

H

Habendum Clause Clause within a deed that describes the type of estate granted; it must always agree with the granting clause.

Hazardous Material Any type of product with toxic, corrosive, flammable, or reactive qualities.

Heir Someone entitled to inherit another person's real or personal property under the laws of intestate succession.

Highest and Best Use The most profitable, legally permitted, feasible, and physically possible use of a piece of property.

Holder in Due Course One who acquires a negotiable instrument in good faith and for consideration and has certain rights beyond those of the original payee.

Holdover Tenant A lessee who remains in possession of property after the lease has expired; a tenant who refuses to surrender possession of property at the tenancy's end.

Home Equity Line of Credit (HELOC) Available money that can be borrowed by a homeowner, secured by a second mortgage on the principal residence. Home equity lines of credit can be accessed at any time up to a predetermined borrowing limit and are often used for non-housing expenditures. *Compare:* **Home Equity Loan.**

Home Ownership and Equity Protection Act (HOEPA) Part of Regulation Z, Truth in Lending Act, which establishes disclosure requirements and prohibits equity stripping and other abusive practices in connection with high-cost mortgages.

Home Page The starting page or first page on a particular website.

Homeowners Association (HOA) Fees Charges imposed on a property owner to pay for upkeep, maintenance, and sometimes hazard insurance of common property, for example, a condominium; when required as a condition of ownership, the monthly amount must be added to PITI to get the complete housing expense.

Homeowners Insurance An insurance policy that will cover loss or damage to the home or property in the event of fire or other disaster.

Homeowners Protection Act (HPA) Federal law that requires lenders or servicers to provide certain disclosures and notifications concerning private mortgage insurance on residential loan transactions.

Homestead Estate Property that is occupied by the owner as the principal residence.

Homestead Protection Limited protection for a debtor against claims of judgment creditors; applies to property of the debtor's residence.

Housing Expense Ratio The relationship of a borrower's total monthly housing expense to income, expressed as a percentage (Total Housing Expense / Income = Ratio%). *Also called:* **Front End Ratio.**

HTML The language that web pages are written in (Hyper-Text Markup Language) so that they can be displayed correctly in a web browser.

HUD *See:* **U.S. Department of Housing and Urban Development.**

Hypothecate To hypothecate property means that a debtor can pledge property as a security without giving up possession of it.

I

Identity Theft A crime that occurs when someone uses someone else's personally identifying information, like a name, Social Security number, or credit card number, without permission, to commit fraud or other crimes.

Illinois Electronic Commerce Security Act A law that removes barriers to conducting business electronically by accepting electronic records, signatures, and requirements for originals; does not apply to instruments that convey property.

Illinois Human Rights Act Extends protected classes beyond those covered in the federal Fair Housing Act to include age, ancestry, marital status, military status or discharge status, sexual orientation or preference, and Order of Protection.

Immobility A physical characteristic of real estate referring to the fact that it cannot move from one place to another.

Implied Agency Agency relationship created through the behavior (actions or words) of one or both parties.

Implied Contract A contract that has not been put into words, but is implied by the actions of the parties.

Impound/Escrow The system in which things of value (e.g., money, documents) are held on behalf of the parties to a transaction by a disinterested third party (called an escrow agent) until the specified conditions have all been complied with.

Improvement A major fixture that impacts the value of the property, such as a building.

In-House Transaction A real estate transaction where the listing broker, or another licensee affiliated with that sponsoring broker, procures a buyer for the listed property.

Inactive A status of licensure where the licensee holds a current license but is prohibited from engaging in licensed activities because the licensee is unsponsored or the license of the sponsoring broker with whom the licensee is associated or by whom is employed is currently expired, revoked, suspended, or otherwise rendered invalid. The license of any business entity that is not in good standing or is not authorized to conduct business in Illinois, shall immediately become inactive and that entity shall be prohibited from engaging in any licensed activities.

Incapacity When someone is not able to sign a note or enter into any other kind of contract (e.g., because of age or mental incompetence).

Incentive Zoning A system by which developers receive zoning incentives on the condition that specific physical, social, or cultural benefits are provided to the community.

Income The money one receives from a job, investment, or other use of skills or capital.

Income Approach An appraisal method which estimates the value of real estate by analyzing the amount of revenue, or income, the property currently generates, or could generate, often comparing the subject property to other similar properties. *Also called:* **Capitalization Approach.**

Income Qualifying Standards The criteria used to evaluate the quality and durability of a borrower's source of income, in conjunction with an assessment of the borrower's housing expense ratio and total debt-to-income ratio.

Independent Contractor Under common law, a person who is self-employed. *See:* **Employee**.

Indestructibility A physical characteristic of real property referring to the concept that it can't be destroyed.

Index A statistical report that is generally a reliable indicator of the approximate change in the cost of money. With an adjustable rate mortgage, the borrower's interest rate increases and decreases as the chosen index fluctuates during the term of the loan.

Index Lease Method used to determine rent for long-term leases.

Indirect Cost Costs associated with a construction project, other than labor and materials.

Inflated Appraisal Valuing property higher than it's actually worth, resulting in lenders issuing loans for more than a home's real value.

Inflation An increase in the cost of goods or services over a period of time, which impacts a buyer's purchasing power.

Informed Consent Written evidence that a client is aware of and has given permission to an agent to perform a specific action or take on a specific role in the client agent relationship.

Ingress and Egress 1. Entering and exiting; usually refers to a road or other means of access to a property. 2. An easement that gives the dominant tenant access to the dominant tenement.

Inherit In strict legal usage, to acquire property by intestate succession; commonly used to mean acquiring property either by intestate succession or by will.

Injunction Court order prohibiting or compelling an act.

Inoperative A status of Illinois licensure where the licensee holds a current license, but is prohibited from engaging in licensed activities because the licensee is unsponsored or the license of the employing sponsoring broker is currently expired, revoked, suspended, or otherwise rendered invalid.

Installment Sales Contract *See:* **Land Contract.**

Intermediate Theory States States where a mortgagee holds a lien against property until the loan is repaid. Mortgagees must pursue judicial foreclosure to gain title in the event of borrower default; a hybrid of lien theory and title theory.

Intestate The act of dying without a legal will.

Intestate Succession Distribution of property to the heirs of a person who died intestate.

Instrument Any document that transfers title (such as a deed), creates a lien (such as a mortgage), or gives a right to payment (such as a note or contract).

Interest 1. A right or share in something, such as a piece of real estate. 2. A charge a borrower pays to a lender for the use of the lender's money. *Compare:* **Principal.**

Interest Rate The rate which is charged by a lender to a borrower for the use of money, generally expressed as a percentage of the principal.

Invalid Not legally binding or legally effective; not valid.

Involuntary Alienation When title to property is transferred during the owner's lifetime without his consent.

IRV Formula A simple calculation for finding the net operating Income, the Rate, or the Value of an in-vestment property. When any two factors are known, the third can be determined. *Also called:* **Capitalization Rate Formula**.

J

Joint Tenancy A form of co-ownership giving each tenant equal interest and equal rights in the property, including the right of survivorship.

Judgment 1. A court's binding determination of the rights and duties of the parties in a lawsuit. 2. A court order requiring one party to pay the wronged party damages.

Jumbo Loans Loans that exceed the maximum loan amount that Fannie Mae/Freddie Mac will buy, which makes them nonconforming.

Junior Mortgage Any mortgage with a lower lien position than another.

K

Kickback Fee or other compensation given for services not performed, but as a means of undisclosed commission for business referrals. Kickbacks are prohibited by RESPA.

L

Land The surface of the earth, the area above and below the surface, and anything attached to the surface.

Land Contract A real estate installment agreement where a buyer makes payment to a seller in exchange for the right to occupy and use property, but no deed or title transfers until all, or a specified portion of, payments have been made. *Also called:* **Installment Land Contract, Installment Sales Contract, Contract for Deed,** and **Land Sales Contract.**

Land Use Controls Any public or private restrictions on how land may be used; are usually government-enacted zoning laws.

Landlord An owner who leases property to a tenant. *Also called:* **Lessor.**

Latent Defect A defect that is not visible or apparent; a hidden defect that would not be discovered in a reasonably thorough inspection of property.

Law of Decreasing Returns Theory that says that beyond a certain point, added value of a feature, addition, repair, etc., is less than the actual cost of that item. *Also called:* **Law of Diminishing Returns.**

Law of Descent Rules of inheritance established by state law in cases in which there is no will naming the persons to receive the possessions of a person who has died (intestate).

Law of Increasing Returns Theory that says that the added value of a feature, addition, repair, etc., is more than the actual cost of that item.

Lawful Objective A legal purpose.

Lead A toxic metallic element found in paint, dust, water, and the ground.

Leads The name or names of a potential buyer, seller, lessor, lessee, or client of a licensee.

Lease A contract where one party pays the other rent in exchange for possession of real estate; a conveyance of a leasehold estate from the fee owner to a tenant.

Lease/Option When a seller leases property to someone for a specific term, with an option to buy the property at a predetermined price during the lease term, usually with a portion of the lease payments applied to the purchase price.

Lease/Purchase When a seller leases property to someone for a specific term, with the tenant agreeing to buy the property at a set price during or following the lease term.

Leasehold Estate An interest that gives the holder a temporary right to possession of the estate without title.

Leasehold Improvement A fixture attached to real property by a landlord for the use of a tenant.

Legal Description A precise description of a specific piece of property. *See*: **Block and Lot Description; Metes and Bounds Description; Government Survey System**.

Legal Title The interest in property held by the rightful owner. Also, the vendor's (seller's) interest in property under a land contract.

Lessee Person who leases property; a tenant.

Lessor Person who leases property to another; a landlord.

Leverage The use of borrowed funds to purchase property with the anticipation of a return on the funds invested, such that the investor sees a profit not only on his own investment, but also on the borrowed funds.

Levy 1. Verb: to impose a tax. 2. Noun: the tax itself.

Liabilities Financial obligations or debt. Any money that is owed. *Compare:* **Debt.**

Liable Legally responsible.

Liability Insurance Insures individuals against financial losses resulting from the person's responsibilities to others imposed by law or contract.

License 1. A temporary, revocable, non-assignable permission to enter another's land for a particular purpose. 2. The privilege conferred by the Illinois Department of Financial and Professional Regulation to a person that has fulfilled all requirements prerequisite to any type of licensure under the Illinois Real Estate License Act.

Licensed Activities Those activities performed by a broker. *See:* Illinois Real Estate Act, Article 1: Section 1-10.

Licensee Any person as defined in Section 1-10 of the Illinois Real Estate License Act who holds a valid unexpired license as a real estate broker, real estate managing broker, or residential leasing agent.

Lien A hold or claim that one person has on the property of another to secure payment of a debt or other obligation.

Lien, Attachment A lien intended to prevent transfer of property pending the outcome of litigation.

Lien, General A lien that attaches to all property, personal and real, owned in the county by the debtor.

Lien, Involuntary A lien that arises by operation of law, without the consent of the property owner. Also called a **statutory lien**.

Lien, Judgment A lien placed against a person's property through court action.

Lien, Mechanic's A specific lien claimed by someone who performed work on the property (construction, repairs, or improvements) and has not been paid. This term is often used in a general sense, referring to materialman's liens as well as actual mechanics' liens.

Lien, Specific A lien that attaches only to a particular piece of property (as opposed to a **general lien**, which attaches to all of the debtor's property).

Lien, Voluntary A lien placed against property with the consent of the owner; a mortgage (or, in other states, a deed of trust).

Lien Priority The order in which liens are paid out of the proceeds of a foreclosure sale. For example, tax liens always have the highest priority and a first mortgage would have the next highest priority.

Lien Theory States States where a mortgagee holds only a lien against property (not actual title) until the loan is repaid. The mortgagor holds the actual title. *Compare:* **Title Theory States.**

Life Estate A freehold estate that lasts only as long as a specified person, the measuring life, lives.

Life Estate Pur Autre Vie A life estate "for the life of another," where the measuring life is someone other than the life tenant. *Also called:* **Pur Autre Vie.**

Life Tenant The holder of a life estate.

Like Kind Exchange A provision of the Internal Revenue Code Section 1031 that allows a taxpayer to sell investment property and purchase another investment property in its place, deferring payment of capital gains taxes. *Also called:* **1031 Exchange.**

Like Kind Property The same type of property (such as real estate for real estate), as a necessary condition for a tax-free exchange.

Limited Common Areas Areas in a condominium or co-op owned by all but used by only one owner (i.e., a designated parking space.)

Limited Liability Company (**LLC**) A type of business structure that shares some characteristics of both a corporation and a partnership (or sole proprietorship if just one owner).

Limited Partnership A partnership comprised of one or more general partners and one or more limited partners.

Liquid Assets Cash and any other assets, such as stocks or bonds, that can be converted to cash quickly.

Liquidated Damages A sum of money the parties to a contract agree in advance (at the time of entering into the contract) will serve as compensation in the event of a contract breach.

Liquidity The ability to convert an asset into cash quickly without the loss of principal.

Lis Pendens A recorded notice that a lawsuit concerning real estate has been filed.

Listing Agreement Written agency contracts between a seller and a sponsoring broker stipulating the conditions under which the broker will be paid a commission with regard to the seller's property. They are employment contracts between a seller and a sponsoring broker.

Listing Presentation Any communication, written or oral and by any means or media, between a real estate broker and a consumer in which the licensee is attempting to secure a brokerage agreement with the consumer to market the consumer's real estate for sale or lease.

Littoral Rights Water rights of a landowner whose property is adjacent to a lake or contains a lake. *Compare:* **Appropriative Rights, Riparian Rights.**

Loan Estimate The mortgage loan originator's disclosure of loan terms, characteristics, true costs, and annual percentage rate (APR) as well as an estimate of closing costs the borrower must pay for a real estate loan. The lender must give this to the borrower within three business days of a completed loan application.

Loan Flipping Refinancing a property over and over again.

Loan Originator One who is responsible for working with a prospective borrower to gather information, assist with completing applications, and otherwise making or initiating a new loan.

Loan Processor One who is responsible for verifying information contained in a prospective borrower's loan file and for coordinating aspects of the loan process.

Loan-to-Value (LTV) The relationship between the unpaid principal balance of the mortgage and the appraised value (or sales price if it is lower) of the property.

Location Survey A survey that determines if a property's buildings encroach on adjoining property, or any adjoining property's buildings encroach on the subject property. *Also called:* **Sketch Survey.**

Lock-In A written agreement guaranteeing the homebuyer a specified interest rate provided the loan is closed within a set period of time. The lock-in also usually specifies the number of points to be paid at closing.

Loss Factor The difference between rentable square footage and usable square footage. *Also called:* **Load.**

Lot A parcel of land; a parcel in a subdivision.

Loyalty A fiduciary duty that requires an agent to put the principal's interests above all others' interests, including the agent's own.

M

Magnet Store A major department or chain store strategically located within a shopping center to give maximum exposure to smaller satellite stores. *Also called:* **Anchor Tenant.**

Maker One promising to pay money in a note, the borrower.

Management Agreement A written agreement that governs the relationship between a property owner/investor and the property manager and outlines the duties of the property manager. *Also called:* **Property Management Employee Contract.**

Management Proposal A plan created by the property manager for overseeing the property, including market analysis, and developing a variety of financial reports including the operating budget.

Managing Broker A licensee who may be authorized to assume responsibilities as a designated managing broker for licensees in one, or in the case of a multi-office company, more than one office, upon appointment by the sponsoring broker and registration with the Department. A managing broker may act as his or her own sponsor.

Marital Status The legal status of being married, single, separated, divorced or widowed.

Market Allocation Agreements in which competitors divide markets among themselves.

Market Price The price that a piece of real estate sold for in an actual transaction.

Market Value The theoretical price that a piece of property would bring if placed on the open market for a reasonable period of time, with a buyer willing (but not forced) to buy, and a seller willing (but not forced) to sell, if both buyer and seller were fully informed as to the possible use of the land.

Marketable Title Title that is free and clear of objectionable encumbrances or defects, so that a reasonably prudent person with full knowledge of the facts would not hesitate to purchase the property. *Also called:* **Merchantable Title.**

Matched Pair Analysis The process of determining the value of specific property characteristics or features by comparing pairs of similar properties.

Material Breach A breach of contract important enough to excuse the non-breaching party from performing his contractual obligations.

Material Fact A condition or occurrence that significantly and adversely affects the value of the real estate, reduces the structural integrity of improvements to real estate, or presents a significant health risk to occupants of the real estate; or information that indicates that a party to a transaction is not able to or does not intend to meet an obligation under a contract or agreement made concerning the transaction.

Material Misstatement False statement of facts.

Measuring Life A person whose life determines the length of a life estate. *See:* **Life Estate.**

Medium of Advertising Any method of communication intended to influence the general public to use or purchase a particular good or service or real estate, including, but not limited to, print, electronic, social media, and digital forums.

Meeting of the Minds Acceptance of the terms of an offer.

Meta Tag A special HTML tag that is used to store information about a web page but that is not displayed in a web browser; Internet search engines can return specific websites based on the meta tags that are embedded in a web page, as well as codes and words actually displayed on a page.

