PREFACE:

This is the textbook for our course, *Risk Management*. It is one of the five, three-hour courses required by the California Department of Real Estate (DRE):

1. **Ethics**: Describes the real estate license law governing the conduct of licensees and the *Code of Ethics and Professional Conduct* practiced by members of the National Association of REALTORS®.

2. **Agency**: Details the *Law of Agency* as it applies to California real estate brokerage.

3. **Trust Funds**: Describes the fiduciary responsibilities of brokers when acting as escrows for their clients' real estate transactions.

4. **Fair Housing**: Details the federal and California fair housing laws.

5. **Risk Management**: Helps licensees avoid litigation.

The DRE requires each licensee to take all five courses when renewing their license for the first time. These five courses are all that are required for salespersons renewing for the first time but brokers renewing for the first time must take an additional 30 hours of continuing education (CE). All licensees renewing after the first time must take 45 hours of CE which may include these five courses for full credit.

Two of the five courses, *Agency* and *Trust Funds*, are based on chapters from the DRE's *Reference Book – A Real Estate Guide* (available from DRE's website, [www.dre.ca.gov](http://www.dre.ca.gov)). The other three courses; *Ethics*, *Fair Housing*, and *Risk Management*; were written by 45HoursOnline and are therefore copyrighted with all rights reserved.

To save space and make the text more readable, we use the following abbreviations and terms:

- **BPC** The *Business and Professional Code of California*.
- **CFR** *Code of Federal Regulations*.
- **Code** NAR®'s *Code of Ethics and Professional Code*.
- **DRE Reg.** The DRE Commissioner's *Regulations*.
- **USC** The *United State Code*.

You can find the California code at [www.leginfo.ca.gov/calaw.html](http://www.leginfo.ca.gov/calaw.html). Unless otherwise stated, all cases cited in this course are California appellate court cases which can be found on [http://www.findlaw.com/cacases/index.html](http://www.findlaw.com/cacases/index.html).

We use margin notes to provide definitions and short footnotes. We use this symbol ☞ to direct your attention to an adjacent margin note.

Side bars like this one are used for notes too long to be placed into the margins.
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Real estate brokers are almost always paid only when escrow closes. Selling isn’t easy. Buyers want a dream house at a bargain price; sellers overvalue their homes. Title insurers, inspectors, lenders, geologists, and appraisers are all potential deal killers. The unexpected happens with regularity – mortgage rates increase, crazy neighbors intervene, building defects come to light.

When a problem gets in the way of a deal, the temptation to obscure, over promise, conceal, misrepresent, or lie can be tempting. Should the broker balk at bending the rules, he knows there are many among his 530,000 (as of 2007) fellow California licensees willing to do so.

The real estate brokerage profession is an ethical minefield through which the busy broker must step through every day. Sad to say, many licensees give in to temptation and go over to the “dark side”; they tarnish the profession making it more difficult for honest real estate professionals to do business.

This course is about professional conduct in the real estate brokerage profession and the California license law which helps to enforce it.

Over generations brokers have developed standards which, when known to all and practiced by the overwhelming majority of licensees, benefit everyone involved: members of the profession, their principals, and the public at large.

This course discusses two parallel but independent standards of professional conduct aka “ethics”:

1. California Real Estate License Law (The “License Law”): As described in the Business and Professional Code (BPC) and implemented by the DRE Regulations, and

2. NAR®’s Code of Ethics (The “Code”): As described in its 17 Articles and associated “Standards of Practice”.

The License Law is enforced by the Commissioner whose power includes the right to suspend and revoke licenses; the Code is enforced by the National Association of REALTORS® to sanction its members who violate its Code. However, licensees should never forget that they are also subject to two other independent standards with considerably more bight than the Commissioner or NAR®: namely civil and criminal law; civil law enforced through law suits and criminal law through prosecutions. Civil and criminal law are not the subject of this course. (The Law of Agency, a subset of the civil law, is the subject of our course Agency.)

The course proceeds as follows:
In the remainder of this section we discuss ethics in relation to morals and the law.

In the second section, we describe California real estate license law; the law which empowers the DRE Commissioner to license individuals to practice real estate brokerage in California and to revoke or suspend the licenses of individuals found guilty of dishonesty, fraud, or incompetence.

Section three is the heart of the course, an annotated presentation of the National Association of REALTOR®’s Code of Ethics as practiced by over one million REALTOR®’s throughout the nation. We also compare the Code to the License Law where the code and the License Law speak to the same issue and we describe how NAR® enforces its Code on its fellow members.

1.2 ETHICAL IDEAL

The underlying foundation of both the Code and License Law is this simple principal: The real estate agent must use his skills and resources to benefit his client. A body of law has evolved over the centuries to fully describe this principal: the Law of Agency (see our course, Agency).

