

# **Risk Management**

## **Understanding the Basic Concept of Risk Management**

The management of risk by real estate licensees is extremely important in today's litigious society. A real estate company's success may be hindered or enhanced depending upon how they manage the risks associated with real estate brokerage, lending, and/or property management in California.

There are several key terms and definitions that are important to understanding real estate risk management in California.

### **Terms and Definitions**

*Standard of Care:* Some duties have a higher standard of care than others. For example, a fiduciary duty is a much higher standard of care than the duty of honest and fair dealing. A fiduciary duty requires utmost honesty, loyalty, integrity, competence, confidentiality, and truth. Whereas the duty of honest and fair dealing owes the duty to disclose all material facts regarding a property.

*Contract Preparation:* The contracts most often encountered by real estate professionals include the listing agreement, purchase agreement and receipt for deposit, counter offers, and addendums. All of these contracts contain inherent risk and must be completed with skill and diligence by the licensee.

*Property Condition:* A property's condition must be observed by the real estate professional through a visual inspection of accessible areas. Items of concern for most one-to-four unit residential properties are generally noted in the Real Estate Transfer Disclosure Statement.

*Property Ownership:* Real property ownership includes land, items affixed to it, and anything appurtenant or incidental to the land. Affixed to the land includes fixtures and emblements (trees and bushes). Items appurtenant or incidental to the land includes appurtenant easements, prescriptive easements, easements in gross, CC&R's (Covenants, Conditions, and Restrictions), stock in a mutual water company, and riparian water rights.

*Trust Fund Handling:* Trust fund handling includes the broker's trust account that is held in trust for his clients. Earnest money checks, property management rents, and security/cleaning deposits are deposited into a broker's trust account. A broker and any bonded employees can access the account. Too much control over the account by one employee can cause embezzlement problems and is a trust fund violation according to the DRE.

*Material Fact:* A material fact is a fact that will affect the value of a property. Agents under both fiduciary duties and duties of honest and fair dealing are required to disclose all material facts regarding a property. Material facts are generally disclosed (on one-to-four unit residential properties) using the Real Estate Transfer Disclosure Statement.

*RESPA:* RESPA denotes the Real Estate Settlement Procedures Act.

There are several key areas that must be examined:

1. Lenders cannot pay referral fees on one-to-four unit owner-occupied property (dwelling) loans.
2. Lenders must provide a good faith estimate and Settlement Costs and You booklet within three business days of the borrower applying for the loan.
3. Lender must provide the HUD-1 (Uniform Settlement Statement) by close of escrow.
4. Lenders cannot charge a fee to provide the HUD-1.
5. Plus several other requirements that lenders must be aware of in today's lending environment.

*Conflict of Interest:* Agents cannot compete with their principles in the purchase of a property. They also do not want to get into a conflict of interest in lending and brokering a home to prospective purchaser—without disclosing this to both the buyer and seller.

*Negligent Advice:* When an agent gives a client advice that is incorrect and the agent should have known that it was incorrect, this is called negligent advice. If, in light of a normal agent's education, training, and experience, the agent should have known certain facts regarding a property or gave bad advice to the principal regarding that property, then the agent is liable for his actions. The broker may also be liable through vicarious liability.

*Agency Duties:* There are several duties that come into existence when an agent represents his principal in a transaction. Both agents owe fiduciary duties to their principals. Each agent owes a duty of honest and fair dealing to the other principal on the other side of the transaction (i.e. listing agent to buyer or selling agent to seller).

*Dual Agency:* When an agent represents both the buyer and seller in the same transaction, this is called dual agency. Dual agency must be disclosed to BOTH the buyer and seller in the transaction.

*Secret Profit:* An agent may not make a secret profit. Clients are relying on real estate licensees to price their properties. For this reason, agents may not make a secret profit on a piece of real property. An unlicensed person can make a secret profit on a parcel of real estate.

*Ostensible Agency:* If there is no written or verbal agency relationship existing between a principal and real estate licensee, and the licensee starts acting as if he is the principal's agent—and the principal starts acting as if the licensee is his agent—then the licensee is considered his agent through ratification. This is called ostensible agency.

*Gratuitous Agent:* When an agent accepts all the liabilities of being an agent—without being paid, he is called a gratuitous agent.

*Agency Disclosure:* In 1988 agency disclosure became a new law in California for one-to-four residential properties where an agent is involved. Agents must complete the agency disclosure form and deliver it to the seller and buyer as soon as possible. The agency disclosure form goes with the listing agreement and also goes along with the purchase agreement when it is presented.

*Patently Frivolous Offer:* The agent is relieved of the obligation of presenting a patently frivolous offer. An offer to purchase a one million dollar residence for one dollar would be considered a patently frivolous offer.

*Contracts:* A contract is an agreement to do or not to do something.

*Express:* An express contract is an agreement to do something that is either written or oral.

*Implied:* An implied contract is a contract that is implied by the actions of the parties. If a party has relied on someone else and that person caused them harm, the party who was harmed can pursue a cause of action under the Doctrine of Promissory or Equitable Estoppel. In other words, if there is no written or oral contract between the parties, the courts will make a contract (under detrimental reliance by one of the parties) and file suit under the Doctrine of Promissory or Equitable Estoppel as a cause of action.

*Unilateral:* A unilateral contract is a contract that contains a promise for an act. An open listing agreement is considered a unilateral contract. The act of bringing in the buyer results in the promise by the seller to pay a commission.

*Bilateral:* A bilateral contract is a contract that contains a promise for a promise. An example is an exclusive authorization and right to sell listing agreement. The agent promises to use diligence in finding a buyer if the seller promises to pay him a commission.

*Valid:* Elements of a valid contract include: Competent parties (cannot be declared incompetent in a court of law), Capacity to contract (not under 18 years of age---unless married, divorced, emancipated by the courts, or in the military), Mutuality (meeting of the minds), Consideration (bargained for exchange between the parties), and Writing. All real estate contracts (except leases of one year or less) must be in writing. In addition to all real estate contracts, all contracts (real estate or not) that are not to be performed within one year of their making must also be in writing according to the Statute of Frauds.

*Voidable:* A voidable contract can be voided by one of the parties to the contract. A contract signed under duress is an example of a voidable contract.

*Void:* A void contract is a contract that has no legal basis. There is no contract at all.

*Aliens:* Non-resident aliens have the capacity to own real property in California.

*Minors:* Someone under 18 years of age is called a minor and is restricted from contracting in California.

*Statute of Frauds:* The Statute of Frauds came from England and states that all real estate contracts must be in writing (except leases of one year or less).

*Power of Attorney:* When one person gives another person the ability to act for them (i.e. sign documents), this is called a power of attorney. The person acting for another is called an attorney-in-fact.

*Specific Performance:* Each parcel of real property is unique and cannot be replaced. If a buyer has a contract to purchase a property and the seller refuses to perform (convey title), the buyer can institute an action called specific performance and try to compel the seller to sell the property according to the terms of the contract.