Metes and Bounds Description A legal description that starts at an easily identifiable point of beginning (P.O.B.), then describes the property's boundaries in terms of courses (compass directions) and distances, ultimately returning to the point of beginning.

Millage A tax rate, expressed as mills per dollar; 1/10 of 1 cent.

Mineral Rights Rights to the minerals located beneath the surface of a property.

Minimum Services The specific services mandated in the Illinois Real Estate License Act that a broker owes a client with whom there is an exclusive agency agreement. The minimum services include presentation of all offers, assisting the client in negotiating offers until a sale or lease contract is signed and contingencies met or waived, and answering the client's questions related to offers.

Ministerial Acts Acts that a licensee may perform for a consumer that are informative or clerical in nature and do not rise to the level of active representation on behalf of the consumer.

Misdemeanor A misdeed that may be tried in a court of special sessions.

Misrepresentation A false or misleading statement.

Mold A fungus that can release toxins into the environment causing allergic reactions in some people.

Mortgage An instrument that creates a voluntary lien on real property to secure repayment of a debt. The parties to a mortgage are the mortgagor (borrower) and mortgagee (lender).

Mortgage, Blanket Mortgage that covers more than one parcel of real estate, usually used to finance entire subdivision developments rather than an individual unit or lot.

Mortgage, Bridge A mortgage that occurs between the termination of one mortgage and the commencement of another. When the next mortgage is taken out, the bridge is repaid.

Mortgage, Cash-Out A mortgage that a borrower gives to lenders so that the borrower can get cash for the equity that has built up in property (e.g., a home equity loan taken out for a non-house purpose, or an investor trying to recoup money invested in fixing up a property).

Mortgage, Closed-End A typical real estate loan in which the balance is expected to be repaid—along with any interest and finance changes—by a specified future date.

Mortgage, Construction A temporary loan used to finance the construction of a building on land. Replaced with a take out loan.

Mortgage, Conventional A loan that is not insured or guaranteed by a government agency.

Mortgage, Equity Participation A mortgage that lets the lender share part of the earnings, income, or profits from a real estate project.

Mortgage, Graduated Payment (GPM) Specialized payment structure that allows the borrower to make smaller payments in the early years of the mortgage, with payments increasing on a scheduled basis at a predetermined point until they are sufficient to fully amortize the loan over the remainder of its term.

Mortgage, Growth Equity (GEM) A fixed rate mortgage set up like a 30-year conventional loan, but payments increase regularly. *Also called:* **Rapidly Amortizing Mortgage.**

Mortgage, Hard Money A mortgage where the borrower receives cash instead of credit (e.g., a cash-out mortgage).

Mortgage, Hybrid A loan to purchase a home that combines an adjustable rate mortgage with a fixed rate mortgage.

Mortgage, Open-End A mortgage where the borrower can request more funds from the lender, up to a certain pre-defined limit, even re-borrowing part of the debt that has been repaid (at lender's discretion) without having to renegotiate the loan.

Mortgage, Package A mortgage where personal property (e.g., appliances) is included in a real estate sale and financed with one contract.

Mortgage, Purchase Money Generally describes a mortgage used to finance the purchase of property; may specifically refer to a situation where the seller finances all or part of the sale price of a piece of property for the buyer, in which case may be called a Seller Held Mortgage.

Mortgage, Refinance A mortgage that a borrower gives to a lender to redo or expand the loan on the property, usually to get a better interest rate or pay off other debts.

Mortgage, Reverse Allows qualified homeowners age 62 or older to convert equity in the home into a lump sum, a monthly cash stream, or a line of credit; becomes due when the last surviving borrower dies, sells the home, or ceases to live in the home for 12 consecutive months.

Mortgage, Wraparound A financing arrangement in which an existing loan on a property is retained while the lender gives the borrower another, larger loan.

Mortgage-Backed Security (MBS) Debt obligations that represent claims to the cash flows from pools of mortgage loans.

Mortgage Banker A company, individual, or institution that originates, processes, underwrites, closes/funds, and services mortgage loans

Mortgage Broker An individual or company that, for a fee, acts as an intermediary between borrowers and lenders.

Mortgage Fraud A scheme in which some type of material misstatement, misrepresentation, or omission is relied upon by an underwriter or lender to fund, purchase, or secure a loan. Mortgage fraud schemes are usually either fraud for profit or fraud for property.

Mortgage Insurance Insurance offered by private companies (PMI) or the government through the FHA (MIP) to insure a lender against default on a loan by a borrower. *See:* **Private Mortgage Insurance (PMI)** and **Mortgage Insurance Premium (MIP).**

Mortgage Insurance Premium (MIP) The fee charged for FHA mortgage insurance coverage. The initial premium can be financed, and there may be a renewal premium. *Also called:* **Upfront Mortgage Insurance Premium (UFMIP).**

Mortgagee A lender who accepts a mortgage as security for repayment of the loan.

Mortgagee's Policy A type of title insurance the lender may have drawn in its own name to protect its interests in the property. This policy is for the loan amount that's outstanding at the time a claim would be paid.

Mortgagor A person who borrows money and gives a mortgage to the lender as security.

Multiple Listing Service (MLS) A listing service whereby local member brokers agree to share listings, and agree to share commissions on properties sold jointly.

Mutual Consent When all parties freely agree to the terms of a contract, without fraud, undue influence, duress, or mistake, and achieved through offer and acceptance. *Also called:* **Meeting of the Minds.**

N

National Association of REALTORS® (NAR®) America's largest trade association. One must be a member to use the title of REALTOR®.

Natural Attachments Things growing on a piece of land, such as trees, shrubs, or crops; considered part of real property while growing and personal property when removed. *Compare:* **Fixture.**

Negative Amortization The effect when a loan balance grows because of deferred interest when payments are not covering the interest portion of the loan.

Negative Easement An easement that prevents the servient tenant from using her own land in a certain way (as opposed to allowing the dominant tenant to use it). *Compare:* **Restrictive Covenant.**

Negligence Conduct that falls below the standard of care a reasonable person would exercise under certain circumstances; an unintentional breach of a legal duty resulting from carelessness, recklessness, or incompetence. *See:* **Tort.** *Compare:* **Strict Liability.**

Negotiable Instrument Documents that may be legally transferred from one party to another party by assignment; such as stocks, bonds, checks, or freely transferable promissory notes.

Neighborhood Group of houses or properties that shares common characteristics. *Also called:* **Market Area.**

Net Lease Lease for which a tenant pays all taxes, insurance, etc., plus utilities and rent.

Net Listing Agreement A listing agreement in which the seller sets a net amount acceptable for a property; if the actual selling price exceeds that amount, the broker is entitled to keep the excess as commission; illegal in many states.

Net Operating Income (NOI) Income left after all operating costs are paid.

Net to Seller An estimate of the money a seller should receive from a real estate transaction, based on a certain selling price after all costs and expenses have been paid.

Net Worth The value of a person's assets, determined by subtracting liabilities from assets.

Non-Agency When a licensee is not performing the minimum services required under an exclusive brokerage agreement, and is, therefore, not acting as the consumer's agent; this fact must be disclosed in writing to the consumer by the licensee.

Nonconforming Use Property use that doesn't conform to current zoning laws, but is allowed because the property was being used that way before the new zoning law was passed.

Nonconforming Loans Residential mortgage transactions that do not meet the qualifying standards required by Fannie Mae/Freddie Mac. *Compare:* **Conforming Loans.**

Nonpossessory Interest An interest in property that does not include the right to possess and occupy the property; an encumbrance, such as a lien or easement.

Note Rate The interest rate stated in a note. *Also called:* **Coupon Rate** or **Nominal Rate.**

Notary Public An official whose primary function is to witness and certify the acknowledgment made by one signing a legal document.

Notice Knowledge or information about a fact, often used with regard to public documents.

Novation 1. When one party to a contract withdraws and a new party is substituted, with the consent of all parties, relieving the withdrawing party of liability. 2. The substitution of a new obligation for an old one.

Nuisance Interference with the quiet enjoyment of land from the outside.

O

Obedience A fiduciary duty that requires an agent to follow the (legal) instructions of the principal, obey the parameters of the agency relationship, and not stray beyond the scope of authority.

Observable Depreciation Any loss of value an appraiser attributes to physical deterioration, functional obsolescence, or economic obsolescence.

Obsolescence, External Any influence that falls outside the actual property site and negatively affects a property's value. *Also called:* **Economic Obsolescence.**

Obsolescence, Functional Loss in property value resulting from changes in tastes, preferences, or market standards.

Offer When one person proposes a contract to another and that offer is accepted, a binding contract is formed.

Offer of Cooperation Usually published in the form of an MLS listing, the listing includes the amount (most frequently a percent of the gross sales price or a flat fee) offered as compensation for either a subagent, broker's agent, or buyer's agent.

Offeree A person who receives an offer or to whom an offer is made.

Offeror A person who makes an offer.

Office Real estate broker's place of business where the general public is invited to transact business and where records may be maintained and licenses displayed, whether or not it is the broker's principal place of business.

Omission Intentionally not reporting information that would disqualify someone for a loan.

Open Listing A nonexclusive listing given by a seller (or the buyer) to as many brokers as he chooses. If the property is sold, the broker who was the procuring cause of the sale is entitled to the commission.

Operating Budget A budget created to project the income and expenses for a property over a one-year period.

Operating Expenses The cost associated with running a building and/or business not including debt service or depreciation.

Operating Statement Document that illustrates total revenues generated for a given period based on rent rolls and management style.

Opinion of Value A method of determining the approximate market value of a home by comparing the subject property to other homes that have sold, are presently for sale, or did not sell in a given area.

Option A contract giving one party the right to do something within a designated time period, without obligation to do it.

Optionee Person to whom an option is given.

Optionor Person who gives an option.

Ordinance A law passed by a local legislative body.

Order of Protection Status A person's status as being protected under an order of protection issued pursuant to the Illinois Domestic Violence Act of 1986 or an order of protection issued by a court of an-other state.

Origination Fee A fee paid to a lender to cover the administrative costs of making and processing a loan, stated as a percentage of the mortgage amount.

Overage Rent The amount of a retail store's rent that is to be paid over the base rent, as determined by the stores' gross sales.

Owner's Policy A type of title insurance issued in the name of the property owner. Coverage runs from the time of purchase for as long as the policyholder owns the property. *Also called:* **Mortgagor's Policy.**

Ownership Title to property, dominion over property; the rights of possession and control of real or personal property.

Ownership in Severalty Ownership by a single individual, as opposed to co-ownership. *Also called:* **Severalty**.

P

Packing A Loan Refers to the prohibited practice of selling credit life, accident and health, disability, or unemployment insurance products or unrelated goods or services in conjunction with a high cost home loan without the informed consent of the borrower.

Parcel A lot or piece of real estate, particularly a specified part of a larger tract.

Parol Evidence Evidence concerning negotiations or oral agreements not included in a written contract that alter or contradict the terms of the written contract.

Part Performance The legal doctrine that allows a court to enforce an oral agreement that should have been in writing when the promisee has taken irrevocable steps to perform his contractual obligation and failure to enforce the contract would result in an unjust benefit for the promisor.

Partially Amortizing Loans Loans where payments are applied to principal and interest, but the payments do not retire the debt when the agreed upon loan term expires, thus requiring a balloon payment at the end of the loan term.

Partition Allows any co-owner to end a joint tenancy.

Partnership Association of two or more people to carry on business for profit. Law generally regards a partnership as a group of individuals, not as an entity separate from its owners. *Compare:* **Joint Venture, Corporation.**

Partnership Property The property partners bring into a business at the outset, or later acquire for the business; property owned as tenants in partnership. *See:* **Tenancy in Partnership.**

Pass-Through A clause found in leases, most commonly in commercial leases, that allows property owners to pass along unexpected increases in operating costs to tenants.

Patent Defect A visible, apparent defect that can be seen in a reasonably thorough inspection of property.

Payee The one promised payment in a note.

Peer Review Advisor A qualified licensee contracted by the Illinois Department of Financial and Professional Regulation to investigate the facts of a complaint against another licensee and make a non-binding recommendation to the Department.

Percentage Lease Lease under which a tenant pays a percentage of gross sales in addition to rent.

Periodic Estate A leasehold estate that continues for successive equal periods of length until terminated by proper notice from either the lessor or the lessee.

Person Includes individuals, entities, corporations, limited liability companies, registered limited liability partnerships, and partnerships, foreign or domestic, expect that when the context otherwise requires, the term may refer to a single individual or other described entity.

Personal Assistant A licensed or unlicensed person who has been hired for the purpose of aiding or assisting a sponsored licensee in the performance of the sponsored licensee's job.

Personal Property Tangible items that are not permanently attached to or part of real estate; any property that is not real property; movable property not affixed to land. *Also called:* **Chattel** or **Personalty.**

Phishing The criminally fraudulent process of attempting to acquire sensitive information such as usernames, passwords, and credit card details by masquerading as a trustworthy entity in an electronic communication.

Pitch A roof's vertical rise in inches, divided by its horizontal span in feet.

PITI Principal, Interest, Taxes, and Insurance; a typical mortgage payment.

Planned Unit Development (PUD) A type of subdivision in which developers do not have to comply with all standard zoning and subdivision regulations.

Plat A detailed survey map of a subdivision, recorded in the county where the land is located. Subdivided property is often called platted property. *Also called:* **Plat Map.**

Plottage An increase in value, over the cost of acquiring the separate parcels, by successful assemblage, usually due to a change in use.

Pocket Card The card issued by the Department of Financial and Professional Regulation to signify that the person named on the card is currently licensed under the Illinois Real Estate License Act.

Point One percent of the loan amount. Points are charged for any reason, but are often used for buydowns, where they may also be called discount points. Points are used to increase the lender's yield on a loan.

Police Power The constitutional power of state and local governments to enact and enforce laws that protect the public's health, safety, morals, and general welfare.

Positive Easement An easement that allows the dominant tenant to use the servient tenement in a particular way.

Possession 1. The holding and enjoyment of property. 2. Physical occupation of real property.

Possessory Interest Interest that entitles the holder to possess and occupy property, now or in the future; an estate, which may be either a freehold or leasehold.

Potential Gross Income The potential income a property would produce in an ideal situation including no vacancy and collection losses.

Power of Attorney A legal document that gives one person the full legal right and authority to act for another person.

Power of Sale Clause A clause that allows the trustee to sell trust deed property, without court supervision, when terms of the trust deed are not kept.

Pre-Approval Process by which a lender determines if potential borrowers can be financed through the lender, and for what amount of money.

Predatory Lending Loans that take advantage of ill-informed consumers through excessively high fees, misrepresented loan terms, or frequent refinancing that does not benefit the borrower.

Prepayment Clause A clause in a contract gives the lender the right to charge the borrower a penalty for paying off the loan early.

Prepayment Penalties Additional money charged by a lender for the borrower paying a loan off early.

Pre-Renewal Period The period between the date of issue of a currently valid license and the license's expiration date.

Pre-Qualification The process of determining how much money a prospective homebuyer might be eligible to borrow; it is not a guarantee.

Prescription Acquiring an interest in property (usually an easement) by using it openly and without the owner's permission. *See:* **Easement by Prescription.** *Compare:* **Adverse Possession.**

Preventive Maintenance Routine maintenance and inspections that keep equipment and the property in good working order.

Price What one person paid for something. *Compare:* **Value.**

Price-Fixing An antitrust violation that occurs when two or more competitors agree to fix the prices that they will charge.

Primary Mortgage Markets When lenders make mortgage loans directly to borrowers. *Also called:* **Primary Markets**. *Compare:* **Secondary Mortgage Markets**.

Principal 1. A person who grants another person (an agent) authority to represent him or her in dealings with third parties. 2. One of the parties to a transaction (such as a buyer or seller), as opposed to those who are involved as agents or employees (such as a broker or escrow agent).

Principal The base amount of a loan.

Principal Meridians North-south lines designated and named throughout the country for use with the government survey system. They are based off of the prime meridian, which is the line of longitude passing through the Royal Greenwich Observatory in England (0 degrees).

Private Mortgage Insurance (PMI) Insurance offered by private companies to insure a lender against default on a loan by a borrower.

Pro Forma Statement A schedule of the projected income and expenses for a real estate investment over a given period.

Probate A judicial proceeding in which the validity of a will is established and the executor is authorized to distribute the estate property; or, when there is no valid will, a judicial proceeding in which an administrator is appointed to distribute the estate to heirs according to the laws of intestate succession.

Probate Court A court that oversees the distribution of property under a will or intestate succession.

Procuring Cause The real estate agent who is primarily responsible for bringing about a sale, such as by introducing the buyer to the property or by negotiating the agreement between the buyer and seller. Sometimes more than one agent contributes to a sale.

Progression A principle that says the value of a home is helped up by the other homes in an area. (Usually said about the "worst" home in the "best" area.)

Promisee A person who has been promised something; a person who is supposed to receive the benefit of a legally binding contractual promise (e.g., with a promissory note).

Promisor A person who has made a contractual promise to another (e.g., in a promissory note).

Promissory Note This is the basic evidence of debt, showing in writing who owes how much to whom.

Property Something that is owned, real or personal, and includes the rights of ownership in that thing.