As an agent, the ideal real estate broker gives no thought to his commission or his own self interests but subordinates his personal objectives completely and irresolutely to that of his clients WHILE treating all other parties honestly.

In his dealings with the public, he follows the Golden Rule, “Do not do unto others as you would not have them do unto you”.

His client may be a back-stabbing ingrate of low moral worth BUT the ideal agent is his samurai; true and loyal.

1.3 FINDING THE LAW

The License Law discussed in this course is mostly from the California Business and Professional Code (BPC) and to a lesser extent, the Civil Code. These two codes together with all California codes can be found at www.leginfo.ca.gov/calaw.html. The regulations the DRE has written to implement License Law, called the DRE Regulations, can be found at www.dre.ca.gov/relaw_pdf/Regs.pdf.

1.4 LAW OF AGENCY

The Law of Agency as applied to the California real estate brokerage business is discussed at length in our course, Agency. However, since we make numerous references in this course to the Law we need to take a moment and summarize the Law of Agency and to contrast its importance with Real Estate License Law and NAR®’s Code of Ethics.
“Agency” is an area of law dealing with a contractual or quasi-contractual relationship between at least two parties: one, the principal, authorizes the other, his agent, to represent his interests in a specified matter.

Agency relationships are everywhere. An employee is the agent of his employer, i.e., his principal. An attorney is the agent of his principal, e.g., a criminal defendant. And a listing broker is the agent of his seller, i.e., his principal.

The common Law of Agency has been compiled by legal scholars into a book, the Restatement of the Law of Agency. It is not law but a guide used by law makers, judges, and other scholars.

The Law of Agency is not to be found fully rendered in the State Code, rather it is a set of legal principals that have evolved over the centuries and which are used by law makers to design laws to regulate specific professions. The Law of Agency is also used by civil courts to resolve disputes between clients, principals, and third parties. Typical disputes in the real estate brokerage profession are:

- Does a seller bear “vicarious” liability for damage resulting from misrepresentations made by his listing agent?
- Does a listing agent violate his duty of loyalty if he fails to present an offer from another agent he believes untrustworthy?
- Should a listing agent be held liable for the financial loss realized by his client should his agent reveal confidential information?

A current controversy in the brokerage profession is whether buyer’s representatives are agents in the legal sense. Unlike listing agents, buyer’s representatives usually do not have a contractual relationship with their prospective buyer and their fees are almost always paid not by the buyer (the agent’s client) but by the seller.

This question of whether a buyer’s representative is really a legal agent is an important one for if he is an agent then he can be sued for abrogating his legal duties as an agent.

Another current controversy in the brokerage business is the awkward institution of “dual agency”; that is, the representation of both the seller and buyer simultaneously – two clients who, after all, are natural antagonists with respect to price.

Imagine dual agency in other professions: an attorney representing both the plaintiff and the defendant in a civil case; a doctor representing both his patient and his patient’s insurance company; and try to imagine how the brokerage business would function if an appraiser represented both the lender and the real estate agent who recommended him.

Many issues concerning agency in the brokerage business have been settled by the DRE Regulations but keep in mind that the worst discipline the Commissioner can impose is to revoke the offender’s license. Similarly, many agency issues have been settled among REALTORS® in their Code of Ethics; but do realize that the worst discipline that can be applied by a Professional Standards Committee is to expel the offender from NAR®.

Beyond the jurisdiction of the Commissioner and NAR®’s self regulation the Law of Agency applies. In a civil proceeding, a defendant found liable for violating the Law of Agency can lose everything he owns.
The Real Estate License Law (or “License Law”) is the State law designed to protect the public from fraud, dishonesty, and incompetence in the purchase and sale of real estate. The text of the law is found mostly in the Business and Professional Code (BPC §10000 et seq.) and its derivative law, the DRE Regulations (based on the BPC). License Law is enforced by the Commissioner primarily by the Commissioner’s power to suspend and revoke the licenses of licensees who violate it.

The Commissioner grants real estate licenses. The most common acts that require a license are set forth in BPC §10131 and include any participation, in person, on telephones or other electronic means in arranging the sale of real property in California once the buyer and seller have been brought together.

2.1 THE FOUNDATION: BPC §§10176, 10177

This section is Chapter 1 of the DRE’s Reference Book, A Real Estate Guide. All section references (“§”) are to the Business and Professional Code, or “BPC”. Sidebars (paragraphs in shaded boxes) contain our comments.