*Liquidated Damages:* On one-to-four unit residential dwellings, if a buyer and seller initial the liquidated damages clause in the purchase agreement, then the damages will be set ahead of time if the buyer “flakes out” and does not close the sale of the property. Of course, collecting this can be difficult since the earnest money funds are generally in escrow and cannot be released without the buyer’s signature.

*Options:* An option is a contract to keep an offer open for a specified period of time.

*Fair Housing:* There are numerous federal and state fair housing laws, including the Civil Rights Act of 1968, Redlining, Unruh Civil Rights Act, Rumford Act, Holden Act, Steering and Panic Peddling, and Americans With Disabilities Act (ADA).

*Intentional Misrepresentation:* When an agent intentionally misrepresents information regarding a property, this is called fraud.

*Negligent Misrepresentation:* When an agent accidentally or innocently makes a mistake regarding a property, this is called negligent misrepresentation.

*Concealment of Material Facts:* If an agent conceals material facts that will affect the value of a property, this is a major infraction by the licensee.

*Unlicensed Assistant:* Unlicensed assistants are restricted from providing property information of any kind. An unlicensed assistant can call for an appraisal; however, the assistant cannot provide property information to the appraiser. An unlicensed assistant cannot write an advertisement, the assistant can only provide to the newspaper (or other advertising medium) what her broker or agent told him or her to write.

*Risk Management Policy:* Each broker should have an office policy and procedures manual outlining office policy regarding all of the items in this course.

*Broker-Salesperson Agreement:* This is a written agreement between the broker and salesperson. The agreement between the broker and salesperson must be in writing, however, the form of the agreement is not regulated by law.

*Office Policies and Procedures Manual:* This is a manual that each office should have available to the agents. The manual outlines policies and procedures for handling day-to-day issues that face a real estate office. All of the risk management items in the manual are covered throughout this course.

*Custodian of the Public Interest:* Agents are the custodians of the public interest and must work for the benefit of the public in general.

*Statutory Duties of Licensee:* Statutory duties of licensees are duties that are prescribed by legislative law. Laws enacted by the California State Legislature are called “Statutes” and must be understood and followed by real estate licensees.

*Mediation, Arbitration, and Litigation:* Mediation is non-binding and non-judicial (not through the courts) dispute resolution. Arbitration is binding dispute resolution, also not through the courts. Litigation is binding dispute resolution through the courts, with an appeal process.

*Department of Real Estate:* Called the “DRE”, regulates licensees in California.

*Real Estate Commissioner:* Appointed by the governor, head of the DRE.

*District Attorney and the Criminal Courts:* The district attorney prosecutes people who act as if they have a real estate license—but does not have one. If a person brokers real estate without a real estate license, the district attorney in the county where the activity occurred will prosecute that person in the criminal courts.

With the previous terms and definitions in mind, let’s take a look at risk management for real estate licensees in California.

## **The Probability of Risk**

It is imperative that real estate agents understand the risks involved in real estate transactions, real estate lending, property management, leasing, business opportunities, as well as several other areas covered by a real estate license. As litigious as California has become over the last many years, an understanding of risk management—as well as a plan to manage risks is essential to a successful career in real estate.

## **Standard of Care Issues**

The standard of care owed by a broker under article 2079.2 of the Civil Code is the degree of care a reasonably prudent real estate licensee would exercise and is measured by the degree of knowledge through education, experience, and examination required to obtain a real estate license.

After a basic understanding of the concepts of risk management, a look at common areas of risk to real estate licensees is important to avoid potential litigation in the future.

## **Common Areas of Risk**

Some common areas of risk include contract preparation, investigation of the property condition, property ownership, trust fund handling, broker supervision of employees, failure to research, investigate, and disclose material facts, RESPA violations, conflicts of interest, and negligent advice.

### **Contract Preparation**

An agent should consider the risks inherent with contract preparation and understand the basic elements of contract law.

Particular areas of concern are competent parties, capacity to contract, mutual consent, lawful objective, sufficient consideration, and in writing.

A capacity issue is a real estate contract to a minor. Unless the minor has been emancipated by the courts, in military service, or married/divorced, they are restricted from contracting in California. Minors do have the ability to contract for necessity items, however, real estate is not considered a necessity item.

Contracts with someone who has been formally committed to a mental institution are void—at least while they are formally committed to the institution. Once they are released they may, however, be able to once again obtain the power to contract.

Contracts with someone who has been declared incompetent by a court of law are also void. There have been instances when a person was NOT declared incompetent by a court of law; however, their medical doctor declared that the person did not fully understand what was going on around her. In this instance, it is a good idea to contact her medical doctor and a competent attorney prior to proceeding with any contracts with that person.

All of these contracts are void and have no force or effect.

### **Property Condition**

The agent is required to make a visual inspection of all accessible areas and note his findings on the Real Estate Transfer Disclosure form. The listing agent should inspect the property condition and note any obvious conditions that are material facts that must be disclosed to the buyer.

### **Property Ownership**

Areas of concern regarding property ownership include the land, any affixed to the land, and anything appurtenant or incidental to the land.

### **Land**

Land includes the soil, rocks, and other substances that compose the earth. It also includes the space below the surface all the way to the center of the earth, as well as the airspace up to the heavens (at least as much as a property owner can reasonably use). Courts have recognized a public right to use the airspace above real property as a highway as long as it does not unreasonably interfere with the landowner's enjoyment of the property.

In addition, the courts recognize the fluid nature of subsurface gas and oil and a property owner has the right to drill vertically to capture these substances. However, an adjoining landowner does not have the right to drill slantwise to capture a neighbor's subsurface gas or oil.

An agent should consider not only the surface area, but the area underneath and airspace above the parcel.

### **Anything Affixed To The Land**

This includes buildings, trees, and anything permanently affixed to the land. Real property does not usually move. Examples include houses and things permanently attached to a house, which may include (for example) a built-in microwave oven or kitchen cabinets. Since these types of items are immovable, they are considered real property.

If a microwave oven is sitting on the top of a kitchen counter (instead of being built into the cabinets) it will probably be considered personal property because it is movable and mobile.

Fixtures are personal property that is incorporated into the land and thus becomes real property. Kitchen cabinets and a built-in microwave oven would generally be considered fixtures and, therefore, real property.

Tests for a fixture include:

**1. Method of attachment**

This is the method by which property is incorporated into the land. The degree of permanence of the annexation is also important. If the fixture is attached by cement or concrete it is probably classified as a fixture, and therefore considered real property.

**2. Adaptability or Annexation**

Personal property that is attached to the land and being used as an ordinary use in connection with the land is usually considered a fixture. A house key is a good example.

**3. Relationship**

The relationship between the person who placed the item (possible fixture) on the property and the person who disputes its classification is another important test in determining whether an item is a fixture. Since the buyer/seller relationship is adversarial in nature, the agent must specify in the purchase agreement particular items that may be disputed by the parties.

**4. Intent**

Intent is the most important test for a fixture. Window coverings are an example of conflicts of intent. The seller's intent is that the item is personal property and will go with him when he sells the property. The buyer's intent is that the item is real property and will stay with the property. Since the buyer's and seller's intents are in conflict, the only answer is what the agent specifies in the purchase agreement.