Property Inspection Report A document from a professional property inspector about the conditions of a property. These are often required by a lender before approval of a loan is granted. These include inspections for termites, structural integrity, septic systems, and radon gas, among others.

Property Insurance Coverage that indemnifies a person with an interest in the property for a loss caused to the property by a covered peril.

Property Management Leasing or renting, or offering to lease or rent real property of others for a fee, commission, compensation, or other valuable consideration pursuant to a property management employee contract.

Proprietary Lease Exclusive, longer term lease given to a person who lives in a cooperative and owns stock in the cooperative.

Proration The division of expenses between buyer and seller in proportion to the actual usage of the item represented by a particular expense. *Also called:* **Adjustments.**

Public Accommodation An establishment that is intended to be available to everyone, either as a place of business or commerce or for federal, state, or local government business. It includes hotels, restaurants, retail, gas stations, theaters, museums, etc.

Puffing Superlative statements about the quality of a property that should not be considered assertions of fact.

Purchase Agreement A contract in which a seller promises to convey title to real property to a buyer in exchange for the purchase price. *Also called:* **Purchase and Sale Agreement, a Purchase Contract,** or an **Earnest Money Agreement.**

Q

Qualifying The process of determining whether or not a borrower is likely to default on a loan and that the property is worth enough to satisfy the debt if the borrower does default.

Qualifying Ratios Guidelines applied by the lenders to determine how large a loan to grant a homebuyer.

Quiet Title Action A lawsuit filed to determine and resolve problems of instruments conveying a particular piece of land; may be required to close any missing links and remove the cloud on the title.

R

Racial Discrimination Treating people unequally because of their race, ancestry, or national origin in violation of civil rights law.

Radon A radioactive gas found in some homes that in sufficient concentrations can cause health problems.

Range Lines Lines that run parallel to a principal meridian, marking off the land into six-mile strips known as ranges; they are numbered east or west of a principal meridian in the government rectangular survey.

Rate Lock A specific fixed interest rate for a specified amount of time that is guaranteed by the mortgage lender.

Rate of Return The rate at which an investor recaptures his investment in income-producing property.

Re-Amortization When payments on a loan are recalculated so the new payment will fully amortize the loan over the remaining loan term. *Also called:* **Recast.**

Real Estate Means and includes leaseholds as well as any other interest or estate in land, whether corporeal, incorporeal, freehold, or non-freehold, including timeshare interests, and whether the real estate is situated in the State of Illinois or elsewhere.

Real Estate Investment Trust (REIT) A real estate investment business with at least 100 investors, organized as a trust.

Real Estate Owned (REO) Property acquired by a lending institution through foreclosure and held in inventory.

Real Estate Recovery Fund A fund maintained by the Illinois Department of Financial and Professional Regulation from which any person aggrieved by an act, representation, transaction, or conduct of a licensee or unlicensed employee of a licensee who is in violation of the Real Estate License Act or Administrative Rules can collect damages.

Real Estate Related Financial Transaction Any transaction involving the sale, lease, purchase, investment in, or exchange of real property, including interests in property or the financing thereof; the refinancing of real property or interests in real property; and the use of real property or interest in property as a security for a loan or investment, including mortgage backed securities.

Real Estate Sales Contract A written agreement in which a seller promises to convey title to real property to a buyer in exchange for the purchase price. *Also called:* **Sales Contract or Agreement of Sale.**

Real Estate Settlement Procedures Act (RESPA) Requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures of the nature and costs of the real estate settlement process.

Real Estate The actual physical land and everything, both natural and man-made, which is attached to it.

Real Property The physical land and everything attached to it, and the rights of ownership (bundle of rights). *Also called:* **Realty.**

REALTOR® An individual in the real estate business, with any kind of license such as a salesperson, broker, or appraiser, who chooses to join the local association of REALTORS®.

Reasonable Accommodation In housing, a change in rules, policies, practices, or services so that a person with a disability will have an equal opportunity to use and enjoy a dwelling unit or common space.

Reasonable Care A duty that is owed by an agent to both his clients and his customers; must always be used, because an agent could be held liable for negligence.

Reasonable Modifications A structural modification that is made to allow persons with disabilities the full enjoyment of the housing and related facilities.

Recertification of Value (Recert) Action taken to validate that any "subject to" conditions of an original appraisal have been met and that the original opinion of value is still valid; as when construction or renovations are complete. *Also called* **Completion Report.**

Reciprocity When states agree to allow licensees from other states to sell real estate in their own.

Reconciliation 1. The appraisal process of analyzing the values derived from the different appraisal approaches to arrive at a final value estimate or opinion. 2. Verifying the debits and credits have been added and subtracted correctly on a real estate settlement statement.

Recording Filing a document at the county recorder's office so it is public record.

Redemption, Equitable Right of The right to save or redeem the property prior to the confirmation of sale in a foreclosure procedure.

Redemption, Statutory Right of The right to save or redeem the property after to the confirmation of sale in a foreclosure procedure.

Redlining When a lender refuses to make loans secured by property in a certain neighborhood because of the racial or ethnic composition of the neighborhood.

Regional Malls Type of retail property which provides a broad range of general mer-chandise and services to customers. Often enclosed, regional malls range in size from 250,000 to more than 900,000 square feet.

Regression A principle that says the value of a home is held down by the other homes in an area. (Usually said about the "best" home in the "worst" area.)

Regular Employee A person working an average of 20 hours per week for a person or entity who would be considered an employee under the Internal Revenue Service rules for classifying workers.

Regulation Z (Truth in Lending Act) A federal law which requires that borrowers are shown how much they are going to pay for credit in dollars and percentages; requires use of annual percentage rate (APR) and full disclosure of credit terms in advertising once any specific financials are mentioned.

Reliction When a body of water gradually recedes, exposing land that was previously under water. *Also called:* **Dereliction.**

Remainder Interest A future interest that becomes possessory when a life estate terminates and that is held by someone other than the grantor of the life estate. *Compare:* **Reversionary Interest.**

Remainderman The person who has an estate in remainder.

Renewal Period The period beginning 90 days prior to the expiration date of a license.

Rent Consideration paid by a tenant to a landlord in exchange for possession and use of property.

Rent Credit When part of a rent payment is applied against the purchase price of a property, especially with lease/purchase contracts.

Rentable Square Footage The amount of space used in calculating a lease payment; rentable square footage is larger than the actual space tenants occupy because it includes their share of the property's service areas like the lobby, corridors, and other common areas. *Also called:* **Gross Square Footage.**

Rent Roll Spreadsheet or listing of key information about a property (i.e., total number of units, tenant names and apartment numbers, lease dates, and the rent each tenant pays).

Renunciation When someone who has been granted something, or has accepted something, later gives it up or rejects it; as when an agent withdraws from the agency relationship.

Rescission When a contract is terminated and each party gives anything acquired under the contract back to the other party (verb form is rescind).

Reserve for Replacements Money that a property owner sets aside regularly in anticipation of needing to fund capital improvement projects or to pay for extraordinary repairs.

Reserve Requirements The percentage of customers' deposits commercial banks are required to keep on deposit, either on hand at the bank or in the bank's own accounts; money the bank cannot lend to other people.

Reserves Cash on deposit or other highly liquid assets a borrower must have in order to cover two months of PITI mortgage payments, after they make the cash down payment and pays all closing costs.

Residential Lead-Based Paint Hazard Reduction Act Requires sellers and landlords to disclose known lead paint hazards for homes built before 1978.

Residential Leasing Agent A person who is employed by a real estate broker to engage in licensed activities limited to leasing residential real estate, and who has obtained a license as provided for in Section 5-5 of the Illinois Real Estate License Act.

Residential Real Property Real property improved with not less than one nor more than four (4) residential dwelling units; units in residential cooperatives; or condominium units, including the limited common elements allocated to the exclusive use thereof that form an integral part of the condominium unit.

RESPA *See:* **Real Estate Settlement Procedures Act.**

Restrictive Covenant A restriction on real property use imposed by a former owner; promise to do or not do an act relating to real property; usually owner's promise to not use property in a particular way.

Retaliatory Eviction When a landlord evicts a tenant in retaliation for complaining about code violations or violations or for participating in a tenants' rights group.

Return on Investment A saver/investor's expectation that he will eventually get back the interest paid while the equity was invested.

Revenue Stamps Indicators that are affixed to the deed or other document conveying title before the deed can be recorded proving that transfer tax was paid.

Reversionary Interest A future interest that becomes possessory when a temporary estate (such as a life estate) terminates, and is held by the grantor (or grantor's successors in interest). *Compare:* **Remainder Interest**.

Revocation 1. When someone who granted or offered something withdraws it, as when a principal withdraws the authority granted to the agent, an offeror withdraws the offer. 2. The withdrawal of a real estate agent's license by the issuing authority for violations; often permanent.

Rider An amendment to a contract.

Right of Disposal Confers upon the owner the ability to transfer all or some property rights to others.

Right of Enjoyment Confers upon the owner the freedom to use land without undue interference from the outside.

Right of First Refusal A right to have the first chance to buy or lease property if the owner decides to sell or lease it.

Right of Survivorship A characteristic of statutory survivorship tenancy, joint tenancy, and tenancy by the entireties; surviving co-tenants automatically acquire a deceased co-tenant's interest in the property.

Right of Use Confers upon the owner the right to make the land productive.

Right of Way (ROW) An easement that grants access.

Right to Rescind The right of a consumer to rescind a credit transaction up to midnight of the third business day.

Riparian Rights The water rights of a landowner whose property is adjacent to or crossed by a river (or any body of water). *Compare:* **Appropriative Rights, Littoral Rights.**

Risk The probability that events will not occur as expected.

Risk Management Identifying, managing, and minimizing the potential risks on the property.

Root of Title The deed or other document of transfer that was the first recorded, going back at least as far as required by state law.

Rough-Ins Items hidden by finished walls, but that are vital to the operation of the house.

Roundtable Closing A closing conducted with all parties present.

Running with the Land Binding or benefiting the successive owners of a piece of property, rather than terminating when a particular owner transfers his interest. Usually refers to easements or restrictive covenants.

Rural Development A government agency under the U.S. Department of Agriculture (USDA) that guarantees or makes loans to help buyers of homes and farms in rural areas or small towns.

S

Safe Drinking Water Act (SDWA) A federal act established by the EPA that sets quality standards for water intended for human consumption.

Sale-Leaseback A method for financing commercial or industrial properties in which a company constructs the building then becomes a tenant by selling the building to an investor.

Sales Comparison Approach An appraisal method which estimates the value of real property by performing a market analysis of the area where the subject property is located. Data are collected and adjustments made for differences. *Also called:* **Market Data Approach.**

Satisfaction of Mortgage The document a mortgagee gives the mortgagor when the mortgage debt is paid in full acknowledging the debt has been paid and the mortgage is no longer a lien against the property.

Savings and Loan Associations Institutions that specialize in taking savings deposits and making mortgage loans.

Scarcity A characteristic of real property that says there is a limited supply of real estate.

Scraping Using or altering existing listing information or keywords that are copied from one Internet site and posted or displayed for the benefit of the general public in front of a firewall at another site without written or electronic authorization and disclosure of ownership.

Secondary Financing When a buyer borrows money from another source in addition to the primary lender to pay for part of the purchase price or closing costs.

Secondary Mortgage Markets The private investors and government agencies that buy and sell real estate mortgages. *Compare:* **Primary Mortgage Markets.**

Section Part of a township, one-mile by one-mile square. Used for the government survey system; one section equals 640 acres, 36 sections equal one township.

Security Deposit Money a tenant gives a landlord at the beginning of tenancy to ensure the tenant will comply with the terms of the lease. The landlord may retain all or part of the deposit to cover unpaid rent, repair costs, or other damages, if necessary.

Security Instrument An instrument that gives a creditor the right to have the collateral sold to satisfy the debt if the debtor fails to pay according to the terms of the agreement.

Seizen The possession of a freehold estate; ownership. *Also spelled:* **Seisin** or **Seizin.**

Self-Help Eviction When a landlord uses physical force, a lockout, or a utility shutoff to remove a tenant, instead of the legal process.

Self-Liquidating Describes a fully amortizing loan where the total payments over the life of the loan pay off the entire balance by the end of the loan's term.

Seller Concession Anything of value added to the transaction by the builder or seller for which the buyer pays nothing additional and which the seller is not customarily expected or required to pay or provide.

Seller Financing When a seller extends credit to a buyer to finance the purchase of the property, which can be instead of or in addition to the buyer obtaining a loan from a third party, such as an institutional lender.

Seller-Paid Items Closing costs paid by the seller instead of the buyer. This usually refers to items normally paid by the buyer, but in some instances are paid by the seller to help close the sale.

Seller's Agent An agent representing the interests of the seller of a property.

Seller's Market A situation in the housing market when sellers can choose from a large number of buyers looking for houses in an area.

Selling Agent The agent who finds a buyer in a real estate transaction, often as a cooperating agent, but it may be a buyer's agent. Do not confuse with the term seller's agent, which is an agent who represents the seller. *Also called:* **Selling broker.**

Senior Mortgage A mortgage that has a higher lien position than another mortgage.

Septic System A type of private sewage disposal system used in areas that do not have public sewers.

Servicing The continued maintenance of a loan after it has been made (e.g., collecting payments, keeping records, and handling defaults).

Servient Tenant The owner of a servient tenement; that is, someone whose property is burdened by an easement.

Servient Tenement Property burdened by an easement; the owner of the servient tenement (the servient tenant) is required to allow someone who has an easement (the dominant tenant) to use his property.

Setback Requirements Provisions in a zoning ordinance that do not allow structures to be built within a certain distance of property lines.

Setback The legal distance that a building must be from a designated position such as a property line; determined by setback requirements.

Settlement Closing on a real estate transaction.

Severable When one part or provision in a contract can be held unenforceable without making the entire contract unenforceable.

Sexual Orientation Actual or perceived heterosexuality, homosexuality, bisexuality, or gender related identity, whether or not traditionally associated with the person's designated sex at birth. "Sexual orientation" does not include a physical or sexual attraction to a minor by an adult.

Sheathing Structural covering, often made of plywood, placed over a building frame's exterior wall studs or roof rafters.

Sheriff's Sale A foreclosure sale held after a judicial foreclosure. *Also called:* **Execution** or **Execution Sale.**

Short Sale Strategy to sell foreclosed property at less than the balance owed so that the lender can sell more quickly and get the property off its books.

Sick Building Syndrome When poor air quality in a building causes symptoms of headache, fatigue, nausea, sore throat, nose and eye irritation, etc. among its occupants.

Siding The outer covering for a home's exterior walls, designed to shed water and protect the home from the elements.

Single Agency The most basic form of agency where one agent represents just one party in a specific transaction.

Single Family Property A single-unit family residence, detached or attached to other housing structures.

Site A plot of land with enhancements that make it ready for a building or structure.

Sole Proprietorship A business owned and managed by one person (or for tax purposes, a husband and wife) who is personally liable for all business debts. It could be organized under a fictitious or assumed name.

Spam The use of any electronic messaging system to send unsolicited bulk messages indiscriminately.

Special Agent An agent with limited authority to do a specific thing or conduct a specific transaction, also called a limited agent.

Special Assessment A tax or levy against real property for improvements; not imposed on all residents of a community, but only to owners who will benefit from the improvement.

Specific Performance A legal remedy in which a court orders someone who has breached a contract to perform as agreed rather than simply paying monetary damages.

Sponsor Card The temporary permit issued by a sponsoring broker certifying that the real estate broker or leasing agent is employed by or associated by written agreement with the sponsoring real estate broker, as provided for in Section 5-40 of the Illinois Real Estate License Act.

Sponsoring Broker The broker (person or entity) that certifies to the Department the sponsorship of a licensed managing broker, broker, or residential leasing agent.

Sponsorship When a sponsoring broker has certified to the Department that a managing broker, broker, or residential leasing agent named thereon is employed by or associated by written agreement with the sponsoring broker and the Department has registered the sponsorship.

Spot Zoning A rezone that favors (or restricts) a particular property owner (or a small group of owners) without justification.

Square Foot A unit of area equal to 12 inches by 12 inches.

Stable Income Income expected to continue in the future.

Statute of Frauds A law that requires certain types of contracts to be in writing and signed to be enforceable.

Statute of Limitations A law requiring a particular type of lawsuit to be filed within a specified time after the event giving rise to the suit occurred.

Statutory Duties What is owed to all clients in an agency relationship—obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care. *Also called:* **Fiduciary Duties.**

Statutory Employee Independent contractors specifically classified as employees by statute for Social Security and Medicare taxes.

Statutory Non-Employee Direct sellers and licenses real estate agents; treated as independent contractors for all tax purposes if certain conditions are met.

Steering Channeling prospective buyers or tenants to particular neighborhoods based on their race, religion, national origin, or ancestry.

Stigmatized Property A property that is undesirable to most people because of a past event, such as a crime or former environmental hazard.

Straight Line Depreciation Simple depreciation method that takes the total cost of a building and divides that by the number of years the building is expected to be useful.

