CALIFORNIA MANDATES DISCLOSURE IN CREATIVE FINANCING ARRANGEMENTS: IMPLICATIONS FOR REAL ESTATE PROFESSIONALS

by Leonard V. Zumpano and Gene A. Marsh

In the past year a number of articles have appeared in newspapers concerning litigation that has involved the creative financing of real estate.[1] These lawsuits are apparently more common in California where the move toward creative financing with significantly large balloon payments started several years ago.[2] While there are no reported appellate decisions dealing with this phenomenon as it has been practiced recently in California,[3] the concern over potential liability in this area did prompt the California Association of Realtors® to sponsor a piece of legislation that will mandate disclosure in creative financing sales transactions.

The law, Chapter 968, Statutes of 1982 (Assembly Bill 3531), will become operative on July 1, 1983. The bill was promulgated as a response to the demand for disclosure to both the seller and purchaser in real property transactions involving creative financing. The primary purpose of the bill is to provide disclosure of specified information to both vendors and purchasers with respect to purchase money liens on dwellings for not more than four families, with certain exceptions.

Those parties required to make the specified disclosures are the buyer, the seller and those who fall within the definition of "arranger of credit," as defined by Section 2957 of the bill. "Arranger of credit" is defined as including a person who is involved in developing or negotiating credit terms, participates in the completion of the credit documents, and directly or indirectly receives compensation for arrangement of the credit or from any transaction or transfer of the real property

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which is facilitated by that extension of credit. The definition does not apply to an attorney who is representing one of the parties (buyer or seller) to the credit transaction. A licensed attorney would fall within the definition of arranger of credit if he or she were a party to a creative financing transaction—a buyer or seller.

The act applies to any transaction where the vendor will extend credit including an outright purchase, a lease with an option to purchase or where the facts demonstrate intent to transfer equitable title. Section 2959 requires that the disclosures be made before execution of any note or security documents, that the disclosure statement be receipted by the purchaser and vendor, and that the arranger retain a true copy of the executed statements for three years.

The information specified to be disclosed to the vendor and purchaser is detailed in Section 2963. There are 15 required disclosures in the section. Among the most noteworthy are the following:

2963(d)—A warning that if refinancing were required as a result of lack of full amortization under the terms of any existing or proposed loans, such refinancing might be difficult or impossible in the conventional mortgage marketplace.

2963(g) — If the financing being arranged or that represented by a prior encumbrance could result in a balloon payment or in a right in the lender under such financing to require a prepayment of the principal balance at or after a stipulated date, a disclosure of the date and amount of any balloon payment or the amount which would be due upon any prior call and a statement that there is no assurance that new financing or a loan extension would be available at the time of such occurrence.

2963(i) — A disclosure on the identity, occupation, employment, income, and credit data about the prospective purchaser, as represented to the arranger by the prospective purchaser; or, specifically, that no representation as to the credit-worthiness of the specific prospective purchaser is made by the purchaser.

2963(J) — A statement that loss payee clauses have been added to property insurance protecting the vendor, or that instructions have been or will be directed to the escrow holder, if any, in the transaction or the appropriate insurance carriers for addition of such loss payee clauses, or a statement that, if such provisions have not been made, that the vendor should consider protecting himself or herself by securing such clauses.

Section 2964 of the bill defines the potential liability for failure to comply with the provisions of the law. The section provides that any person who willfully violates any provision of the article shall be liable in the amount of actual damages suffered by the vendor or purchaser as the proximate result of the violation. Furthermore, the section provides that no person shall be held liable in any action under this article if it is shown by a preponderance of the evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid any such error.

The California statute addresses most of the issues which have been raised in the lawsuits involving creative financing. Much of the litigation has developed between the buyer and seller when balloon payments came due and the obligor (buyer) was not able to make the payment. Buyers allege that they were not warned of the potential difficulty of refinancing the original loan.

The failure to adequately investigate the credit-worthiness of the buyer has also been an issue in the resulting litigation. According to a recent survey of 80 Realtors®, conducted by the Federal Reserve Bank of Atlanta, it is not common to run adequate credit checks on potential buyers in creative financing arrangements.[4] When they are performed, someone unskilled often does the job. The potential for litigation in the Southeast on this issue is evident, at least among the Realtors® surveyed by the Federal Reserve.

The extent of the liability of the real estate professional in arranging creative financing packages is now being defined and tested by cases in litigation. The California disclosure statute, sponsored by the California Association of Realtors®, is an attempt to mandate disclosure and at the same time define the limits of the potential liability for the real estate industry. The alternative, should this kind of litigation become more common in other jurisdictions, is to have the limits of liability established in cases alleging fraud, negligence and breach of fiduciary duty on behalf of the agent. While Section 2964 of the California statute makes it clear that actions based on fraud, misrepresentation or deceit are still maintainable by the parties in these transactions, the statute will provide the standards against which the actions of the real estate professional will be measured. Without such standards, the potential for liability is probably more broad.

Since the state of California has often preceded other states in enacting consumer protection statutes, it would not be surprising to see other jurisdictions follow suit. While such statutes may help limit lawsuits, no single disclosure statement can possibly cover all the potential sources of legal liability real estate professionals may be exposed to when helping arrange real estate transactions that are creatively financed. Consequently, Realtors®, attorneys and real estate consultants are advised to familiarize themselves and their clients with the risks, effective cost and tax consequences of alternative creative financing arrangements.

NOTES

1. " 'Creative Financing' Ends in Foreclosure for More Home Buyers," *Wall Street Journal* (February 26, 1982), 1; "Suits Against Realtors Grow as Financing Balloons Burst," *Wall Street Journal* (September 1, 1982), 17.

2. "Lawsuit Foreclosures Rise as 'Balloon' Notes Burst in California," *The Washington Post* (October 31, 1982), F1.

3. Letter from W. Jerome Thomas, chief legal officer, State of California, Department of Real Estate to Gene A. Marsh (January 20, 1983).

4. D. Koch, D. Steinhauser and K. Inlanfeldt, "The Risks of Creative Financing," *Economic Review*, Federal Reserve Bank of Atlanta, (December 1982).