**5. Agreement**

When there is a clear agreement between the buyer and seller, whether an item is a fixture should not be in dispute. It should be plainly determined through the agreement.

## **Emblements**

Emblements include planted trees, vegetation, and trees in nature. When emblements are severed they become personal property. A growing corn crop is considered an emblement and real property since it is attached to the land. However, once it is severed (harvested) it becomes personal property. Therefore, the un-harvested corn crop is real property unless specified in the purchase contract. If the seller of the real property would like to harvest the corn crop after the sale, and he doesn't state this in the contract, the corn transfers with the property and is now owned by the buyer. If, however, the growing crop was sold (even if it is still on the stalks) it is considered personal property.

## **Anything Appurtenant To The Land/Incidental To The Land**

An appurtenance is anything that is used with the land for its benefit. Hence the name, "runs with the land." Examples of appurtenances include: easements, water company stock, covenants, and riparian water rights.

## **Easement**

An easement is the right to use someone else's land. For example, an easement over "B's land benefits A. The easement is appurtenant to A's parcel and must stay with that parcel. If owner Smith who owns Parcel A decides to sell it, the easement across Parcel B (which is in the deed) must STAY with the property. Smith cannot take the easement with him when he leaves the property. Any future owners of Parcel A will enjoy the rights to drive across Parcel B.

There are generally three major types of easements: appurtenant easement, prescriptive easement, and easement in gross.

## **Appurtenant Easement**

Property owned by Anderson has an easement from Baker over Baker's property, this is called an appurtenant easement. Appurtenant easements are always held by the dominant tenement.

An appurtenant easement must benefit one tenement and burden another, parcels of land must be owned by two different persons, and the easement is transferred with the dominant tenement. Remember, however, the dominant and servient tenements do not have to abut or adjoin each other (touch each other). However, an appurtenant easement does benefit adjoining landowners.

### **Prescriptive Easement**

A prescriptive easement is a way of gaining the right to use another person's property without their permission. The use must be open and notorious, uninterrupted for five (5) years or more, claim of right, and hostile to the owner's intent.

Adverse possession is very similar to a prescriptive easement. An adverse possessor must be open and notorious, used continuously for five (5) or more years, have a claim of right, and be hostile to the owner's intent. In addition, an adverse possessor must pay the property taxes on the portion of neighbor's property being used. If he does all of these things (including paying the property taxes), he acquires title and owns the property. A quiet title action will perfect his title. Conversely, a prescriptive easement holder only has the right to *use* the property—he does not own it (as in adverse possession).

### **Easement in Gross**

Farmer gave Bryan an irrevocable right to cross his farm and fish for "lunker trout" in his crystal clear trout stream. Bryan has an *easement in gross*. Utility company easements are considered easements in gross. An easement in gross is irrevocable and a license is revocable.

### **Stock in a Mutual Water Company**

Water users may organize a mutual water company in order to secure an ample water supply at a reasonable cost. In most cases, the stock is made appurtenant to the land; that is, each share of stock is attached to a particular parcel of land and cannot be sold separately. This enables the water company to plan its distribution more easily and prevents speculation in shares. No cash dividends are given to the mutual water company stockholder; however, credits are given if there is a water surplus. If operating revenues are not covered, then a special assessment may be levied to make up the loss.

### **Covenants, Conditions, and Restrictions (CC&R's)**

A covenant is usually defined within the framework of "CC&R's." This stands for Covenants, Conditions, and Restrictions. CC&R's usually run with the land and are thus appurtenant to the land and automatically go to the new owner.

CC&R's can be created by deed, agreement, or recorded declaration of restrictions. A breach of a covenant (promise) is a minor breach and is remedied by monetary damages. A breach of a condition is a major breach and is remedied by loss of title to the property. Because of loss of title, a condition must be contained in the deed. A restriction is a private deed restriction and restricts

the use of the property. An injunction is used to enforce private deed restrictions.

### **Riparian Water Rights**

Riparian water rights allow a parcel that is adjacent to a river, stream, or watercourse to use as much water as they can reasonably use. This right runs with the land and can be a great advantage to agricultural properties.

### **Trust Fund Handling**

Trust funds are funds held in trust by a broker for his principal. Trust funds fall into two categories, (1) earnest money deposits collected in the course of sales transactions and (2) property management rents (and security/cleaning deposits) collected from tenants.

When a broker mixes his own money with the money or property of others it is called *commingling*. The broker must deposit or place trust funds received into the hands of the principal, into escrow, or into a trust fund account within three (3) business days after receipt. The broker may not keep buyer's cash deposit in the broker's safe, it must be in the trust account.

A broker must keep trust fund checks for a minimum of three years. He can keep up to \$200 of his own money in the account to cover the costs of the account.

If a broker negotiates a deal between a buyer and seller and then opens escrow, and the buyer deposits an earnest money check directly into escrow, the broker must log the deposit in his trust account ledger as un-deposited funds. It is illegal for a broker to place rents collected on his own apartment building into his client's trust account. Employees who have access to the account must have divided duties to guard against potential embezzlement of the trust funds. Giving one employee too much control over the account is a trust fund violation according to the DRE.

The broker or an unlicensed employee of a broker who is authorized in writing can make withdrawals from the broker's trust account provided the employee is covered by a fidelity bond for at least the amount of the funds to which the employee has access at any given time

A broker must reconcile his trust fund account on a monthly basis. A broker must deposit his trust account all monies paid to him specifically for advertising, etc.

### **Broker Supervision**

It is the broker's duty to properly supervise each salesperson under his broker's license. If the broker does not properly supervise these subagents, he can be liable for their actions through vicarious liability.

### **Failure to Research, Investigate, and Disclose Material Facts**

According to Civil Code sections 1102-1102.7, agents must make a visual inspection of all accessible areas and disclose any material facts that result from the inspection. A material fact is a fact that will affect the value of a property. Material facts must be disclosed to both buyers and sellers.

For most resale one-to-four unit residential properties, a Real Estate Transfer Disclosure Statement (TDS) is required in the sale of the property. The TDS may not be waived in an "as is" sale. With an "as is" sale, the seller is not going to fix anything—however, he must disclose all material facts regarding the property to the buyer.

### **RESPA Violations**

Section 8(a) of RESPA prohibits giving and receiving any fee, kickback, or thing of value for the referral of settlement services. Things of value are broadly defined under RESPA's rules and may include monies, trips, an opportunity to win a prize, free advertising, and stock in a company.

Some examples of prohibited practices include:

1. Title companies, mortgage broker, and lenders offering real estate agents a free chance to win a contest or prize, such as trips, money, coupons, and discount certificates.
2. Mortgage brokers, lenders, and title companies offering to pay or defray any costs that real estate brokers or agents would otherwise have to incur, such as providing continuing education or paying disproportionate costs for joint advertising.
3. Mortgage brokers, lenders, and title companies providing "thank you" gifts to real estate agents for referring business.
4. Mortgage brokers or lenders paying "finders fees" to friends and past customers for referring new business (soliciting business, not a mere introduction).