Straw Buyer A person who receives payment from a conspirator for the use of that person's name and credit history to apply for a loan, generally as part of a mortgage fraud scheme. *Also called:* **Straw Owner** or **Straw Purchaser.**

Strip Center Type of retail property which typically contains a minimum of three stores with a total gross leasable area of up to 30,000 square feet.

Subagent In common law, an agent of an agent; a person that an agent has delegated authority to, so that the subagent can assist in carrying out the principal's orders. In a real estate scenario, a broker who accepts subagency from a listing broker to represent the seller may be a subagent of the seller client. Subagency may not be offered through a Multiple Listing Service in Illinois.

Subdividing Splitting a larger parcel of land into several smaller parcels.

Subdivision 1. Land divided into two or more parcels. 2. A residential development.

Subject Property The property being appraised or for which a value opinion is being sought.

Sublease When a tenant transfers only part of his right of possession or other interest in leased property to another person for part of the remaining lease term. *Compare:* **Assignment.**

Subordination Agreement An agreement that gives a mortgage recorded at a later date the right to take priority over an earlier recorded mortgage.

Subprime Loan A loan with higher interest rates and fees to compensate for increased risk of the borrower with a poor credit history.

Substitution A "rule" that says an informed buyer will not pay more for a home than a comparable substitute.

Supply and Demand A law of economics that says for all products, goods, and services, when supply exceeds demand, prices will fall and when demand exceeds supply, prices will rise.

Substantial Performance When a promisor does not perform all of his contractual obligations, but does enough so the promisee is required to fulfill his obligations. *Compare:* **Material Breach.**

Superfund Amendments and Reauthorization Act (SARA) Act that amended the CERCLA, designated more money to the Superfund trust, and established new environmental laws and regulations.

Surrender Giving up an estate (such as a life estate or leasehold) before it has expired.

Survey The process of precisely measuring the boundaries and determining the area of a parcel of land.

Suspension A real estate agent's license being temporarily withdrawn. Usually, reactivation is automatic the day after the suspension is lifted. *Compare:* **Revocation.**

Syndicate An association of people or entities formed to operate an investment business. A syndicate is not a recognized legal entity; can be organized as a corporation, partnership, or trust.

T

Taking When the government acquires private property for public use by appropriation. The difference between a "taking" and eminent domain is that the property is regulated by a government authority to the economic detriment of the owner, without compensation.

Taxation The process of a government levying a charge on people or things.

Team Any two or more licensees who work together to provide real estate brokerage services, represent themselves to the public as being part of a team or group, are identified by a team name that is different than their sponsoring broker's name, and together are supervised by the same managing broker and sponsored by the same sponsoring broker; does not mean a separately organized, incorporated, or legal entity.

Teaser Rate A low initial rate on an adjustable rate mortgage. The rate usually returns to normal at the first adjustment date.

Tenancy at Sufferance Possession of property by a holdover tenant.

Tenancy at Will When a tenant is in possession with the owner's permission, but with no definite lease term and no rent being paid (or rent is not paid on a regular basis); e.g., a landlord lets a holdover tenant remain on the premises without paying rent until a new tenant is found.

Tenancy by the Entirety A type of joint ownership of property that provides right of survivorship and is available only to a husband and wife.

Tenancy in Common A type of joint ownership in a property without right of survivorship.

Tenant Someone in lawful possession of real property. Someone who is leasing property from the owner. *Also called:* **Lessee.**

Tender An unconditional offer by one party to a contract to perform his or her part of the agreement; made when the offeror believes the other party will breach to establish the offeror's right to sue if the other party doesn't accept it. *Also called:* **Tender Offer** or **Tendering Performance.**

Term A prescribed period of time; especially, the length of time a borrower has to pay off a loan, or the duration of a lease.

Testate The act of dying with a legal will.

Tester Person who poses as a customer or client attempting to secure real estate services to ensure fair housing is practiced. *Also called:* **Checker.**

Tie-In Agreement An agreement in which one transaction or agreement is contingent on a second transaction or agreement; also called a tying agreement.

Time is of the Essence A contract clause that means performance on the exact dates specified is an essential element of the contract; failure to perform on time is a material breach.

Timeshare An ownership interest giving the owner a right to possession of the property only for specific, limited periods.

Title Lawful ownership of real property. Also, in informal usage, the deed or other document that is evidence of ownership.

Title Closing The final stage in a real estate transaction when transfer of real property ownership from seller to buyer occurs according to the terms and conditions in a sales contract or escrow agreement.

Title Company A company that specializes in examining and insuring titles to real estate.

Title Insurance Insurance that indemnifies against losses resulting from undiscovered title defects and encumbrances.

Title Report A report issued by a title company, disclosing the condition of the title to a specific piece of property. *Also called:* **Title Guaranty.**

Title Search A check of the title records to ensure that the seller is the legal owner of the property and that there are no liens or other claims outstanding.

Title Theory States States where a mortgagee holds actual title to property until the loan is repaid. *Compare:* **Lien Theory States**.

Topography The physical characteristics of the surface of a parcel of land.

Tort A breach in standards of reasonable conduct imposed by law that causes harm to another person.

Townhomes Properties developed for co-ownership where each co-owner has a separate fee simple interest in an individual unit, including its roof and basement, as well as the land directly beneath the unit, and an undivided interest in the common areas of the property.

Township Square division of land, six miles by six miles, in the government survey system. One township contains 36 sections.

Trade Fixtures Equipment a tenant installs for use in his or her trade or business, and can be removed by tenant before the lease expires. *Also called:* **Chattel Fixtures.**

Transfer Tax State, county, or local tax on the value of real property payable by the seller when title passes from one owner to another.

Trespass An unlawful physical invasion of property owned by another.

TRID Rule The TILA-RESPA Integrated Disclosure rule, issued by the Consumer Financial Protection Bureau to create standardized, consumer-friendly disclosure documents, including the Loan Estimate and the Closing Disclosure.

Trigger Term A word or phrase that describes a loan, including the down payment, terms, and monthly payment. If an ad uses a trigger phrase, disclosures are needed to tell everything about the loan. *Also called:* **Trigger Phrase**.

Triple Net Lease A lease in which the tenant pays all the expenses associated with the property, including rent.

True Picture The mandate to present accurate words and images that do not misrepresent a property or mislead a consumer in all advertising, marketing, and other representations.

Trust A legal arrangement in which title to property (or funds) is vested in one or more trustees who manage the property (or invest the funds) on behalf of the trust's beneficiaries, in accordance with instructions set forth in the document establishing the trust.

Trust Deed *See:* **Deed of Trust.**

Trustee A person appointed to manage a trust on behalf of the beneficiaries; in a trust deed, an independent third party that holds the trust instrument.

Trustor The property owner who grants a trust to a third party for the benefit of someone else; in a trust deed, the borrower.

Truth in Lending Act (TILA) Federal act that requires lenders to disclose credit costs in order to promote informed use of consumer credit.

Truth in Lending Statement (TIL) Disclosure of the true costs associated with a residential loan, including the annual percentage rate, that is required to be given to prospective borrowers within three business days of a completed loan application.

U

Underground Storage Tanks (USTs) Holding tanks that can used to store chemicals, fuels, toxic wastes and other substances. Regulated by the EPA.

Underwriter Individual who evaluates a loan application to determine its risk level for a lender or investor; final decision maker on a loan application.

Underwriting The process of evaluating and deciding whether to make a new loan and on what terms.

Underwriting Standards The criteria an underwriter uses to determine if a borrower or property qualifies for a loan.

Undisclosed Dual Agency Very often may be practiced unintentionally, possibly by implying to a party that, for example, an agent's loyalty is to them when the agent's duty is actually to someone else.

Undivided Interest Legal doctrine that gives co-owners the right to possession of the whole property and not just part of it.

Unencumbered Property Property where the seller has clear title, free of mortgages or other liens.

Uniform Commercial Code Comprehensive code governing, among other things, transactions involving personal and real property; used as a model that has been enacted in some form or another by all 50 states.

Uniform Residential Appraisal Report (URAR) A standard appraisal report form used by lenders and appraisers and developed and approved by secondary mortgage market players Fannie Mae and Freddie Mac.

Uniform Standards of Professional Appraisal Practice (USPAP) Professional appraisal standards developed by The Appraisal Foundation, and now recognized throughout the United States as accepted standards of appraisal practice.

Unilateral When only one party makes a legally binding promise and the other has not. The promise will become legally binding if the other party chooses to accept it (similar to an offer).

Unity of Interest Each co-owner having an equal interest (equal share of ownership) in a piece of property.

Unity of Possession Each co-owner being equally entitled to possession of the entire property, because the ownership interests are undivided. *See:* **Undivided Interest.**

Unity of Time When each co-owner acquired title at the same time.

Unity of Title When each co-owner acquired title through the same instrument (deed, will, or court order).

Uniqueness Characteristic of real property that says that every piece of land, every building, and every house is said to be a different piece of real estate. *Also called:* **Non-Homogeneity.**

Unlicensed Assistant Someone hired by a licensed broker to help with administrative, clerical, or personal activities for which a license is not required, even if the activities may be brokerage related.

Universal Agent An agent authorized to do everything that can be lawfully delegated to a representative.

Urea-Formaldehyde A clear chemical that is used in manufacturing including building materials such as particle board, plywood paneling, carpeting, and insulation.

Usable Square Footage The amount of actual space within the perimeter of the tenant's premises, including walls, columns, and airshafts; the floor area where tenants can actually lay carpet and place furniture. *Also called:* **Net Square Footage** or **Carpetable Square Footage.**

Use Variance Allows landowners to use their land in a way that is not permitted under current zoning laws, such as commercial use in a residential zone.

Usury The lending of money at excessive rates of interest.

U.S. Department of Housing and Urban Development (HUD) Established in 1965 to increase homeownership, support community development, and increase access to affordable housing free from discrimination.

V

Vacancy and Collection Losses Estimate as to how much future income may be lost when a building isn't fully occupied or tenants don't pay rent.

Vacant Land Unimproved land or land with no building on it.

Valid The legal classification of a contract that is binding and enforceable in a court of law.

Value An amount of goods or services offered in the marketplace in exchange for something else.

Variable Expense Expenses that are not consistent and regular amounts, and depend on issues including the type, size, age, and condition of a property.

Variance A form of administrative relief that allows property to be used in a way that does not comply with the literal requirements of the zoning ordinance. There are two basic types of variances: Use variances and area variances.

Vendee A buyer or purchaser; particularly, someone buying property under a land contract.

Vendor A seller; particularly, someone selling property by means of a land contract.

Veterans Administration (VA) Government agency that guarantees mortgage loans for eligible veterans.

Vicarious Liability When one person is responsible for the actions of another.

Void Having no legal force or effect.

Voidable A contract that one of the parties can disaffirm, without liability, because of a lack of legal capacity or a negative factor such as fraud or duress.

Voluntary Alienation When title to property is transferred voluntarily through a sale, gift, dedication, or grant.

Voluntary Conveyance When a debtor returns property to the lender in lieu of foreclosure. Generally, the debtor does not receive any compensation for surrendering title to the property, but does avoid foreclosure.

Voluntary Partition When co-owners agree to terminate their co-ownership, dividing the property so each owns a piece of the property in severalty.

W

Waiver The voluntary relinquishment or surrender of a right.

Warranty Deed A deed that carries certain warranties related to title and the grantor's right to convey title; warranties may be broad or limited.

Waste Use or abuse of property in any way that permanently damages it or reduces its market value.

Water Rights The right to use water in or from a river, stream, or lake. *See:* **Appropriative Rights, Littoral Rights, Riparian Rights**.

Wetlands Ecosystems where the land is permeated with water, which either lies on or near the surface of the land.

Will A person's legally binding instructions regarding how his or her estate should be disposed of after death. *Also called:* **Testament.**

Words of Conveyance Deed language that clearly states the grantor's intention to transfer the real property.

Z

Zoning The classification of land by types of uses permitted and prohibited in a given district, and by densities and intensities permitted and prohibited, including regulations regarding building location on lots.

Zoning Ordinances Local laws dividing a city, county, etc., into zones, allowing different types of land use in different areas, as well as codes that must be followed to ensure safe construction practices.

Chapter Quiz Answer Keys

Chapter 1

1. B. Although license laws certainly benefit everyone, their primary purpose is to protect the public by ensuring a consistent level of competence, ethics, and professionalism.
2. B. The Illinois Compiled Statutes (ILCS) are a cumulative organization of Public Acts—bills that have become law—compiled into a coherent framework. The Illinois Real Estate License Law Act can be found in Chapter 225.
3. D. A broker may work only under the name and supervision of a sponsoring licensed managing broker. A broker cannot operate independently and can be compensated only by his or her sponsoring broker.
4. B. The Illinois Department of Financial and Professional Regulation (IDFPR) oversees real estate activity in the State of Illinois.
5. D. A broker must be at least 18 years old and have completed 75 hours of prelicensing education.
6. B. As the new sponsoring broker, Tim must register the sponsorship online within 24 hours.
7. C. When a licensee transfers his sponsorship, the license will immediately be assigned inactive status until the licensee becomes officially associated with a new sponsoring broker and the required change of registration is completed.
8. C. Brokers must be able to show a copy of their license whenever they are performing activities that require a license.
9. A. A licensee must complete and pass all continuing education requirements then renew their license before April 30 of each even-numbered year.
10. B. Nina's license status is classified as inactive. Because Nina has not met the renewal requirements due to a family leave of absence, she would be in direct violation of the law by engaging in any licensed real estate business activities while not properly licensed.
11. A. Anyone who even offers to negotiate the sale of real estate for another in exchange for compensation is required to be licensed. All other examples here are specifically exempted under the Illinois Real Estate License Act.
12. B. Juan is performing an activity that requires a license. The others are performing activities that an unlicensed personal assistant can perform.
13. B. To remain unlicensed, Marty must reside in the building he manages.

Chapter 2

1. D. The IDFPR must commence action against someone for violating the terms of the Illinois Real Estate License Act or the Administrative Rules within five years after the occurrence of the alleged violation.
2. C. Civil fines are deposited into the Real Estate Recovery Fund to compensate people for damages resulting from the business conduct of a licensee or an unlicensed employee in violation of the Illinois Real Estate License Act or Administrative Rules.
3. D. The Board will first investigate to determine the merit of the complaint, then a hearing will be scheduled prior to imposing any disciplinary action.
4. B. A typical circumstance requiring such emergency action would be if a licensee's conduct poses a threat that the public's or another licensee's money will be stolen or embezzled.

5. A. With a guaranteed sales plan, the licensee must purchase the property when the listing expires if it is not sold. The guaranteed sales contract must be signed before entering into a brokerage agreement by the sponsoring broker and the seller.

6. C. Annie could face any of these consequences, except that the IDFPR cannot bring criminal charges against someone.

7. D. The maximum civil penalty that may be imposed by the Department for any violation, including practicing without a license, is $25,000.

8. A. The Department could revoke a license if such a delinquency is certified. Defaulting on a student loan could mean denial of a license renewal. Failure to pay taxes could possibly result in license suspension. Paying an unlicensed assistant to assemble documents is not a violation.

9. B. At least 30 days before the hearing date, the Board must notify the accused in writing of the charges made and the time and place set for the hearing on the charges. The accused has 20 days to file a written answer to the charges.

10. D. A citation may be issued when a licensee does not complete the required continuing education.

11. A. Although the Secretary can petition for an injunction or cease and desist order, such an order must be issued by the court. The other choices are examples of non-disciplinary action that could be taken against a licensee by the IDFPR.

12. C. When payment is made from the Fund, the licensee's license is terminated until the money is repaid, plus interest; repayment does not nullify any disciplinary action resulting from the violations.

13. A. The Illinois Department of Financial and Professional Regulation (IDFPR) has the authority and power to investigate any and all unlicensed activity.

14. D. Licensees must disclose their status when involved in a real estate transaction in which they have some interest.

15. B. The Illinois Supreme Court ruled in the case of Quinlan and Tyson that real estate licensees could use acceptable pre-printed forms for purchase agreements.

Chapter 3

1. C. The federal Fair Housing Act prohibits discrimination in the sale or lease of residential property based on these protected classes: Race, color, religion, sex (gender), handicap or disability, familial status, or national origin.

2. B. Choices A, C, and D could be alleged to be discriminatory in that they might be used to single out individuals on the basis of familial status or religion.

3. C. Familial status was added as a protected class in 1988 with the passage of the Fair Housing Amendments.

4. A. Blockbusting is defined as inducing or attempting to induce, for profit, any person to sell or rent property based on representations made regarding entry into the neighborhood of persons in a protected class. Blockbusting is also referred to as panic selling or panic peddling.

5. C. The federal Fair Housing Act requires landlords/owners to make provisions for handicap accessibility, but it does not require the landlord to bear the expense of the renovations. The landlord is also allowed to require the property be returned to its original condition upon termination of occupancy.

6. C. The refusal to make loans on property in certain neighborhoods for discriminatory reasons is called redlining and is prohibited under the Federal Fair Housing Act.

7. A. Brown v. Board of Education overturned Plessy v. Ferguson by ruling that "separate but equal" was unconstitutional.

8. C. Steering relates to buyers or renters and is defined as channeling prospective buyers or renters to or away from specific neighborhoods.