The provisions under Section 8 of RESPA do NOT prohibit compensation for providing actual goods, facilities, or services. However, compensation must be reasonably related to the market value of such goods, services, or facilities. HUD may consider any excess payment as compensation for referring business.

Here are some situations to avoid involving compensation for goods, facilities, and services:

1. Mortgage brokers paying commissions to lenders or other mortgage brokers for their turndowns or so-called "leads." It is okay to purchase lead lists as they are considered "goods." However, compensation based on the outcome of the lead is not permissible.
2. Title companies paying real estate agents for performing duplicate or unnecessary work.
3. Mortgage broker or lenders attempting to employ real estate agents as loan officers to pay them a percentage of the loan amount for performing minimal, duplicative, or unnecessary services, such as completing or helping with loan applications.
4. Real estate agents receiving additional payment without performing additional work, remember that providing referral services is not a compensable service.
5. Real estate brokers receiving above-market rates for renting desk or office space to loan officers, mortgage brokers, lenders, or title companies. Or, collecting rent for desk or office space that is rarely used by the loan officer, mortgage brokers, lenders, or the title companies.
6. Real estate brokers and agents who enter into marketing agreements with lenders to provide marketing services, but only provide referral services.

In 1983, Congress amended RESPA to permit referrals between settlement service providers in an Affiliated Business Arrangement (AfBA), under certain conditions. An AfBA exists when a person in a position to refer business, or their "associate," owns more than one (1) percent of a provider of settlement services, and either person directly or indirectly refers business to that provider. An associate of a person in a position to refer business includes a partner, employer, officer, spouse, parent, or child; or where an entity is a corporation related to another corporation as parent to subsidiary by an identity of stock ownership.

Under the 1983 rule, referrals made between affiliates do not violate RESPA so long as the following three conditions are met:

1. The consumer receives a written disclosure of the nature of the relationship and an estimate of the affiliate's charges. (This disclosure must be provided at the time the referral is made, by the person making the referral. HUD provides the format for this disclosure at Appendix D of the regulations, 24 CFR 3500.)
2. The consumer is not required to use the affiliate.
3. The only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest.

An example of a RESPA-compliant AfBA might include a real estate broker who owns a mortgage brokerage company and the real estate agents refer loan business to the broker. Under this scenario, the broker and agents would satisfy the law provided the agents give the customer the AfBA disclosure at the time they make the referral, the broker does not require agents to refer loan business, and the broker does not compensate agents for making referrals.

Participation in "sham" affiliated business arrangements violate RESPA's anti-kickback and unearned fee provisions. HUD recently increased its investigation and enforcement activity of sham affiliated business arrangements as more settlement service providers try to circumvent RESPA's prohibitions by establishing shell settlement service businesses to function as a conduit for paying referral fees.

Often, title companies or lenders create sham arrangements with persons in positions to refer business. Additional guidance of AfBAs is contained in HUD's 1996-2002 Statement of Policy, "Sham Controlled Business Arrangements."

The following are a couple of examples of sham arrangements:

1. A title company and a real estate firm establish an affiliated title agency. The affiliated title agency has the same business address as the partner title company, the real estate firm is the affiliated title agency's sole source of business, and employees of the partner title company perform the core title functions.
2. Several real estate agents create an LLC to purchase an interest in a title company. The title company and the LLC share profits based upon their ownership interest. However, the LLC disburses profits to its member real estate agents based on the volume of title business referrals.

All licensees should operate in compliance with RESPA, particularly the provisions of Section 8, as the violation of this part may carry a fine of up to \$10,000 or imprisonment of up to one year, or both. For more information on RESPA, visit HUD's website at [www.hud.gov/offices/hsg/sfh/res/respa\\_hm.cfm](http://www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm) or call HUD at (202) 708-0502.

### **Referrals to Vendors and Third Parties**

Agents need to be particularly careful referring vendors and third parties. RESPA does not allow referral fees to be paid between loan officers and agents if the property is an owner-occupied (dwelling) and one-to-four units.

As mentioned earlier, some companies have affiliated business arrangements that allow them some flexibility in this area.

### **Conflicts of Interest**

An agent has a duty not to compete with his principal. If a property is offered for sale, the agent must not move forward and make an offer to purchase the property when his principal is attempting to purchase the property also.

### **Negligent Advice**

An agent must not be negligent in giving advice to his client. In light of the normal education and training that goes into being a real estate agent, an agent must not give negligent advice to his clients. If knowledge of the circumstances should have been within the agent's diligent observation, then he will be guilty of negligence.

Next is a look at licensee activities that are likely to contribute to risk.

## **Licensee Activities Likely to Contribute to Risk**

Licensee activities that are likely to contribute to risk include agency duties, authorization to accept a deposit, secret profit, ostensible agency, gratuitous agency, agent acting in excess of his authority, patently frivolous offers, preparation, formation, interpretation, performance, and termination of contracts, express contracts, implied contracts, unilateral contracts, bilateral contracts, executory contracts, executed contracts, elements of a valid contract, minors, aliens, handwritten items vs. preprinted clauses in the contract, sufficient consideration, statute of frauds, voidable contracts, void contracts, attorney-in-fact, novations, statute of limitations, specific performance, liquidated damages, and options.

## **Agency Duties**

An agency relationship is created when one person (the principal) gives another person (the agent) the right to act on his behalf. These acts are generally limited to a special agency of a broker listing a property for sale. In this instance, the agent is employed to find a ready, willing, and able buyer to purchase the property; and can neither sell the property for the principal nor bind him to any contract for the sale of the property.

An agency gives rise to a fiduciary duty of utmost care, honesty, integrity, and loyalty of the agent to the principal. This is a higher standard of care that the agent must exercise when acting for his principal. The agency relationship is terminated at close of escrow.

The best way to avoid litigation between a principal and a broker is to have a written contract or agreement.

An agency relationship/fiduciary duty can be terminated by revocation by the parties, agreement of the parties, or death of one of the parties.

An agency gives rise to a fiduciary duty of truth, confidentiality, and competence. A real estate agent generally acts as a fiduciary. The relationship between principal and agent is called a fiduciary obligation.

## **Broker Owes Buyer**

The listing agent owes the buyer the duty of honest and fair dealing. This is disclosure of all material facts related to the property. The same duty is owed by the selling agent to the seller (however, he usually doesn't know anything about the property).

## **Dual Agency**

Dual agency occurs when a broker represents both the buyer and the seller in a real estate transaction. Thus, the broker has fiduciary duties to both the seller and the buyer and must act with extreme care. Loyalty and confidentiality can be easily compromised for each party.

If an agent does NOT disclose dual agency to both parties, he may be disciplined by the Real Estate Commissioner, he may not receive his commission, and it may be grounds for either party to rescind the contract.

Mr. Brown hired a broker to find a warehouse for lease and agreed to pay a commission for the service. Several days later, Mr. Green tells the broker he has a warehouse lease and agrees to pay a commission if he finds a tenant. The broker writes the lease that is signed by both parties. Mr. Brown knows that the broker was representing Mr. Green, but Green did not know that the broker was representing Mr. Brown. In this case NEITHER is liable to pay a

commission. Acting for more than one party in a transaction without the knowledge or consent of all parties is called a divided agency (not dual agency). Dual agency occurs when the agent informs and obtains consent from each principal. Then he may collect a commission from each.

Therefore, a dual agency is legal if the buyer and seller consent to it.

### **Accidental Dual Agency**

When a real estate agent acts as an agent for both the buyer and seller in a transaction, but does not specifically reveal this fact because he is unaware that both consider him their agent, he is involved in accidental dual agency.

### **Authorized to Accept Deposit**

Able, the owner of Blackacre, lists a property for sale with Broker Baker. Able fails to authorize the agent to accept the deposit on his behalf. Buyer Charlie makes an offer on Blackacre and gives Broker Baker a check for \$5,000 as a deposit. Under these circumstances, Broker Baker can accept the deposit check on behalf of Buyer Charlie and place the monies in his broker's trust account.

The agent is required to do as his principal instructs him to do. However, he must inform the seller of the any check held by the broker because this is a material fact.

### **Secret Profit**

A broker cannot receive secret profits. It is a violation of the Real Estate Law, laws of agency, he is subject to disciplinary action by the Real Estate Commissioner, and subject to a civil suit by the seller or buyer.

A licensee may not receive a secret profit from the sale of one of his listings or other purchase he is involved in as a licensee.

A person who is NOT a licensee may make as many secret profits as possible on the transaction.

Licensee must disclose to his principal the full amount of commission or profit if he purchases the property.

A licensee must reveal to the other party (buyer or seller) that he has a license when involved in real estate transactions as a principal. He cannot buy through a "dummy" buyer.

If the buyer is a close relative (brother), the broker must reveal this fact to the seller.

### **Ostensible Authority**

An agency relationship can result from the conduct and actions of the parties, even though there is no express agency agreement between the broker and principal(s) in the transaction.

Ostensible authority occurs when Seller Able lets Buyer Baker assume that Broker Charlie is his agent.

### **Gratuitous Agent**

Compensation is not essential to establish an agency relationship. An agent who acts without compensation is still held under certain standards of care to his principal. A gratuitous agent assumes all the liabilities of an agent who is being paid a commission in the transaction, yet doesn't receive a commission.

### **Agent Acting In Excess Of His Authority**

The seller is not liable for the broker's actions if the broker acts in excess of his authority.

### **Agency Disclosure**

As soon as practical or practicable an agent must disclose who is representing whom in a real estate transaction. This includes who is representing the seller, buyer, and if a dual agency exists. This disclosure must be in writing.

### **Patently Frivolous Offer**

A broker is relieved of the obligation to present an offer to purchase real property to the principal when the offer is patently frivolous, he is acting under express written instructions of his principal, or the property is sold and escrow has closed.

### **Preparation, Formation, Interpretation, Performance, and Termination of Contracts**

A contract is an agreement to do or not to do something. It is a legally enforceable agreement between competent parties who have agreed to perform certain acts for consideration or refrain from performing certain acts.

### **Express Contract**

An express contract is a contract where the parties put their intentions and the terms of the agreement in words, either written or oral.

### **Implied Contract**

An implied contract is a contract where the agreement between the parties is shown by acts or conduct rather than words.

**Enforceable Contract**

A purchaser may make a contract contingent upon obtaining satisfactory leases (inspection of an existing lease and approving it). This would be considered an enforceable contract. However, if a purchaser attempts to make an offer subject to obtaining a satisfactory lease, this is called an illusory contract and is not a contract.

**Bilateral Contract**

A bilateral contract is a promise for a promise. The promise of one party is given in exchange for the promise of the other party. For example, when a seller promises to pay the agent a commission when the home is sold and the agent promises to use diligence in marketing the property, this is called a bilateral contract. A listing agreement is usually considered a bilateral contract. Able gave Broker Charlie a listing and promised to pay him a 6% commission if he finds a suitable buyer. This is a bilateral executory contract.

**Unilateral Contract**

A unilateral contract is a promise for an act. A promise is given by one party to induce an act by the other party. For example, A promises to pay B \$10 if she will walk across Brooklyn Bridge. B walks across Brooklyn Bridge, therefore, A owes B \$10. B performs her requirements under the contract with an act rather than a promise. An example of a unilateral contract is an open listing.

**Executory Contract**

An executory contract is a contract that is in the process of being performed and has not yet been completed.

**Executed Contract**

An executed contract is a contract that has already been completed.

## **Valid Contract**

There are four essential elements of any valid contract (all contracts):

1. **Competent Parties/Capacity To Contract** – The parties to the contract must not have been declared incompetent in a court of law. In addition, the parties to the contract must have the capacity to contract—specifically, minors may not contract for real property. The exceptions to this rule are minors who are married, divorced, in the military, or emancipated by a court of law.

2. **Mutual Consent** – This is mutuality of agreement. In other words, what the buyer thinks he has agreed to in the contract the seller thinks he has agreed to also. There is a meeting of the minds. Genuine offer and genuine acceptance is used to facilitate a meeting of the minds.

3. **Lawful Objective** – The purpose of the contract must be of a legal purpose. A contract to smuggle illegal drugs into the U.S. would not be a valid contract because it has an unlawful objective.

4. **Sufficient Consideration** – Consideration is the bargained for exchange that occurs when two people contract to do or not to do something. For example, if Able gives Baker \$100,000 for Baker's real property and Baker signs the deed conveying the real property to Able, there is sufficient consideration and a valid contract. Able's \$100,000 is consideration on his part, and Baker's conveying the property to Able is Baker's consideration.

5. Real estate contracts have a fifth element: **in writing**. Not all contracts are required to be in writing, however, real estate contracts are required to be in writing (except leases of a year or less are not required to be in writing).

## **Minors**

A minor can receive title to real property by gift or inheritance without court approval. However, the minor cannot convey the real property without court approval.

A single young man enters into a contract to sell real property he owns. After escrow had closed and the deed was recorded, the title company determines that the young man is under 18 years of age. In this circumstance, the transaction was void.

A minor can receive a parcel of real property by gift or inheritance without court approval. He cannot sell it without court approval.

A married or divorced person under 18 years of age has the capacity to contract and is not considered a minor.

**Aliens**

Non-resident aliens have the capacity to contract. Minors, convicts, children, and incompetents are all restricted from contracting. Non-resident aliens who are not citizens of the United States of America, however, do have the capacity to contract.

**Handwritten vs. Preprinted Clauses**

Many real estate contracts contain preprinted clauses and spaces for information to be handwritten. In a legal dispute, when there is a conflict between the preprinted clauses and the handwritten information, the handwritten information takes precedence over the preprinted clauses.

**Sufficient Consideration**

Consideration is required for a valid contract. Anything of value can be used as consideration (bargained for exchange).

Consideration is defined as services rendered, a promise to perform an act, an act of forbearance, or an exchange of money.