9. B. Religious organizations may give preference to their members. Licensees may never discriminate.

10. D. Individuals who are illegally addicted or have been convicted of manufacturing or distributing a controlled substance are not protected under the federal Fair Housing Act.

11. D. Sexual orientation is not currently a protected class under the federal Fair Housing Act. It is, however, protected under the Illinois Human Rights Act.

12. C. Anyone can file a complaint of discrimination with HUD's Office of Fair Housing and Equal Opportunity (FHEO) within one year of the incident.

13. D. At this time, the federal Fair Housing Act does not recognize sexual orientation as a protected class.

14. A. All of these are exemptions under the Act except for the mandate to allow a guide, hearing, or support dog for any blind, hearing impaired, or physically disabled person.

15. C. It is not against the law to refuse to enter into a contract with someone who has not yet attained the legal age of majority. If the refusal to contract was based only on one's membership in a protected class, however, that would be a violation.

Chapter 4

1. B. Antitrust laws were enacted to ensure that there are no restraints on trade.

2. D. The Sherman Antitrust Act was passed in 1890. It was enhanced by the Clayton Antitrust Act and the Federal Trade Commission Act, both passed in 1914.

3. B. When two brokers agree to divide territory or customers, they are engaging in the illegal practice of market or territory allocation.

4. D. Obviously, your local association of REALTORS® would not have a pricing policy, since that would violate antitrust laws against price-fixing (and if you did have a copy of such an illegal document, you would be well-advised to destroy it).

5. C. Gary and his fellow brokers were guilty of illegal boycotting when they conspired to refuse to deal with another broker.

6. B. Even the appearance of discussing fees could be considered an example of illegal price-fixing.

7. C. All of these phrases could get a real estate licensee into severe trouble except for choice C. In that example, there is no collusion with other agencies.

8. D. She is trying to tie in other business in exchange for taking the listing. This could be an antitrust violation.

9. B. RESPA prohibits kickbacks for referring settlement services.

10. A. RESPA prohibits a real estate broker from receiving anything of value, such as a fee or commission, for referring business to a settlement service provider.

11. B. Real estate brokers and mortgage companies may have an interest in each company so long as the real estate broker discloses its relationship with the joint venture company when it refers a customer to the mortgage broker or title company.

12. D. Sam violated RESPA by not disclosing his affiliated business arrangement with Julie. RESPA allows a buyer to sue a violator in a civil lawsuit for three times the amount paid for settlement services.

Chapter 5

1. B. The client in an agency relationship is known as the principal.

2. D. Teresa is a universal agent. She is authorized to do anything and everything that can be lawfully delegated to a representative.

3. A. Ed is a general agent in terms of his relationship to his sponsoring broker.

4. C. An agency relationship is created when the principal, Lisa, retains an agent, the broker, to act on her behalf. A seller agency relationship is created when the principal signs a listing agreement.

5. A. In Illinois, an agent is assumed to be a designated agent unless the brokerage agreement specifically indicates a different agency relationship.

6. D. In Illinois, if a sponsoring broker designates different agents to represent both clients in a single real estate transaction, no one is considered to be a dual agent.

7. C. There is an implied agency in this situation.

8. D. An agency relationship is created by a contract between a client and a sponsoring broker. If a designated agent leaves the brokerage, the agency relationship is unaffected.

9. A. The only situation listed that would free Frank of an agency relationship with all of his employing broker's clients would be if Top practiced designated agency.

10. D. The MLS does not create an agency relationship. Ivy is simply a customer of Ron's.

11. A. In this scenario, only the designated licensee, Gloria, represents the client Susan. Neither Dan or any of the other affiliated licensees working for him are considered to be agents of the seller.

12. D. In this scenario, no one represents the best interests of the buyer, who is simply a customer. The buyer would need to sign a buyer brokerage agreement with a broker to create a buyer's agency relationship.

Chapter 6

1. D. The licensees are both designated agents. Whenever specific licensees are designated to represent two different parties in a transaction; neither the brokers nor the sponsoring broker take on the role of dual agent.
2. A. The disclosure of designated agency does not, in and of itself, create an exclusive agency relationship, although such disclosure may be included as part of an exclusive brokerage agreement.
3. D. Alex is not a client, so there is no dual agency situation. Karen does not have to do anything, although we will assume that she has presented Alex with a non-agency disclosure since she has been working with him for awhile.
4. B. It should be in place as soon as possible during the first meeting but definitely prior to discussing any confidential information.
5. B. No cause of action shall arise against a licensee for failure to disclose fact situations on a property or physical conditions located on a property that is not the subject of the transaction.
6. C. Bruce is obligated to disclose to his buyer client that he is receiving payment from the seller.
7. B. The designated agent has breached his duty of confidentiality to his client. Other licensees do not have a relationship with his designated client.
8. C. The agent has misrepresented the condition of the property and is therefore negligent. Fraud is an intentional misrepresentation; while the agent did not intentionally misrepresent the condition of the basement, she should have exercised reasonable care and viewed the basement before making any statements concerning its condition.
9. B. If Maggie didn't sign a buyer brokerage agreement, she is simply a customer. No one in Evan's agency has an obligation to provide Maggie with the minimum services due a client, such as assisting in negotiations.
10. A. In general, confidential information includes anything that could have an adverse effect on the client's position. All of the information listed should be kept confidential except the termite damage, which is a latent defect that must be disclosed.
11. B. Licensees must disclose compensation and contemporaneous offers. Although not obligated to supply buyers with a Property Disclosure Report, he is obligated to disclose latent defects. He has no obligation to disclose facts not affecting the physical condition of the property, such as an illness by an inhabitant.
12. A. Peter cannot provide any advice to the buyer customer without breaching his duty of loyalty to Jan. The performance of clerical tasks by a licensee on the behalf of a customer does not create an agency relationship and so does not breach Jan's trust.

Chapter 7

1. C. Data maintained behind a company's Internet firewall is private and is, therefore, not considered to be a form of advertising.
2. A. A blind ad is any real estate advertisement used by a licensee that does not include the sponsoring broker's business name.
3. D. Nothing requires a sponsoring broker to include the name of one of its sponsored licensees on signs or other general advertising. All other statements are true.
4. C. Since Chris is listing his property with a broker, disclosure of ownership is not necessary on broker yard signs or in broker advertisements, the ownership must be indicated on any property data form and disclosed to persons responding to any advertisement or any sign.
5. D. The Fair Housing Act requires that a fair housing poster be posted and maintained at any place of business where housing is offered for sale or rental, and should be "prominently displayed."
6. A. In this example, the word "exclusive" is a restricted word in real estate advertising.
7. B. The geographic area or location of property being marketed should be on any page advertising that property, but is not required to be on the broker's home page.
8. C. Puffing is generally considered to be an opinion that is not necessarily intended to be a statement of fact. The use of an adjective such as "stunning" is not necessarily puffing. Calling a street the "most prestigious in town," however, would qualify as puffing.
9. A. Licensees from other states can advertise property in Illinois as long as the ad includes the regulatory jurisdictions in which the broker holds a real estate broker license. The other choices are violations.
10. C. If a consumer has asked to be put on a company's internal do not call list, the company may not call to solicit new business, even if there is an EBR.
11. B. The Act prohibits calls between 9:00 p.m. and 8:00 a.m. Though perhaps Bill is annoying, he's not in violation.
12. C. Messages must include a clear and conspicuous explanation of how the recipient can opt out of receiving e-mail.

Chapter 8

1. A. An independent contractor is paid commission for finding a ready, willing, and able buyer. It doesn't matter how many hours he put in to do that.
2. D. For an employee, all compensation is considered wages, and no deductions are allowed.
3. B. An independent contractor receives a 1099 MISC form detailing any commission-based income.
4. D. A real estate licensee who works for a supervising broker, yet maintains independence in his work schedule, is most likely classified a statutory non-employee under the IRS code.
5. A. A real estate licensee would have a fiduciary relationship with clients regardless of whether he is an employee of his broker or an independent contractor.
6. B. A real estate broker who is an independent contractor is paid based on successful real estate transactions, not on hours worked.
7. D. A licensee may only receive compensation directly from his/her sponsoring broker. In a cooperative sale, the listing brokerage will pay the selling brokerage and the respective sponsoring brokers will pay their respective brokers.
8. D. If the contract between Doug and Lisa indicates that as long as buyer's agent Doug earns 3% as contracted, even if he gets it from the listing agent, Lisa owes him nothing.
9. B. While it makes good business sense to do so, a sponsoring broker is not required to have an E&O policy.
10. C. Licensees may offer compensation to consumers and may limit the opportunity to win such a prize. But when advertising this, she must disclose any conditions in the same ad.
11. A. A real estate office may be located in a financial business establishment as long as it is in a separate and distinct area.
12. B. Escrow audits may be conducted at any time with the sponsoring broker's consent or with at least 24 hours notice without consent.
13. C. A license is required in order to show properties.
14. C. Of these activities, the only one that Maggie could perform as an unlicensed assistant is to pick up the keys from a homeowner for an open house.

Chapter 9

1. D. Once a harvested crop is no longer attached to the land, it becomes personal property.
2. B. The right of disposition gives a property owner the ability to transfer all or some of the property.
3. B. While ownership of real property is usually transferred with a deed, personal property is transferred with a bill of sale.
4. D. A trade fixture is attached to real property by a commercial tenant, who generally removes the trade fixture at the conclusion of the lease.
5. D. Trespass is a physical invasion of land by another person with no lawful right to be there.
6. D. When a life estate is based on the life of someone other than the beneficiary, it is called "pur autre vie." In this case, Bart is the beneficiary of the life estate and Carla is the measuring life.
7. C. With tenancy in common, each co-owner has an equal right to possession of the entire property, even if their interests are unequal.
8. B. Joint tenancy includes the right of survivorship. When one joint tenant dies, that interest is automatically transferred to the remaining joint tenant(s). In this case, since Donna is the only remaining owner, she owns the property in severalty.
9. C. Tenancy in common allows one co-owner to transfer his or her share of the property to others by deed or devise.
10. B. A cooperative is a building owned by a corporation. Those living in the co-op are shareholders in the corporation. This is evidenced by a proprietary lease.
11. C. A corporation is considered a single legal entity, therefore property owned by a corporation is owned in severalty.
12. D. The requirement in Illinois is 20 years.
13. C. Jane will own the property but will not completely possess the property until Earle passes away. She is the remainderman since she has a future interest in the property. Earle actually doesn't own the property but only has the right to live in the property for as long as he lives. He is the life tenant.
14. D. Since Jean put a condition on how the land can be used, she is creating a qualified fee. This can also be called fee simple defeasible.
15. C. Patricia is the trustor; Mary is the trustee and will hold the property title until the beneficiary, Ellen, turns 25.

16. B. The main feature of joint tenancy is that it allows co-owners to take ownership shares of a deceased co-owner equally and automatically. A person can't will or inherit a survivorship estate. Mary now has a 33% interest, as do Donna and Lou.

17. C. Kyle and Eric are still joint tenants, but Ryan's interest does not include the unity of time or title. He is simply a tenant in common.

18. C. The measuring life is Chris. He has no interest in the property, present or future.

19. B. Fee simple includes the entire bundle of rights, where leased fee is fee simple minus whatever is conveyed in the lease. Landlord Donna will have fee simple interest again once Jack moves out.

20. A. Of these, only a conventional life estate is not inheritable since the estate ends at the death of the life tenant.

Chapter 10

1. B. An easement in gross burdens one parcel of land for the benefit an individual or a corporation.

2. C. Both allow someone else to enter or cross another's property. A license, however, can be revoked at any time and is much less restrictive than an easement, which creates an encumbrance and runs with the land.

3. C. The property that benefits from the easement is known as the dominant tenement.

4. D. A lien is a type of nonpossessory interest that is also a financial encumbrance.

5. C. Mortgages are the most common type of voluntary lien. A lien that results from a confession of judgment is also voluntary.

6. C. A materialmen's lien is involuntary and attaches only to the property in question, which makes is specific.

7. D. Property tax liens are always paid first. Then liens are generally paid in the order in which they were filed.

8. D. With an easement in gross, the property that is burdened by the easement is called the servient tenement. It is serving the needs of the gas company by letting them dig up the lawn.

9. A. Since the land was originally owned by Heather and she has established years of going through the gate to the beach, the easement is created by implication.

10. D. A negative easement prevents the servient tenant from using his or her own land in a certain way.

11. C. This situation most likely describes an easement, since it appears to have been conveyed with the property. Licenses do not run with the land.

12. B. The shrub hanging over the property line is an encroachment, not an encumbrance. Liens and easements are encumbrances.

13. D. Since the two properties have been combined under one owner, the easement is terminated by a merger.

14. C. Special assessments are taxes on specific properties for improvements that benefit just that property, such as sewers, street lights, etc.

15. C. Licenses merely grant permission to use property, not an interest. They are revocable and terminate at the sale of the property or the death of either the licensee or the licensor.

Chapter 11

1. D. Zoning ordinances set forth the type of use permitted under each zoning classification and specific requirements for compliance.

2. B. Deed restrictions that become illegal after they were written automatically terminate.

3. A. In order to condemn Frank's property, even if for the public good, the government must give him just compensation.

4. D. Escheat is a police power that provides for the state to take ownership of property of a deceased person who leaves no will, heirs, nor creditors.

5. D. Variances allow property to be used in a way that does not comply with the literal requirements of the zoning ordinance.

6. C. A nonconforming use occurs when land use does not conform to current zoning laws, but is legally allowed because the land use was established before the new zoning laws were enacted.

7. D. This is known as spot zoning, and it is illegal.

8. D. Setback requirements indicate a specific distance between the front property line to the building line, as well as from the interior property lines.

9. C. This is known as police power. It includes things such as escheat, eminent domain, etc.

10. A. The government survey system divides land up into sections and defines a particular parcel by ever smaller subdivisions of those sections.

11. B. Metes measures distance and bounds indicate direction.

12. C. Each township is comprised of 36 sections that are one square mile each or 640 acres.

13. D. A purchaser who was not given a public property report has two years to rescind the contract.

14. C. Special assessments may be imposed by jurisdictions with taxing authority on specific neighborhoods or areas in order to pay for specific improvements that benefit that neighborhood. A specific project such as new siding for one specific property owner would not warrant a special assessment.

15. B. Such a plan would be called a plat.

Chapter 12

1. B. Radon is a naturally occurring, odorless, colorless, and tasteless radioactive gas that emanates from rocks. Radon can seep into a home through cracks in the foundation.

2. B. Real estate licensees should not ignore a known material defect.

3. B. Real estate agents are equally responsible for presenting the lead paint disclosure when required.

4. D. There is no definitive proof that electromagnetic fields cause cancer.

5. D. Tanks less than 110 gallons are excluded. A tank with a 200-gallon capacity must follow the regulations on underground storage tanks.

6. B. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act (SARA) create requirements for closed or abandoned waste sites, and establish taxes and fines that provide money for the Superfund.

7. A. Chlorofluorocarbons (CFCs) are a chemical compounds used as a coolant in refrigerators, air conditioners, and dehumidifiers. The EPA regulates use and handling of CFCs, and sets fines for misuse. There are now less dangerous alternatives.

8. A. Mold is a fungus that can grow anywhere and on any organic material. In order to grow, mold requires moisture, oxygen, and a food source.

9. D. Termites do not leave behind sawdust, but they can be detected by looking for these mud formations.

10. B. This disclosure is mandated for houses built prior to 1978, which is the year lead paint was discontinued.

11. B. Radon leaches out of the ground, so units that are at least three stories above ground do not require the Illinois radon awareness disclosure.

12. A. Asbestos is a fibrous, heat-resistant material once commonly used as insulation. Inhaled asbestos particles can cause lung cancer, so its removal is expensive and requires professionals. It's often a better solution to encapsulate it.

Chapter 13

1. B. A room's area is determined by multiplying length by width. When you know the area and the width, divide the area by the width: 176 / 16 = 11.

2. A. In almost all jurisdictions and uses, a bathroom is not included in the room count.

3. D. Slab-on-grade is a type of foundation consisting of a concrete slab on the ground with no basement or crawl space.

4. B. The term that describes the angle of a roof's slope is pitch.

5. A. A home that is not connected to a municipal waste water system would instead have a septic system, which includes a septic tank and soil absorption system such as a leach bed.

6. B. Sheathing refers to the exterior of the structure, such as siding or brick.

7. A. Lot B is 43,005 square feet, divided by the length of 235, which gives you a lot width of 183 feet.

8. B. The square footage of this lot is 90,000 square feet (150 x 600). At $2.80 per square foot, the asking price is $252,000.

9. B. The easiest way to solve this is to divide the square footage of one acre (43,560) by 2.5 to find 17,424 square feet per lot.

10. C. A 1.75 acre lot has 76,230 square feet (1.75 x 43,560). At 40 cents per square foot, the selling price is $30,492.

Chapter 14

1. B. Yvonne is the only party making a promise and her inducement is specifically expressed in words. This is an express unilateral contract.

2. C. The contract is express because it is written, unilateral because only Hannah has made a binding promise, and executory because both parties have yet to perform the obligations of the agreement.