**Statute of Frauds**

The Statute of Frauds is an old concept that came from England (where it was abandoned a few years ago). However, it is still used in California. The Statute of Frauds states that all real estate contracts must be in writing including any and all agreements that are not to be performed within one year of their making (real estate or not). Since a lease of a year or less WILL be performed within one year of its making, it does not fall under the statute. Thus, a lease of one year or less is not required to be in writing. All other real estate contracts must be in writing.

**Unenforceable Contract**

An unenforceable contract is a contract that is valid, however, for some reason cannot be proved or sued upon. An example is when a contract cannot be enforced because of the passage of time within the statute of limitations. Another example of an unenforceable contract is an oral contract to purchase real estate. However, an oral agreement may be enforced if the purchaser has gone into possession, paid part of the purchase price, and made improvements to the property.

**Voidable Contract**

A voidable contract is a contract that appears valid and enforceable but is subject to rescission by one of the parties who acted under a disability. In other words, one of the parties is able to void the contract or go through with it at their discretion. An example of a voidable contract is one that is signed under duress. The person who was held under duress while signing a contract can void the contract (rescind it) or enforce it at their sole discretion.

### **Void Contract**

A void contract has no legally binding effect. It is unenforceable from the very beginning and is not a contract at all.

Examples of void contracts include:

- contracts to commit a crime.
- real estate contracts with minors.
- contracts with someone who has been formally committed to a mental institution.
- contracts with someone who has been declared incompetent by a court of law.

### **Power of Attorney**

A power of attorney is a written instrument giving authority to an agent. For example, Brother #1 is in Sydney, Australia and would like Brother #2 to sign for him in the conveyance of a home purchased by the two of them some years ago. Brother #1 signs a power of attorney form at the American Consulate in Sydney, has it notarized, and sends it to his brother in the U.S. Brother #2 then acts as attorney-in-fact for Brother #1 and signs escrow instructions on his behalf.

### **Attorney-In-Fact**

An attorney-in-fact is a person who is authorized to act on behalf of another person. Brother #2 in our previous example would be considered an attorney-in-fact for Brother #1.

### **Assignment**

An assignment is the transfer of rights, interests, or title to property of a person (assignor) to another person (assignee). A typical assignment is when trust deeds are sold from one lender to another.

### **Novation**

A novation is the substitution of a new contract for an old one. For example, when the lender releases a seller from the

obligation to pay the loan in a loan assumption, and substitutes the buyer as the one responsible to repay the debt, this is called a novation.

### **Statute of Limitations**

The statute of limitations is the amount of time in which a person can bring an action in court. A purchaser of real property generally has two (2) years to bring a claim in court if it is related to disclosure on a Transfer Disclosure Statement. Breach of fiduciary duty is generally four (4) years from the close of escrow or when the defect is discovered by the plaintiff in the lawsuit. If these time periods are exceeded, then the statute of limitations takes effect and the person is prevented from bringing an action in court.

### **Specific Performance**

Specific performance is a court action brought to force a party to carry out the terms of a contract. Specific performance is usually used to force a party to convey real property as stated in a purchase agreement. Each piece of real estate is considered unique and legal damages are many times not adequate to compensate a buyer for a seller's breach of contract. Therefore, the courts force the seller to convey the property to the buyer under the terms of the contract. Consideration for the contract, however, must be reasonable or sufficient relative to value for the courts to require specific performance.

### **Liquidated Damages**

Liquidated damages are the predetermined amount of damages the parties in the contract agree to as the total amount of compensation an injured party will receive if the other party breaches the contract.

For example, a buyer and seller include the liquidated damages clause in a real estate purchase agreement. The buyer reneges on the contract and then defaults on the purchase of the property (changes his mind and does not go through with the contract). The maximum amount of damages the seller can receive from the defaulting buyer has already been predetermined by the liquidated damages clause in the contract. The amount is usually 3% of the sales price or the earnest money deposit, whichever is lower for all one-to-four unit dwellings in California.

The liquidated damages clause in a real estate purchase contract must be initialed by both buyer and seller. If the buyer subsequently receives news of a job transfer and decides not to buy the property. Under these circumstances, the deposit is generally split 50% seller/50% listing broker.

## **Option**

An option is an agreement to keep an offer to sell or lease real property open for a specified period of time. Options are commonly used in the purchase of raw land, allowing the buyer to resolve zoning, entitlement, and feasibility questions prior to committing the funds necessary to purchase the property. An option must be accompanied by consideration. Options are assignable.

If the optionee decides to exercise his or her option during the period specified, then the optionor must perform and sell the property as per the contract.

Next is a look at the broker's risks associated with advertising.

## **Advertising**

Risks associated with advertising include blind ads, misleading advertising, and a broker breaking his promise to advertise.

### **Blind Ad**

A blind ad does not have the name of the agent or broker who has the property listed for sale. Blind ads are illegal because "agt.", "bro.", "bkr.", or the name of the broker must accompany each advertisement for the sale of the property.

A licensee must disclose when advertising, that he is an agent. A blind ad makes the agent appear to be the owner. It does not identify the broker.

### **Misleading Advertising**

Advertising cannot mislead a prospective buyer regarding the condition or other facts about a subject property. A "fixer" property should be called a "fixer," and not a "move right in" dream home.

### **Broker Breaks Promise to Advertise**

A broker breaking his promise to advertise is illegal. If a broker promises to advertise a property and then does not do as promised, she may be liable for damages under actual fraud.

Next is a look at fair housing risks.

## **Fair Housing**

Fair housing risks include Federal Fair Housing Laws, State Fair Housing Laws, race restrictions on a deed, marital status discrimination, and the Americans With Disabilities Act (ADA).

### **Federal Fair Housing Laws**

The main federal fair housing law was the Civil Rights Act of 1968. This Act has been instrumental in prohibiting discrimination in the sale and lease of housing throughout the U.S. In 1968 the U.S. Supreme Court prohibited all racial discrimination when real property is sold or rented.

The Civil Rights Act of 1968 allows all prospective buyers to be given the same opportunity to purchase residential properties without racial restrictions.

If a seller asks a broker to disclose a buyer's race, the broker should not disclose the purchaser's race because it is not a material fact.

### **Redlining**

Redlining occurs when a lender obtains a map and places a red line around an area where he does not want to make loans. This is called "redlining" and is illegal.

### **State Fair Housing Laws**

There are four important fair housing laws that have been enacted in the State of California:

*California Fair Housing Act* – The owner of a single-family residence may take in a boarder and be exempt from the California Fair Housing Act.

*Unruh Civil Rights Act* – prohibited discrimination in business establishments in California.

*Rumford Act* – prohibited discrimination in the sale and rent of residential properties in California.

*Holden Act* – prohibited discrimination in lending in California.

### **Housing Financial Discrimination Act of 1977 (Holden Act)**

For example, XYZ Savings and Loan Association negotiates a \$200,000 loan with Maria Gomez. Maria speaks no English. In order to complete the transaction XYZ provides loan forms written in Spanish. In the escrow closing statement Maria is charged a 1/8% higher interest rate than other borrowers who speak English. Under these circumstances the lender could not impose the extra charge. This is a violation of the Housing Financial Discrimination Act of 1977.

If a loan broker asks a person applying through the broker's office for a new loan to fill out a questionnaire in which the borrower's race and marital status are requested, the applicant can refuse disclose his race or marital status.

### **Steering**

Steering occurs when an agent steers a client out of communities that are not of his ethnic race. Steering is illegal.

A real estate licensee has a practice that when he is approached by members of minority groups who want to be shown property, he avoids showing them property in integrated areas. This would be an example of steering.

### **Panic Peddling and Blockbusting**

Panic peddling and blockbusting are very similar terms. For example, when an agent goes into a neighborhood and informs the homeowners that they should sell their homes now because minorities are coming into the neighborhood and their homes will suffer a loss in value, this is called panic peddling or blockbusting. Both of these activities are illegal.

A real estate broker who undertakes to canvas a neighborhood area that is very near to a section into which minorities have recently moved telling the people to whom he talks that they should sell now as their property might suffer a loss in value in the future, this is called panic peddling and blockbusting. Again, both are illegal.

A licensee who contacts owners of homes in an area indicating that they should list their homes for sale with him because minorities may be moving into the area, this practice would be considered blockbusting, panic peddling, and illegal.

### **Race Restrictions On A Deed**

Regarding the conveyance of a deed including race restrictions, the deed is valid but the race restrictions are unenforceable. Race restrictions on a deed are unenforceable because they violate the U.S. Constitution.

When a deed includes race restrictions, the race restrictions can be changed with a court order.

### **Marital Status Discrimination**

It is illegal for a landlord to require a tenant to have a co-signor because he or she is not married. This is marital status discrimination and illegal.

### **Americans With Disabilities Act (ADA)**

The Americans With Disabilities Act (ADA) requires equal access to public buildings for all handicapped persons.

### **Real Estate Commissioner Creates Color Blind Industry**

The Real Estate Commissioner's policy is to create a "color blind" industry. This means that agent's should maintain an attitude that is color blind and free of bias, race, creed, and color are not material facts in a real estate transaction, and agents should treat all people like they themselves would like to be treated.

Next are some practical examples of high risk areas for licensees.

## **Practical Examples of High Risk Areas**

Practical examples of high risk areas for licensees are fraud, misrepresentation, non-disclosure, concealment of material facts, and unlicensed assistants.

### **Fraud/Misrepresentation/Non-Disclosure**

Fraud is a nice word for lying. Misrepresentation occurs when the agent misrepresents the condition of the property or some other material fact(s) about a property. Non-disclosure occurs when a licensee or his clients (seller or buyer) do not disclose material facts that are pertinent to the purchase of real property.

When an agent makes a promise that influences a person to enter into a transaction, this is called a False Promise.

### **Misrepresentation**

Misrepresentation has two categories:

- intentional misrepresentation (another name for fraud or lying)
- negligent misrepresentation (unintentional mistake).

Obvious knowledge by the broker is considered misrepresentation.

### **Concealment of Material Facts**

A material fact is a fact that affects the value of a property and if a buyer knew about the fact she probably would not purchase the property. Examples of material facts are leaky roofs and extensive plumbing repairs.

### **Unlicensed Assistant**

If a broker has his unlicensed receptionist schedule an appraisal for a property, she cannot give the appraiser information concerning the property. She can only schedule the appraisal. If she were a licensed assistant, then she would be able to provide information regarding the property.

An unlicensed receptionist cannot advertise (design and make advertisements) for the broker. She can only place what the broker told her to write in the newspaper or other advertising medium.

If a real estate broker has his unlicensed assistant hand out door hanger fliers in his farm area and make telephone cold calls soliciting prospective buyers, sellers, and borrowers, this is unlawful for both the broker and the unlicensed assistant.

Next is a look at some risk reduction techniques to help licensees reduce their exposure to risk.

## **Risk Reduction**

Risk reduction techniques include a company adopting an official risk management policy; risk can be minimized by planning, training, supervision, and enforcement; broker delegating document review to salesperson; it is the responsibility of brokers, office managers, and supervisors to manage risk by educating, training, and supervising employees and associates; broker-salesperson agreements; goals of risk management clearly stated and communicated to agents and employees; consequences of illegal and unethical behavior; need for licensees to stay current; and risk is ongoing and reduced through proper training, supervision, and enforcement of office policies.

### **Companies Should Adopt an Official Risk Management Policy**

It is advisable for real estate companies to adopt an official risk management policy. This policy should cover areas of risk to the company and its licensees, as well as the company's policies dealing with each area. This should be contained in the company's office policy and procedures manual.

### **Risk Can Be Minimized by Planning, Training, Supervision, and Enforcement**

Risk to the real estate company can be minimized by planning, training, supervision, and enforcement. The company should plan to train, supervise, and enforce the policies set forth in their office policies and procedures manual.

*Planning:* A formal plan regarding minimizing risk as set forth in the office policies and procedures manual.

*Training:* Coverage of risk reduction issues within the company's formal training program for new agents and on-going training for experienced agents.

*Supervision:* All broker-officers and sales managers should be aware of risk reduction issues when supervising licensees. Corrections should be made to on-going licensee training as needed to reduce risk to the company.

*Enforcement:* Licensees who do not follow the company's risk reduction policies should be reprimanded and then, if the policies are not followed, subsequently terminated by the company.

### **Broker Delegates Document Reviews to Salesperson**

It is quite common for large real estate brokerage operations to delegate to a salesperson (usually called a sales manager) within an office the ability to review and initial documents completed by other salespersons within the office. The broker can delegate these reviews to a salesperson who has at least two (2) years full-time experience as a real estate salesperson within the past five (5) years.

### **The Responsibility of Brokers, Office Managers, and Supervisors to Manage Risk by Educating, Training, and Supervising Employees and Associates**

It is the responsibility of brokers, office managers, and supervisors to manage risk by educating, training, and supervising employees and associates. These responsibilities should be covered within the office policies and procedures manual. Educating, training, and supervising should be covered within the post-license training program for new licensees—as well as on-going training during office meetings. The broker-officer and sales managers should adequately supervise the licensees under their responsibility.

### **Broker-Salesperson Agreement**

A written broker-salesperson agreement is required between all real estate brokers and salespersons in California. A written agreement between the broker and salesperson is required by the Real Estate Commissioner's regulations. A salesperson is legally an employee of the broker; however, he is an independent contractor for tax purposes. The broker must keep a copy of broker-salesperson agreements for three (3) years after termination of employment. The agreement between a broker and salesperson is not required to be approved by the Department of Real Estate. However, it must be in writing.

### **Goals of Risk Management Clearly Stated and Communicated to Agents and Employees**

Brokers during initial and on-going training, office meetings, and in their Policies and Procedures Manual should clearly state risk management goals. Proper completion of all contracts and disclosures is critical to file management and resulting risk reduction.