3. C. This contract is void because Bob committed fraud; he never had the right to sell the property in the first place.

4. A. This oral contract would be unenforceable in a court of law since the law requires that all real estate sales contracts be in writing to be enforceable.

5. D. This listing agreement can be nullified by Ann if it can be proven that she signed it under duress or without mental capacity. The listing agreement is a voidable contract.

6. B. A broker should always ensure, when the principals in a transaction are not personally executing binding documentation, that their representatives have full authority to commit the principal to the terms of the obligation.
7. D. The statute of frauds requires real estate contracts to be in writing in order for the courts to enforce the contract.
8. A. Duress is a useful defense against enforcing a contract because there is no genuine meeting of the minds. A contract entered into under duress is not enforceable against the forced party.
9. C. The assignor, Jess, remains secondarily liable in addition to the assignee, Owen. She can be sued if Owen doesn't perform by paying the rent.
10. C. Karen didn't cancel the contract, since she and Dave came to some agreement. It's not rescission, since they did not return consideration. It's not novation, since it involves personal services. They mutually agreed to accept partial performance.
11. B. Money damages awarded by the court to compensate the victim for their financial loss are compensatory damages.
12. C. According to the Illinois Electronic Commerce Security Act, an electronic signature would not be valid on a will, power of attorney, negotiable instrument (such as a mortgage), or a document whose possession is deemed to confer title. A listing agreement, however, could be valid with an electronic signature.

Chapter 15

1. C. A real estate listing is not considered a property owner's offer to sell, but instead, it invites buyers to make an offer.
2. A. Typically, an agent fulfills his or her contractual obligation when delivering a ready and willing buyer.
3. B. An exclusive right to sell agreement means the broker is paid even if someone else sells the property during the listing period.
4. A. Under an exclusive agency agreement, the seller can still sell the property on his/her own and not owe a commission. In an exclusive agency listing, unlike an open listing, only the listing company can put a sign in the yard and advertise it.
5. D. An open listing is one where the seller is not represented by any agent or broker, but offers all brokers the chance to find a buyer without signing any listing agreement.
6. C. All brokerage agreements must list the duties of the broker, but only an exclusive agreement is required to list the minimum services of a sponsoring broker. The other statements are true.
7. B. This is an example of a buyer agency agreement.
8. B. A listing agreement is a contract between the client and the brokerage, in this case, Rob of Rob Realty. As such, Rob owns that listing and Amy cannot take it with her, even if she was the agent who worked to get a signed listing agreement.
9. A. Mixing personal and/or brokerage general funds and client deposit money is considered commingling.
10. C. Escrow accounts must be in a demand account, such as a checking account, and may be interest bearing. A certificate of deposit is not a demand account.
11. C. The seller is the true beneficiary of the deposited funds, although, if the seller and buyer agree in writing, the deposit funds can be disbursed to anyone when the transaction goes to settlement.
12. B. The broker must deposit that money into the escrow account by the next business day after it is received.

Chapter 16

1. C. The contract between the seller and the broker is the listing agreement.
2. A. A contingency clause is a condition placed on a contract.
3. D. There is no written rule about the order to present offers in most states. However, the seller has the right to know all the facts and look at all the offers before reaching a decision.
4. B. There was no meeting of the minds. Acceptance must not vary the terms of the offer. When Tom failed to accept Jim's offer as submitted, he, in effect, rejected it, and it became void.
5. D. Rejection automatically terminates an offer. A rejected offer does not have to be formally withdrawn or revoked. An offer may also be terminated by lapse of time, communication, or notice of revocation before acceptance, qualified acceptance (counteroffer), or death or insanity of either the offeror or the offeree before acceptance.
6. B. The acceptance must be clearly communicated back to the person who made the offer, the offeror.
7. C. The acceptance was not communicated to Ellen, the offeror, so she is not bound by it. Ellen can revoke her offer.

8. D. The listing agent is under the control of the seller, so there has not yet been delivery or communication of the acceptance. To be delivered, the contract must be out of the possession and control of the party accepting it.

9. C. This is an example of a counteroffer. Remember, when someone makes a counteroffer, it's essentially a rejection of the first offer and a new offer is made.

10. B. Homeowner Sam, originally the offeree, is now the counterofferor. Taylor is the counterofferee.

11. D. Remember that a counteroffer is both the rejection of the original offer and the making of a new offer with new terms. Once the offer has been rejected, it may not be accepted later.

12. C. Licensees are obligated under the law to present all offers to a seller client, who is the ultimate decision maker.

Chapter 17

1. C. Equitable title is an interest in property created by a sales contract. The actual title will be transferred at a future date. It's not the same as having title, but the holder is entitled to some benefits. A land contract is an example of equitable title.

2. B. A bill of sale is used to transfer title of personal property.

3. D. Documents are recorded to give the world "constructive notice" of legal transactions involving property. The public can gain "actual notice" by going to the county courthouse and seeing the records.

4. C. Since she left no will and has no surviving spouse, legal partner, parent, brother, or sister, next in line would be any descendent of a brother or sister, which, in this case, is her nephew.

5. A. That's a general warranty deed. Each of the other choices refers to a deed in which the grantor's warranty extends only to the time of the grantor's ownership.

6. B. The closing date is generally indicated in the purchase agreement. Since it may be difficult to get all of the required documents, such as discharge of mortgage, by the designated date, however, closing should take place within a reasonable time period.

7. C. Quitclaim deeds convey any interest in real estate a grantor may have at the time the deed is executed. It could be used to clear a cloud on the title.

8. B. The deed that grants property to the buyer is required to be signed only by the seller.

9. B. Illinois state transfer tax is 50 cents for every $500, or portion thereof. Add the county transfer tax of 25 cents for every $500, or portion thereof, to get the total transfer tax of $279: 185,900 / 500 = 371.8 "units." Round up to account for the portion to get 372 x .75 = 279.

10. C. Under RESPA, a lender has the responsibility to provide the Closing Disclosure to the borrower at least three business days prior to closing.

11. D. Much of the closing is based on what is outlined in the purchase agreement.

12. B. The promissory note is the buyer's pledge to repay the mortgage loan. The lender will bring this to the closing table for the buyer to sign.

Chapter 18

1. C. A tenancy at will leasehold usually ends on the death of the landlord or tenant.

2. C. Lessors (owners) have a reversionary interest in the property, which means the property reverts to them at the end of the lease term.

3. B. Novation is the act of creating a totally new lease, substituting the original party to the lease for someone else. This relieves the original tenant of all liability.

4. A. An assignment is when one lessee transfers interest in leased property to another party for the remainder of the lease term.

5. B. Most residential leases are gross leases. The other types mentioned are more common for commercial leases.

6. D. Tenants with a percentage lease pay a percentage of gross sales, often in addition to a fixed monthly rental payment. This type of lease may include a clause that allows the owner to reclaim the premises if gross sales fall below a specified point.

7. B. According to Illinois law, when an owner has a single building or multiple buildings on contiguous parcels of land that total more than 25 units, that owner must pay interest on the tenant's security deposits. The law does not apply to public housing.

8. C. The sale of rental property does not terminate the lease. The new owner must honor the lease, and so must the tenant. Both the previous owner and the new owner share liability for the tenants' security deposits.

9. B. This is the covenant of quiet enjoyment. Of course, there are exceptions to requiring the tenant's consent for emergency situations.

10. D. A periodic estate, also called a month-to-month estate or, in this case, a holdover estate, is created once the landlord accepts rent from an holdover tenant.

11. D. According to the Illinois Tenant Utility Payment Disclosure Act (765 ILCS 740/), a residential lease must explicitly define the utility metering in the unit. The other elements are optional.

12. B. In Illinois, proper notice of intent to terminate a periodic estate must be provided, in writing, a prescribed number of days before the tenancy ends. For a year-to-year tenancy, the proper notice is 60 days.

Chapter 19

1. C. A property's price is the amount a ready, willing, and able buyer agrees to pay for a property and a seller agrees to accept under the terms of the transaction.

2. B. The economic base of an area is the main business or industry which a community uses to support and sustain itself.

3. A. All four of these value characteristics must be present and in harmony for the item to achieve maximum value: Demand, Utility, Scarcity, and Transferability. Remember the acronym D-U-S-T.

4. B. Almost anything can define neighborhood, except for race, ethnicity, and other characteristics of protected classes.

5. D. The principle of substitution says that an informed buyer will not pay more for a property than a comparable substitute. All of these factors and principles are considered by an appraiser when making an estimate of the value of real property.

6. B. Highest and best use is the use that is the most physically possible, legally permissible, economically feasible, and maximally profitable or productive. A home in a residential neighborhood meets these criteria.

7. B. The value of the "worst" home in a given area is increased by the other homes in the area. The value of this theoretical "worst" home can only go so low, because the desirability of the other homes in the neighborhood keeps it from falling too far. This is known as the concept of progression.

8. D. Market value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale.

9. D. An arm's length transaction is a transaction that occurred under typical conditions in the marketplace with each party acting in his own best interest. It's not a typical transaction if the seller offers financing concessions to the buyer.

10. C. The real estate market is said to be in balance when there are slightly more homes available than buyers. This keeps real estate prices in check and curtails the impact of people putting their homes for sale at a higher price to test the market.

11. C. Plottage is an increase in value (over the cost of acquiring the parcels) by successful assemblage, usually due to a change in use. By creating a larger parcel with more utility and higher and better use than the individual sites, the owner has successfully achieved an increase in the inherent value of the land.

12. D. When indicating the size of a commercial property, the first number indicates the front foot, or frontage. This is the size across the access side of the property. Frontage generally adds value to commercial property.

Chapter 20

1. C. An appraisal is only an estimate or opinion. It is not a guarantee of value or the ultimate price that a buyer actually pays.

2. D. To find the estimate of value using this data, you first need to determine the monthly rent for the property. If each unit brings in $6,600 a year, the monthly rent on the property is $1,100 ($6,600 x 2 = $13,200 / 12). Multiply the monthly rent ($1,100) by the GRM (135): $1,100 x 135 = $148,500.

3. C. When an appraiser is looking for comps, he or she will only look at homes that have sold recently.

4. B. A minimum of three comparables is required by most secondary market lenders to ensure an accurate appraisal from sufficient data.

5. B. When making adjustments, you subtract the value of an extra feature from the comp's value.

6. C. Gross rent multiplier is held to be not as reliable as the capitalization rate method to perform an income approach appraisal for a piece of real estate because the GRM does not take into account expenses and losses.

7. C. The sales comparison approach looks at past sales that are similar to the subject property and that have recently sold in the area.

8. D. The first adjustment to be made would be any difference in the property rights conveyed, for example if the subject is transferred fee simple and the comp was transferred as a leasehold estate. Some adjustments must be made first because they are adjusted as a percentage of the comparable's sales price, rather than a set dollar amount.

9. C. The Uniform Residential Appraisal Report (URAR) is the primary form used by lenders for residential property appraisal.

10. A. The cost approach is an objective method to provide an accurate value for replacing or reproducing buildings, especially new or nearly new buildings with few comparable sales.

11. C. Functional obsolescence occurs when a building is less desirable because of something inherent in the design of the structure.

12. C. The formula for determining value using the cost approach is Reproduction/Replacement Cost – Accrued Depreciation + Site Value = Property Value.

Chapter 21

1. C. The secondary market exists to standardize loan qualifying criteria and buy loans from the primary market as a stabilizing influence. The secondary markets do not loan money nor do they accept deposits from consumers.

2. B. The primary market consists of lenders making mortgage loans directly to borrowers, such as commercial banks, savings and loans (S & Ls), savings and mutual savings banks, and mortgage bankers.

3. A. Mortgage brokers do not make loans to lenders. Instead, they earn a fee to act as an intermediary to bring together borrowers and the lenders who originate the actual loans.

4. D. Through its monetary policy, the Federal Reserve can make more or less money available for banks to lend, in effect raising or lowering interest rates for the banks' customers.

5. D. Fannie Mae is the primary player in the secondary market. If a primary lender wants to sell a loan to Fannie Mae, it must following the secondary market guidelines. This is known as a conforming loan.

6. A. The Equal Credit Opportunity Act (ECOA) prohibits discrimination in lending based on sex, age (if at least 18), marital status, race, color, religion, national origin, receipt of public assistance, or exercised rights under the Consumer Credit Protection Act.

7. D. The Equal Credit Opportunity Act requires lenders to make a decision on a completed loan application within 30 days.

8. C. The Real Estate Settlement Procedures Act, or RESPA, mandates certain disclosures on residential loan transactions, including the disclosure of the estimated settlement costs found on the Loan Estimate.

9. D. Anyone involved in the transaction—even a real estate broker—can have a role to play in a mortgage fraud scheme.

10. A. A straw buyer is someone who allows his name and credit history to be used to apply for a loan on property he will not occupy. Ann is using her own name to buy a house she wants to live in, but she's falsifying documents. It's an example of fraud, but she is not a straw buyer.

11. D. Each of these could be an indicator of predatory lending.

12. A. A subprime loan simply means that the borrower has less than perfect credit. A lender may be willing to take on additional risk and give him a loan, perhaps by charging higher fees or interest. That in and of itself does not make it predatory.

Chapter 22

1. C. A point is 1% of the loan amount. Since he made a $30,000 down payment, the loan amount is $120,000. One point of the loan is $1,200, so three points is $3,600.

2. C. While a gift may be accepted for a borrower's down payment, there must be a gift letter—signed by the donor—stating the gift does not have to be repaid.

3. A. If the alimony payments will continue for three years, the underwriter will consider it as stable income if the borrower chooses to disclose it. The other income streams are not likely to be considered as stable and durable.

4. A. PITI (principal, interest, taxes, and insurance) divided by gross monthly income determines the amount of the borrower's income that will be used to pay housing expenses. Underwriters have a maximum housing ratio that can be used to approve a mortgage loan.

5. B. The cell phone is a debt that she could cancel, while the others would have to be considered as recurring debt that impacts her qualifying.

6. A. With a conventional loan, the housing expense ratio of 28% would mean he could afford a mortgage of $896. But you have to consider the back-end ratio, too: The debt-to-income ratio. On a conventional loan, that's 36%, so multiply gross month income of $3,200 x .36 to get $1,152. From that, subtract monthly debts of $370 to get $782. The lesser number is maximum mortgage amount.

7. B. Pre-qualification is a task that a real estate broker or lender might take to get a rough idea of how much of a mortgage a buyer might be able to afford. It is not binding on the lender in any.

8. C. It is RESPA, the Real Estate Settlement Procedures Act, that requires the use of the Closing Disclosure on transactions of 1- 4-unit residential property.

9. B. Income should be stable and durable. Occasional income would likely not be allowed when determining a borrower's qualifications for a loan.

10. D. To find the monthly income for an hourly worker, multiply the hourly rate by 40 to find the weekly rate; multiply that by 52 weeks per year then divide by 12 months ($2,730). Then add the monthly amount of the overtime: $15.75 / 2 + $15.75 = $23.63 x 5 hours per week x 52 weeks / 12 months = $511.88; $2,730 + $511.88 = $3,241.88

11. B. The purpose of a credit report is to provide a historical picture of a borrower's credit, for example, what their debts are, their record of repaying the debts, etc.

12. D. Of these, an underwriter will give the least consideration to a potential borrower's source of income, as long as the income is stable and durable.

Chapter 23

1. B. A fully amortizing loan is repaid with periodic payments of both principal and interest so that the entire loan amount is paid in full at the end of the loan term.

2. C. Promissory notes are written promises to pay money. They are negotiable instruments and are freely transferable so creditors can sell them for cash.

3. B. In order to avoid private mortgage insurance, the maximum loan-to-value is 80% of the purchase price or appraisal price, whichever is lower. If Barbara is able to put down 20%, she should be able to get a loan for $128,000 without having to pay PMI.

4. D. A reverse mortgage provides monthly income, a lump sum of cash, or a line of credit to borrowers aged 62 or older, based on the equity in their homes.

5. B. The concept of hypothecation allows a borrower to live in the house used as collateral for a loan.

6. A. While many people believe that FHA loans are for low-income borrowers or first-time homeowners, that is not true. Any qualified borrower is eligible for an FHA-insured loan. The other statements are true.

7. B. An alienation clause, also called a due on sale clause, gives a lender certain rights when a borrower transfers property.

8. A. A Certificate of Eligibility (COE) is required to show a veteran's entitlement when applying for a VA-guaranteed loan.

9. C. With an adjustable rate mortgage, the index is added to the agreed-upon margin to determine the interest rate due on the loan.

10. B. Conforming loans adhere to the standards set by secondary market leaders Fannie Mae and Freddie Mac.

11. C. The borrower who pledges property as collateral is called the mortgagor. The lender is called the mortgagee.

12. A. After the reasonable costs of the sale itself are covered, any liens against the property will be paid, generally in the order in which they were recorded. Real estate tax liens will take precedence over every lien holder, even a recorded mortgage.

Chapter 24

1. B. Any licensed real estate broker can list commercial property for sale or lease.

2. D. Landlords may insert a use clause to restrict the use of the leased space.

3. B. When expenses are passed on to the tenant, this is an example of pass through. Many contracts include an expense stop which sets a maximum limit on the additional amount of expenses that can be passed through.

4. A. Basic property law and contract law are the same for commercial property and residential property.

5. D. A net-net-net lease requires the tenant to pay more of the cost of ownership separate from the rent, so the base rent is typically lower.

6. C. If Lucy closed down the operation, she would still owe the agreed to rent, even though she would no longer have operating expenses. This is only an acceptable option if there's just a short time left on the lease.

7. B. It breaks down this way: 5% of $200,000 = $10,000; 4% of $300,000 = $12,000; and 6% of $100,000 = $6,000. Add them together to get $28,000.

8. A. Instead of a business owner having his money tied up in real estate, he can sell the property and reinvest that money back into the business.

9. B. Typically, investors in single-family residential properties prefer them because of the smaller management requirements.

10. C. She's paying two of the three elements associated with a net lease, so she has a double net.

11. A. Triple net leases are uncommon for residential property.

12. C. A percentage lease in and of itself is no hedge against rising costs; it rewards a landlord if a retail tenant is successful. An index lease and an escalation clause provide a way to increase rent, while a triple net lease shields the landlord from costs of ownership.

Chapter 25

1. A. Tenants occasionally negotiate provisions referred to as accordion clauses, which give the tenant the flexibility to expand and contract the amount of space occupied.
2. A. The annual base rent is $10,000 ($5 x 2,000 sq. ft.). GEM has 20% of the office space (2,000 of 10,000), and so should pay that percentage of the annual maintenance ($10,000 x .20 = $2,000) for a total of $12,000 annually, which is $1,000 each month.
3. D. Building efficiency is the ratio of usable square footage to rentable square footage. In this example, you need to take 36,000 and divide by 48,000 to get a building efficiency of 75%. The opposite of building efficiency is load or loss factor (which is 25% in this example).
4. C. New buildings may be purposely built as Class C space.
5. A. Of the choices, an architect is the most likely Class A tenant; since an architect is most likely to want to impress prospective clients. The other choices are more likely examples of Class B or C tenants.
6. C. The load, also called loss factor, is a ratio of rentable space to usable space. When a tenant's rent is calculated, that loss factor is added on to the usable space to account for the tenant's share of the common areas.
7. A. An anchor tenant is a magnet store strategically located in shopping centers to generate traffic for smaller stores.
8. A. Ingress/egress refers to accessibility – how easy it is for customers to get in and out of the retail location.
9. D. The strip center typically contains a minimum of three stores with a total gross leasable area of up to 30,000 square feet. A wide range of tenants may provide goods like groceries and services like dry cleaning.
10. B. Income levels would be included as part of the demographics for a retail business.
11. D. The annual base rent is $42,000 (3,500 x 12). To find the natural breakpoint, you divide the annual base rent by the agreed upon overage percentage (42,000 / .06 = 700,000). He had to pay a 6% overage percentage on the $20,000 he earned over the breakpoint (20,000 x .06 = 1,200). Adding that $1,200 to the $42,000 base rent equals $43,200 total.
12. C. First, to find a natural breakpoint, divide the annual base rent by the overage percentage (12,000 / .075 = $150,000). Kim did not exceed her breakpoint, so she pays only the base rent.

Chapter 26

1. A. He's using the bank's money to make money. This is an example of leverage.
2. B. A liquid investment is one that can be converted to cash quickly. Generally speaking, it's more difficult to get rid of real estate quickly with assurance of protecting your principal, making it the most illiquid of investments.
3. A. To find net operating income (NOI): First, subtract vacancy losses from gross income to get effective gross income. From that, subtract expenses to find NOI. Debt service is not used to find NOI.
4. D. A pro forma statement uses hypothetical data to assist in decision-making, such as whether or not to purchase property.
5. A. The capitalization rate is a percentage rate used by investors to calculate the present value of future income.
6. D. Gross potential income assumes no vacancies. When in a pro forma, however, gross income could be figured as the highest rent rates possible in the market.
7. B. To find the cash flow, you have to deduct the total annual debt service.
8. A. Net operating income minus debt service is equal to cash flow.
9. C. The formula for determining NOI using these figures is this: Annual income (10 units x $1,000 x 12 months = $120,000) – Vacancy loss (5% or $6,000) – Expenses ($30,000) = NOI ($84,000). Depreciation does not figure into the calculation. As you saw in the previous unit, the potential buyer will most likely start with the current owner's operating statement to find the NOI.
10. B. The formula for determining value using these figures is this: Income ($84,000) / Rate (12%) = Value ($700,000).
11. D. His cash flow is $12,000, which makes the cash-on-cash return 12% (12,000 / 100,000 = .12).
12. C. Straight-line depreciation for residential income-producing property is based on a useful life of 27.5 years. This is based on the value of improvements ($220,000 / 27.5 = $8,000).

Chapter 27

1. B. The property owner is the principal, the one to whom the property manager owes his or her fiduciary obligations.
2. C. In Illinois, a residential leasing agent is someone who is employed by a real estate broker to engage in licensed activities limited to leasing residential real estate.
3. A. Ross's fiduciary obligations include obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care.
4. B. A property manager is a general agent authorized to handle all of the principal's affairs in one area or in specified areas.
5. C. Tim must be responsible for risk management—identifying, managing, and minimizing risks on the property.
6. A. An anchor store is included in a mall in order to attract customers to smaller stores.
7. C. A candidate for a broker's license must be at least 21 years old, but a residential leasing agent is only required to be 18.
8. D. A warehouse is most likely to be classified as industrial property.

Chapter 28

1. B. Gross income is the total income, both cash and non-cash, received from an investment or business before expenses are paid.
2. B. Property taxes and insurance are fixed expenses—ongoing operating expenses that do not vary based on occupancy levels of a property.
3. C. Expenses, net operating income, and total income are usually included in an operating budget.
4. B. Cash flow is net operating income minus debt service: $28,000 - $15,600 = $12,400
5. C. Operating budgets are created to project the income and expenses for a property over a one-year period.
6. C. Nora is getting routine inspections done. This is an example of preventive maintenance.
7. B. The rent for units in Bart's building may not be competitive if no one has moved in five years. It might be a good idea to raise the rent.
8. B. A typical management proposal should include a one-year operating budget and a five-year plan.

Chapter 29

1. D. Leasehold estates provide temporary possession to tenants without benefit of title. When the term of the leasehold estate ends, possession reverts to the property owner.
2. C. One who leases his property is called the lessor or the landlord. A lessee or tenant is the person who rents the property.
3. B. An estate for years is a leasehold estate that covers a specific time period, including a specific expiration date.
4. C. Larry cannot discriminate on the basis of familial status, but he can limit the number of occupants in a unit. A two-bedroom unit may be limited to a total of four people, no matter who shares what room.
5. B. It's not against the law for a landlord to expect a tenant to have good credit. The other statements may be construed as discriminatory on the basis of age, familial status, and religion.
6. C. The Illinois Security Return Act indicates that landlords must provide tenants with an itemized list and an estimate of the costs (or paid receipts showing the actual costs) within 30 days after vacating the premises.
7. D. Rachel appears to be guilty of illegal steering, which is channeling prospective tenants to particular neighborhoods based on their race, religion, national origin, or ancestry.
8. C. According to the federal Fair Housing Act, a landlord may not refuse to let a disabled renter make reasonable modifications to the apartment or common areas at the person's expense if such modifications are necessary for that person to use the housing.
9. C. Adverse possession requires notorious, continuous, and hostile possession of property for a statutory period of time. It is not an option tenants may exercise when the landlord fails to pay utility bills. The other actions may be taken by tenants under the Illinois Rental Property Utility Service Act.
10. D. The first step in the legal eviction process is to give the tenant a written notice to quit. For non-payment of rent, Pat has five days to either make full payment or vacate the premises.
11. A. A forcible entry and detainer action is a lawsuit filed by a landlord to evict a defaulting tenant and regain possession of the property. It is the second step in the legal process of actual eviction.
12. C. Lois is trying to evict Tom in retaliation for complaining about code violations. She will not be successful if this is her rationale for eviction since retaliatory eviction is illegal.

Chapter 30

1. C. If you represent both buyer and seller, you are a dual agent. Remember that dual agency requires written permission from both parties.
2. B. A listing agent may purchase the property only after full disclosure to the seller that she is the buyer.
3. C. The agent working for the seller has the duty to disclose agency relationship in order to eliminate confusion or mistake. The disclosure of agency relationship should be provided at the first substantive contact and in any event, no later than beginning to work with that person as a designated agent.
4. C. A listing agreement is an employment contract that creates an agency relationship between a seller and a broker.
5. B. A licensee must disclose other sources of compensation to a client.
6. D. Even if the relationship ends, the duty to keep information to yourself does not end.
7. D. A licensee must follow the laws governing the federal Fair Housing Act, even if the seller is in violation. If the listing is active, the licensee should consult with her broker so that the broker may determine the method in which to proceed or terminate the listing.
8. B. A listing agreement cannot contain an automatic renewal clause; it must have a definite termination date. These other items are negotiable, and a licensee must inform the consumer of that fact.
9. C. An exclusive right to sell agreement means the broker is paid even if someone else sells the property during the listing period.
10. A. All brokerage agreements must indicate the duration of the contract and include a statement about discrimination. No brokerage agreement may contain an automatic extension clause. Only an exclusive agreement is required to list the minimum services of a sponsoring broker.
11. C. A listing agreement is a contract between the client and the brokerage, in this case, Ace. As such, Ace owns those listings and you cannot take them with you, even if you are the agent who worked to get the signed listing agreements.
12. A. If the buyer is also a client, this is a dual agency situation and the seller agent cannot disclose the buyer's confidential financial information.

Chapter 31

1. A. An agent should not adjust commissions without the consent of the broker. Commissions may be fixed by company policy, but are not dictated by law or even local custom; they are negotiable between the company and the client.
2. D. The pool is real property. While furniture or lawn mowers are sometimes sold with a house, it's very common to include appliances.
3. B. To find the daily rate: $3,600 / 365 = 9.8630. There are 130 days between January 1 and May 10. To find the seller's share: 130 x 9.8630 = $1282.19.
4. D. Although a CMA is similar to an appraisal, it is never equal to an appraisal.
5. A. Bonnie starts with 93% of the sales price, which is $97,696.50. Then subtract the other expenses to find a net to seller of $38,993.92.
6. C. Although sellers are not obligated to accept any offer on their home, the contract with the broker will most likely obligate them to pay a commission, as the broker has done what he was hired to do.
7. C. You can offer your advice, but you owe your client obedience to all legal instructions. You should list at $249,000.
8. D. Obviously, your local association of REALTORS® would not have a pricing policy, since that would violate antitrust laws against price-fixing (and if you did have a copy of such an illegal document, you would be well-advised to destroy it).
9. D. Given the current market in Pam's area—one house sold per month—it would not be unreasonable to think that her house could be on the market for 12 months.
10. B. The goal here is for the real estate licensee to assist the client by providing a range of probable selling prices for the given subject home.
11. C. Since Nancy and Jim are tenants by the entireties, Dave needs to ask when both of them will be available to sign the contract.
12. B. The principle of contribution says that a particular item or feature of a property is only worth what it actually contributes in value to that piece of real estate.

Calculating Seller Net Equity

SELLER'S ESTIMATED NET PROCEEDS			
Sale price			410,000.00
Broker commission	6 %	24,600.00	
Existing first mortgage		205,000.00	
Prorated interest for the month of sale		785.83	
Existing second mortgage			
Prorated interest for the month of sale			
Prorated property taxes		6,957.38	
Prorated county special assessment			
Title insurance		1,100.00	
State and county transfer taxes		615.00	
Municipal transfer taxes			
Prorated assessments			
Prorated association special assessment			
Survey		650.00	
Total expenses		239,708.21	
Estimated Net Proceeds			170,291.79

The information provided on this worksheet is estimated based upon reasonable expectation as to the charges applicable at the time of closing. Sellers should seek additional information from their attorney and accountant.

Chapter 32

1. A. This is a latent, or hidden, defect. If Rob knew about it but does not disclose it, he could be held liable and the buyer might be able to recover damages. Either way, the buyer would most likely be able to rescind the contract.

2. C. This information is not considered to be material to the condition of the property; therefore, you are not required to disclose. If you take this listing, you must keep this information confidential, even if specifically asked about it.

3. D. This form is customarily completed at the time of listing the property for sale and is referenced in the agreement of sale.

4. A. Information about the condition of the property is usually considered to be material, and the presence of a nearby sewage treatment plant could have some bearing on that property's condition, perhaps even on its well water. Loud neighbors would most likely not be considered a material fact.

5. C. A mold disclosure, though typically provided with residential real estate transactions, is not required. The other disclosures are mandated either by state or federal law.

6. B. If a defect is patent, then there is no requirement to disclose it. Yet, to avoid gray areas, many agents recommend that their sellers disclose all defects, whether patent or latent.

7. C. A real estate sales agent is obligated to follow only the lawful instructions of the principal. Being instructed not to disclose a hidden defect would be an illegal request, which the sales agent should not follow; the agent should consider terminating the listing.

8. D. A short sale, or short payoff, is when a lender agrees to accept less than the loan balance when real property is sold.

9. C. By law, this information must be disclosed to the buyer because it is a material defect in the property.

10. D. The seller is NOT required to mitigate any lead paint for homes built before 1978.

11. B. An agent should not participate in filling out the required Residential Real Property Disclosure Report. It should be completed by the seller and signed by the seller. If the agent were to assist in preparing the form and were to provide false information, the agent could be held liable.

12. D. This is a patent defect because it should be clearly evident to anyone looking at the house. Unless it happened after Jessica made an offer and she was unaware of it, you should have no obligation to disclose this.

Chapter 33

1. A. With this breach of confidentiality owed to his client, the seller, Jan is acting in the buyer's best interest at this point by divulging this information about her seller client.
2. A. There is no written rule about the order to present offers. However, the seller has the right to know all the facts and look at all the offers before reaching a decision.
3. B. When a seller makes changes to a buyer's offer, he is, in effect, rejecting the offer and creating a counteroffer.
4. D. Licensees are permitted to strike out language or make insertions and deletions at the request of a client. All of the other acts are prohibited based on the Quinlan and Tyson decision.
5. A. Sam may advertise only the agreed-upon price. To do otherwise is a breach of his fiduciary obligation to the seller.
6. D. Patricia gave Ben express authority to sell her house, which Ben apparently interpreted to mean that she gave him implied (or incidental) authority to publish the photo in order to carry out her express orders. However, brokers must get permission to advertise from their seller clients.
7. B. It is important to listen. The Johnsons know if they are late and will likely have some reason. Maybe they were lost, or they found another house a few streets away. If they are always late, however, you would need to discuss it with them in a professional manner.
8. D. Harold must use the licensed name of the brokerage, in this case, High Flying Realty.

Chapter 34

1. B. Even though you are related by marriage, you are legally permitted to work with your broker-in-law as a customer or enter into a dual agency relationship with both seller and buyer so long as everyone agrees to the representation in writing. The issue is an ethical one. Can you adhere to the limitations dual agency imposes under the law with your brother-in-law? In addition, have you participated in idle chatter during family settings where you may have made comments about the seller's negotiating position that could have been overheard by your brother-in-law? Wouldn't that give him an advantage over the seller?
2. D. Paul had a contract with Mary, which she breached. He could take her to court and try to get a judgment against her for the commission. Arbitration through a REALTORS® board is only for disputes between REALTORS®.
3. A. Even though Jake is not Lucy's agent, he still owes her honesty and fair dealing as a customer.
4. C. In this relationship, the agent, Sally, exclusively represents the buyer. The seller is representing himself and is Sally's customer.
5. A. Before an agent discusses potential confidential information, he should disclose the details about possible agency relationships.
6. A. The payment of fees from one sponsoring broker to another does not establish any agency relationship between them or the clients that they represent. In this instance, the buyer's broker is the representative of the buyer and is accepting a fee on behalf of the client.
7. D. As long as buyer's agent Doug earns 3% as contracted, even if he gets it from the listing agent, Lisa owes him nothing.
8. B. Debra has a contract saying she will earn 3%. Since the listing agent was willing to pay 2%, Ray would have to pay Debra's sponsoring broker the 1% difference.
9. C. The listing agent commission is 7%, but the seller is not obligated to pay the buyer's broker anything.
10. D. The seller pays the sponsoring broker who listed the property, who pays any cooperating brokers. Kevin can accept compensation only from his sponsoring broker, Ace.
11. C. Information about terms of the transaction is off limits to a dual agent. The other information can certainly be shared as part of a dual agent's administrative duties to his clients.
12 A. The listing agent has been designated "to the exclusion of all others as the agent of the seller." Any real estate licensee sitting an open house other than the designated agent can become the designated agent of the buyer without any potential for dual agency.