### **Consequences of Illegal and Unethical Behavior**

The consequences of illegal and unethical behavior is either a correction of the agent's actions or termination and notification to the DRE.

### **Need for Licensees to Stay Current**

All real estate licensees should stay current in their area(s) of expertise by reading industry publications and completing continuing education requirements as prescribed by the DRE.

### **Risk is Ongoing and Reduced Through Proper Training, Supervision, and Enforcement of Office Policies**

As mentioned earlier, risk reduction is a constant and ongoing process and can be reduced by training, supervision of agents, and enforcement of office policies.

Next is a look at risk management and the consumer.

## **Risk Management and the Consumer**

Risk Management and the Consumer investigates the impact of the consumer's increased access to information and the consumer's demand for greater value from a licensee's services. Licensees are custodians of the public interest when conducting licensed activities and have fiduciary duties to the consumer.

### **Impact of the Consumer's Increased Access to Information and the Consumer's Demand for Greater Value from a Licensee's Services**

With the advent of the internet, information is much more accessible than ever before. For this reason consumers are demanding more value from their agents.

Agents bring several things to a real estate transaction:

1. Knowledge of the contracts.
2. Knowledge of the disclosures.
3. Knowledge of the real estate market.
4. Knowledge of financing.
5. Knowledge of inspections and repairs.
6. Buffer zone between the seller and buyer.
7. Negotiator and advocate for their client in the transaction.

### **Licensees are Custodians of Public Interest When Conducting Licensed Activities**

Real estate licensees are custodians of the public's interest when conducting licensed activities. For this reason, the DRE takes its regulatory duties very seriously.

An agent who harms members of the general public and then skips town and does not pay any judgments against them, is definitely the exception and not the rule in California.

The DRE has a Recovery Fund or Recovery Account that can be used by members of the general public who have un-collectable judgments against a licensee. Part of all license fees go into the Recovery Fund. If there is an un-collectable judgment against a real estate licensee, the consumer who was harmed may collect up to \$20,000 from the fund. However, the DRE will pay a maximum of \$100,000 for each licensee. So if there are more than five consumers harmed by the licensee, the sixth will receive nothing ( $5 \times \$20,000 = \$100,000$ ).

### **Fiduciary Responsibility**

An agency relationship gives rise to a fiduciary duty of utmost care, honest, integrity, and loyalty of the agent to the principal. This is a higher standard of care that the agent must exercise when acting for his principal. Fiduciary obligations include truth, confidentiality, and competence. A real estate agent has a position of trust and generally acts as a fiduciary.

The following are two major breaches of an agent's fiduciary duty to his principal:

1. A listing agent informed the buyer that the seller will take less money for the property. This is a breach of fiduciary duty to the seller.
2. A selling agent cannot reveal anything negative about his buyer to the seller. This is a breach of fiduciary duty to the buyer.

Next is a look at the legal responsibility placed on real estate licensees.

## **Legal Responsibilities**

Legal responsibilities include vicarious liability for individuals, supervisors, and the company; statutory duties and responsibilities for licensees; legal claims based on mediation, arbitration, and litigation; license discipline; the Real Estate Commissioner; claims stemming from self-regulation, such as grievances/arbitration; and the district attorney and criminal courts.

### **Vicarious Liability for Individual, Supervisor, and Company**

If a salesperson does something unethical or illegal, the salesperson and the broker are both liable. If the broker does something unethical or illegal the salesperson is NOT liable for the broker's action.

### **Statutory Duties and Responsibilities of the Licensee**

There are many statutory duties for licensees that have been imposed by the State Legislature. Some duties to consider are disclosure of material facts, agency disclosure, and natural hazards disclosure.

### **Legal Claims Resolved by Mediation, Arbitration, or Lawsuit**

Legal claims between licensees and principals can be resolved by mediation, arbitration, or litigation (lawsuit). Mediation is voluntary.

A mediator hears the case and makes a determination. The mediator's ruling is non-binding.

An arbitrator hears the case and makes a determination. His determination is binding between both parties. Both the buyer and seller must agree to the type of dispute resolution used by initialing the arbitration clause in the purchase agreement and/or listing agreement. A binding arbitrator (usually a former judge or real estate attorney with at least five years experience) hears the case and makes a determination. There is generally no appeal—and arbitration can cost more than litigation.

In litigation, a judge or jury hears the case. They make a determination and there may be an appeal process. Generally the trial courts hear the case, and the one of the appellate courts in California reviews the case on appeal. The three appellate court justices check the rules of law that relate to the trial court's decision.

In lieu of litigation, both plaintiff and defendant may agree to alternative dispute resolution which entails mediation of the dispute. This is generally a cheaper and easier way to decide the matter.

### **License Discipline by the Department of Real Estate**

The Real Estate Commissioner suspends and revokes real estate licenses. When an agent has done something wrong, the Real Estate Commissioner first issues an accusation. The licensee can then plead his case and the Commissioner may suspend his license for a certain period of time or revoke it entirely. The DRE Bulletin is now published on their website and lists all of the agents who are in trouble.

### **Real Estate Commissioner**

The Real Estate Commissioner is appointed by the Governor of the State of California. The Real Estate Commissioner has primary regulatory authority over all real estate subdividers and licensees in California.

The Real Estate Commissioner revokes real estate licenses. In addition, the Commissioner issues cease and desist orders to subdividers who do not follow the real estate laws.

The Real Estate Commissioner will start an action against a licensee with an injunction and has three years to take action on a violation.

The maximum fine the Real Estate Commissioner can levy against a broker who pays an unlicensed person for soliciting borrowers or negotiating loans is \$10,000.

### **Claims Stemming from Self-Regulation of the Real Estate Industry, Such as Grievance/Arbitration**

The National Association of Realtors (NAR) is a national industry group associated with the California Association of Realtors (CAR) and local associations. A licensee MUST be a member of NAR to call themselves a "Realtor."

If a licensed real estate broker is not a member of the California Association of Realtors or the National Association of Realtors and in his advertising he indicates that he is a Realtor, he is subject to disciplinary action by the Real Estate Commissioner.

Should a dispute regarding a commission arise between two sales licensees who are members of the National Association of Realtors, by provisions of that organization's Code of Ethics they will settle the matter by arbitration.

Misuse of the name "Realtor" is a violation of the California Real Estate Law.

### **District Attorney and the Criminal Courts**

The district attorney would prosecute a non-licensee who performs acts required by a real estate license. In the event a non-licensee performs an act for which a license is required, the party

that would prosecute the non-licensee is the district attorney in the county where the activity occurred.

For example Jones, who does not have a real estate license, is the owner and president of an investment firm. He advertises and sells properties for his clients. Since these transactions involve real estate, the district attorney will prosecute him for violating the real estate law.

Risk management is a critical area for real estate licensees to consider in all of their real estate endeavors. The Risk Management course has been designed to address some of the most pressing areas that confront licensees on a day-to-day basis and it is hoped that real estate licensees will be able to reduce their risk in today's litigious environment.

This concludes our three (3) hour continuing education course in Risk Management.