Chapter 35

1. A. Only a lender can pre-approve a prospective buyer, since it is binding on the part of the lender. While it's helpful to be pre-approved before showing the buyer properties because it can improve the buyer's negotiating position, it's not necessarily required. A broker should, however, at least pre-qualify a buyer to get a clear idea about what he or she can afford.
2. B. If Gordon really needed to make some changes in order to afford payments on the home, he could cancel his cable service. Therefore, such a payment is generally not considered when accounting for long-term debt when qualifying a potential borrower.
3. A. Under the housing expense ratio, she would qualify for $896 ($3,200 x .28). Using a debt-to-income ratio of 36% for a conventional loan, Nicole would qualify for a total housing expense of $1,152 ($3,200 x .36). From that, however, you need to subtract her recurring debt of $370, resulting in a maximum housing expense of $782. The lower number is the maximum housing expense.
4. D. The lender bases the loan-to-value on the lesser of the sales price or the appraised price. If Laura is paying $230,000 on a house appraised at $225,000, the lender will loan her $180,000 ($225,000 x .80). That means Laura will have to make a down payment of $50,000 ($230,000 sales price - $180,000 loan).
5. A. Discount points may be deducted only when paid for a principal residence.
6. D. Choices A, B, and C could be alleged to be discriminatory in that they might be used to single out individuals on the basis of familial status or religion.
7. B. The LTV, or loan-to-value, is found by dividing the loan amount by the lesser of the appraised value or the sale price. If the borrower is putting down $25,750, the loan amount is $149,250. Divide that by the sale price of $175,000 to get a LTV of 85.3%.
8. D. You should never render an opinion regarding the racial makeup or the amenities (e.g., schools) of an area. Direct your client to local libraries, government offices, or online sources where statistical data is available.
9. C. A real estate broker can help determine how much house he or she may be able to afford. This process may be referred to as pre-qualification. Only a lender can pre-approve a borrower or underwrite a loan. A lender or mortgage broker can originate a loan, i.e., assist a borrower with submitting an application and required documentation.
10. D. When someone touches her face, rubs her brow, or scratches her head, she is most likely thinking about what you're saying or thinking about the property she's looking at. Remember the value of holding your peace and letting her gather her thoughts.
11. C. Open-ended questions—such as those that ask "why?"—allow a buyer to offer more insight into what they want to find in a house. Questions that simply need a straight-forward answer, while helpful and necessary, may not be as valuable in drilling down to what will really make your buyer happy.
12. C. Occasional overtime income would not be considered when qualifying a borrower, but the other sources of income, if consistent and durable, should be considered. Also, recall that the Equal Credit Opportunity Act makes it illegal to discriminate based on source on income.

Chapter 36

1. A. Licensees can be disciplined for failing to provide copies of signed documents to the signing party immediately.
2. C. You may feel uncomfortable doing this, and you may mention to your clients that such a drastic price cut is unusual, but you must honor the wishes of the client you're representing as long as it's a legal request.
3. B. You need to determine what kind of objection the buyer is making. Is it valid? If so, is there a reasonable response? You must be prepared to address valid objections, if possible.
4. D. The Illinois Good Funds Act indicates that a personal check may be acceptable, but only if it is for less than $5,000. The other forms of payment would be accepted by a closing agent as good funds and, therefore, could be disbursed at closing.
5. D. The house may be perfect, but if it's not in the specific school district that the buyer wants, the agent may not be able to provide a reasonable answer to that objection.
6. B. The disclosure and referral requirements are required when there are contemporaneous offers. Contemporaneous offers are offers to purchase or lease on behalf of two or more clients represented by the same designated agent for the same parcel when he knows the seller will consider both offers at the same time.
7. D. The 1966 decision by the Illinois Supreme Court in the case of Chicago Bar Association, et al. v. Quinlan and Tyson allows real estate licensees to use acceptable pre-printed "fill-in-the-blank" purchase agreements.

8. C. The contract between the seller and the broker is the listing agreement or buyer brokerage agreement. The purchase agreement serves all of these other purposes.

9. C. The broker can be held liable because his statements to the buyer were possibly fraudulent and could be looked upon as an inducement to enter into the purchase agreement.

10. B. A home inspection is generally not warranted, and does not provide any type of guarantee on the items or systems inspected. The property inspection is geared towards finding items that are dangerous, items that are damaged, and items that don't work.

11. D. The agent should always encourage buyers and sellers to consult an attorney prior to entering into any contract.

12. C. A buyer's agent has a fiduciary obligation to protect the client's interest and should present any offer to purchase to the seller's agent in a timely manner, even if the property is subject to a contract of sale. A listing broker must accept all offers on behalf of his client, but the seller may decline to entertain other offers.

Chapter 37

Converting Fractions, Decimals and Percents

Percents	Fractions	Reduced Fractions	Decimals
40%	40/100	2/5	.40
62.5%	5/8	5/8	.625
8%	8/100	2/25	.08
55%	55/100	11/20	.55
9%	9/100	9/100	.09
120%	120/100	6/5	1.20

Calculating Part, Whole, or Percent

1. $150,000 (Part) ÷ .30 (Percent) = $500,000 (Whole)
2. .40 (Percent) x 1,200 (Whole) = 480 houses with garages (Part)
3. .005 (Percent) x $246,800 (Whole) = $1,234 (Part)
4. $1,020 (Part) ÷ $24,000 (Whole) = .0425 or 4.25% (Percent)

Measurements

1. 150 front feet x $2,000 = $300,000

   150' x 600' = 90,000 S.F.

   90,000 S.F. x $2.50 = $225,000
2. 60' x 4' x (4" ÷ 12 = .3333') = 79.992 cubic feet

   79.992 ÷ 27 cubic feet = 2.9627 cubic yards or 3 bags
3. One method is to first average the two uneven sides:

   80' + 110' = 190'

   190' ÷ 2 = 95'

   50' x 95' = 4,750 square feet
4. NE 1/4, NE 1/4 of the section
5. 640 ÷ 2 ÷ 4 = 80 acres PLUS 640 ÷ 4 ÷ 4 ÷ 4 = 10 acres; 80 + 10 = 90 acres
6. This is a four part calculation. Because measurements are provided in both acres, yards and feet, you must convert all measurements to the same unit. We will convert to square yards since the question is asking how many 50 x 60 square yard lots can be created. Therefore, convert the 10 acres to square yards. There are 4,840 square yards in one acre (43,560 square feet in one acre ÷ 9 = 4,840 square yards). Now, multiply this by the number of acres: 4,840 x 10 = 48,400 square yards total. Next, calculate the square yardage of the access road: 20 x 840 = 16,800 square feet. Convert this to square yards by dividing by 9: 16,800 ÷ 9 = 1,867 square yards (rounded). Next, subtract the area of the access road from the total lot area: 48,400 – 1,867 = 46,533. This is the amount of land available to divide into lots. If each lot measures 3,000 square yards (50 x 60 = 3,000), then 46,533 ÷ 3,000 = 15.51. 15 lots can be created.

Interest

1. To determine the interest earned by the bank, use the interest formula and plug in the known variables and calculate: $220,000 loan amount x .08 annual interest rate = $17,600 interest earned.
2. To calculate the interest rate, first calculate the annual interest paid by multiplying the $693 paid for 1 quarter (3 months) by 4 (3 months x 4 months = 12 months/year). So, $693 x 4 = $2,772. Now, use the interest formula and plug in the known variables and calculate. $2,772 interest earned ÷ $52,800 = .0525 or 5 1/4% interest rate charged.
3. Simply multiply the original loan amount by the interest rate for the annual interest, then divide by 2 to get six months' interest. In this case, $200,000 x 6.5% (0.065) = $13,000; $13,000 ÷ 2 = $6,500.

Points

1. One point always equals 1% or .01, therefore 3 points equals .03. $2,250 ÷ .03 = $75,000 (loan amount).
2. $3,200 ÷ $160,000 = .02. Two points were paid on the loan.
3. First, calculate the amount of the loan by subtracting 20% down payment from the price of the property. $210,000 x .20 = $42,000. $210,000 - $42,000 = $168,000. If one point equals 1% or .01, 2 1/2 points equals .0250. Now, plug the known variables into the formula: .0250 x $168,000 = $4,200 (amount Jennifer will owe in points).

Loan Qualifying

1. Use the qualifying formula and insert the known variables: .28 x $5,500 = $1,540. The maximum monthly payment Sam and Lacy can qualify for is $1,540. But, since they have no other debt, you can apply the higher ration: .36 x $5,500 = $1,980.
2. First calculate the total house payment: $1,750 (P&I)+ $51 (insurance) + $125 (taxes) + $38.25 (PMI) = $1,964.25 total house payment. Next, determine the combined gross monthly income: $90,000 ÷ 12 (months) = $7,500. Then divide the total house payment by combined monthly income: $1,964.25 ÷ $7,500 = .2619 or 26.2%. This does not exceed the PITI ratio of 28% so they meet this qualification. Now, calculate their total debt payment by adding the car payment ($350) and student loan payment ($300) to their total house payment ($1,964.25) to get a total debt payment of $2,614.25. Find the total debt-to-income ratio: $2,614.25 ÷ $7,500 = .3485 or 35%. This does not exceed the DTI ratio of 36% therefore John and Libby qualify for the loan because their ratios are less than those required.
3. If they maintain their maximum monthly debt at $2,700, they can qualify for the loan ($7,500 x .36 = $2,700). However, if they incur another monthly payment of just $50, they would not qualify for the loan because their second ratio would exceed the 36% ($2,750 ÷ $7,500 = .3666 or 36.6%).
4. Use the qualifying formula and insert the known variables: $970 ÷ .28 = $3,464.29 (required monthly income).

Net to Seller

1. There are two steps to this problem. First add up the expenses: $145,500 + $2,300 + $460 = $148,260. This is the base cost. Now, factor in the broker's commission fee: 100% (sale price) – 6% (commission) = 94% (net to seller). Using the net to seller formula, plug in the known variables: $148,260 ÷ 94% = $157,723.40. The minimum offer the Patricks should accept is $157,723.40.
2. There are two steps to this problem. First add the closing costs to the selling price to get the base ($180,300 + $4,200 = $184,500). Now, factor in the broker's commission fee: 100% - 5.5% = 94.5% net to seller. Using the net to seller formula, plug in the known variables: $184,500 ÷ 94.5% = $195,238.09 (selling price).

Appreciation and Depreciation

1. This is a two-step process. First, multiply the annual depreciation rate by the number of years: 4 x 7 years = 28. Now, use the depreciation formula and plug in the known variables: $135,000 ÷ .72 = $187,500 (original value of the beach front property).
2. This is a two-step process. First, multiply the annual appreciation rate by the number of years: 3 x 10 years = 30. Use the appreciation formula and plug in the known variables: $564,000 ÷ 1.30 = 433,846.15 (the original value of the office building).
3. This requires a multi-step process. First, multiply the annual rate of appreciation and depreciation by the number of years: Appreciation equals 7 x 6 = 42; deprecation equals 7 x 5 = 35. Now, determine the appreciation of the condos by using the appreciation formula and plug in the known values: $950,000 ÷ 1.42 = $669,014.08 (appreciation). Next, determine the depreciation of the parking garage by using the depreciation formula and plugging in the known variables: $250,000 ÷ .65 = $384,615 (depreciation). Once you have these numbers, add them together to get the original price of the property (parking garage and condos together): $669,014 + $384,615 = $1,053,629 (original value of the total property).

Capitalization Rate

1. To determine the value of the property, use the capitalization formula. Because this formula requires the net income, calculate this before plugging the numbers into the formula (remember, net income is gross income minus expenses): $325,000 - $78,000 ($6,500 monthly expenses x 12) = $247,000. Plug these values into the formula: $247,000 ÷ .08 = $3,087,500 (property value).
2. To determine the capitalization rate, use the capitalization formula and plug in the known variables: $21,450 ÷ $165,000 = .13 or 13% cap rate.
3. This requires several steps. First calculate the annual net operating income. You know that 8 units rent for $525 per month so, 525 x 8 = 4,200 per month. $4,200 x 12 = $50,400 per year. But, there is a 95% occupancy rate which means you need to calculate 95% of the annual gross income. So, $50,400 x .95 = $47,880. Now, subtract the annual operating expenses. We know the monthly operating expenses are $800, so $800 x 12

= $9,600 of annual operating expenses. Now, subtract the annual operating expenses from the gross monthly income to get the net operating income: $47,880 - $9,600 = $38,280 NOI. Now you have the numbers needed to plug into the capitalization formula: $38,280 ÷ .11 = $348,000 (maximum the investor should pay for this property).

4. This requires several steps. First calculate the annual net operating income. You know the monthly potential gross income is $45,600, so $45,600 x 12 = $547,200 per year. But, there is a vacancy rate of 6% which means you need to calculate 94% (100% - 6% = 94%) of the annual gross income: $547,200 x .94 = $514,368. Now determine the 3% annual operating expenses: $547,200 x .03 = $16,416. Now subtract the annual operating expenses from the gross monthly income to get the net operating income: $514,368 - $16,416 = $497,952. Now you have the numbers needed to plug into the capitalization formula: $497,952 ÷ .125 = $3,983,616 (the appraised value of the property).

Gross Rent Multiplier

1. The first thing you need to calculate is the gross monthly income by dividing $81,000 by 12 to find $6,750. Now, insert the numbers into the GRM formula: $750,000 ÷ $6,750 = 111.1111 (GRM).
2. Insert the numbers into the GRM formula: $450,000 ÷ $4,165 = 108.0432 (GRM). Remember, though questions will include expenses that may lead you to net income, use only GROSS income for GRM problems.
3. First, determine the gross monthly rent ($7,680 ÷ 12 = $640), then use the GRM formula and insert the known variables: $640 x 132.5 = $84,800 (estimated value of the property).
4. Insert the numbers into the GRM formula: $3,600 x 108 = $388,800 (estimated value).

Proration

1. Because the question specified using a banker's year, you can first calculate a simple cost per month ($3,100 ÷ 12 = $258.3333). Next, determine the number of months taxes haven't been paid (July, August, September, October and half of November = 4.5 months). Finally, multiply the number of months by the monthly tax rate (4.5 x 258.3333 = 1,162.4999). The prorated taxes due the buyer are $1,162.50 (rounded).
2. First calculate the cost per day for two years: $620 ÷ 730 = $.8493. Next, determine the number of days in which insurance has been paid, but should be credited back to the seller: 28 (April) + 31 (May) + 30 (June) = 89. Finally, multiply the number of days for which insurance was paid by the daily rate: 89 x $.8493 = $75.587 (amount credited to seller).

Property Taxes

1. Use the tax formula and plug in the known variables: $3,600 ÷ .062 = $58,064.515. The assessed value of the property is $58,064.52.
2. Use the tax formula and plug in the known values: $8,200 ÷ $148,900 = .0550. The tax rate used is 55 mills.
3. First calculate the assessed value: .45 x $325,000 = $146,250. Then use the tax formula: .023 x $146,250 = $3,363.75 (annual taxes).

Transfer Tax

1. Find the number of taxable units, based on the sales price, not the appraised value: $422,500 ÷ $1,000 = 422,5, or 423 taxable units. Then multiply by the taxable units by the tax rate: 423 x 1.50 = $634.50. The transfer tax is $634.50.
2. This is a three-part calculation. Because the $100,000 mortgage the buyer assumed is exempt from taxes, you will need to subtract this amount from the total sale price of the house: $165,800 - $100,000 = $65,800. This is the amount subject to transfer tax. Remember, the down payment of $15,000 is not needed to calculate the transfer tax. Now, calculate the taxable units by dividing the sale price by the tax rate: $65,800 ÷ $500 = 131.6, or 132 taxable units. Then multiply by the taxable units by the tax rate: 132 x .75 = $99.00. The transfer tax is $99.

Commission

1. Using the commission formula, plug in the known variables and calculate: .065 x $234,500 = $15,242.50 (commission earned).
2. This is a two-part question. First, determine the total commission made on the sale. If the agent received $11,268 as half of the commission, then the total commission was $22,536 ($11,268 x 2). Now, use the commission formula and plug in the known variables: $22,536 ÷ $375,600 = .06. The commission rate charged was 6%.
3. This is a two-part question. First, determine the total commission made on the sale by using the commission formula and plugging in the known variables: .07 x $236,400 = $16,548. Once you know the total commission, take 40% of that: $16,548 x .40 = $6,619.20 (commission received).

Profit/Loss

1. This is a two-part calculation. First determine what was made: $245,400 - $222,000 = $23,400. Now, plug these numbers into the formula: $23,400 ÷ $222,000 = .11. The return on investment (profit) was 11%.

2. This is a two-part calculation. First determine what was lost: $620,000 - $567,000 = $53,000. Then plug these numbers into the profit/loss formula: $53,000 ÷ $620,000 = .09. The percent of loss was 9%.
3. This is a two-part calculation. First determine what 12% profit would be on $148,700 by multiplying it by 112% (the original investment plus 12%): $148,700 x 1.12 = $166,544. Next, divide the result of $166,544 by 93.5% (100% minus 6.5% commission): $166,544 ÷ .935 = $178,121.93. Melissa must sell the townhouse for at least $178,122.
4. To calculate the original list price, use the percent formula: $170,000 ÷ .85 = $200,000. The original list price was $200,000.

Math Quiz

1. a	9. d	17. c	25. b
2. c	10. b	18. d	26. a
3. d	11. c	19. b	27. d
4. c	12. b	20. a	28. c
5. d	13. a	21. c	29. b
6. c	14. b	22. d	30. c
7. c	15. c	23. a	
8. d	16. a	24. c	

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