§10176 and §10177 of the BPC constitute the foundation for most license suspensions or revocations. §10176 is concerned with the actions of a real estate licensee performing or attempting to perform any of the licensed acts within the scope of the Real Estate Law. As a general rule, the licensee must have been acting as an agent in a real estate transaction before the section will apply. The provisions of some parts of §10177, on the other hand, will apply to situations where the licensee was not necessarily acting as an agent. The following is a brief discussion of the various grounds for disciplinary action against a licensee and the reasons for which a real estate license may be denied:

Misrepresentation. §10176(a)
Many complaints received by the Commissioner allege misrepresentation on the part of the broker or salesperson. Included also as a cause for discipline under this section is failure of a broker or salesperson to disclose to his or her principal material facts of which the principal should be made aware. If the misrepresentation was not important, and the person to whom it was made would have proceeded with the transaction anyway, the misrepresentation probably would not be material. However, an Attorney General’s opinion holds that damage or injury need not be present to support an action under this section. The reason is that the California Real Estate Law concerns the conduct of licensees rather than the settling of disputes about damages or injuries between licensees and their clients.

False promise. §10176(b)
A false promise and a misrepresentation are not the same thing. A misrepresentation is a false statement of fact. A false promise is a false
statement about what the promisor is going to do. Many times a false promise is proved by showing that the promise was impossible to perform and that the person making the promise knew it was impossible.

**Continued misrepresentation. §10176(c)**
This section gives the Commissioner the right to discipline a licensee for “a continued and flagrant course of misrepresentation or making of false promises through real estate agents or salespersons”.

**Dual agency. §10176(d)**
Failure to inform all principals that the licensee is acting as agent for more than one party in the transaction.

**Commingling. §10176(e)**
Commingling takes place when a broker has mixed the funds of a principal with the broker’s own money. (Conversion is misappropriating and using principal’s funds. Conversion, of course, can be a more serious offense.)

**Definite termination date. §10176(f)**
Failure to include a specified termination date on all exclusive listings relating to transactions for which a real estate license is required. The exclusive listing itself must be clear as to expiration.

**Secret profit. §10176(g)**
Secret profit cases usually arise when the broker, who already has a higher offer from another buyer, makes a low offer, usually through a “dummy” purchaser. The broker then sells the property to the interested buyer for the higher price. The difference is the secret profit. (See 2.6.1 for a related DRE article on "Undisclosed Compensation").

A better definition of “secret profit” is any direct income derived from a sale which is not known to the agent’s principal.

**Listing-option. §10176(h)**
A licensee who has used a form which is both an option and a listing must inform the principal of the amount of profit the licensee will make, and must obtain the written consent of the principal approving the amount of such profit, before the licensee may exercise the option. This section does not apply where a licensee is using an option only.

**Dishonest dealing. §10176(i)**
“Dishonest dealing” is a sort of catch-all section similar in many ways to Section 10177(f). The difference is that under §10176(i) the acts must have been those requiring a license, while there is no such need under §10177(f).

**Signatures of prospective purchasers. §10176(j)**
Brokers must obtain a written authorization to sell from a business owner before securing the signature of a prospective purchaser to any agreement providing for compensation to the broker if the purchaser buys the business.

A broker can not contract with a buyer to receive a commission for the sale, lease, exchange, or rent of a property not already listed.
Obtaining a license by fraud. §10177(a)
Misstatements of fact in an application for a license; procurement of a license by fraud, misrepresentation, or deceit (e.g., failure to reveal a previous criminal record).

Convictions. §10177(b)
Criminal conviction for either a felony or a misdemeanor which involves moral turpitude and is substantially related to the qualifications, functions, or duties of a real estate licensee. A court has defined moral turpitude as "everything done contrary to justice, honesty, modesty, or good morals".

False advertising. §10177(c)
Includes subdivision sales as well as general property sales.

Violations of other sections. §10177(d)
This section is the Department’s authority to proceed against the licensee for violation of any of the other sections of the Real Estate Law, the Regulations of the Commissioner, and the Subdivided Lands Law.

Many of these “other sections” are summarized in the below section.

Misuse of trade name. §10177(e).
Use of any trade name or insignia of membership in any real estate organization if the licensee is not a member of that organization.

Conduct warranting denial. §10177(f)
An essential requirement to the issuance of a license is that the applicant be honest and truthful. If any of the acts of a licensee establish that a licensee is not possessed of these characteristics, §10177(f) will apply. This section also provides for disciplinary actions when a real estate licensee has either had a license denied or a license issued by another agency of this state, another state, or the federal government, revoked or suspended for acts which if done by a real estate licensee would be grounds for the suspension or revocation of a California real estate license.

Negligence or incompetence. §10177(g)
The Department proceeds in those cases where the licensee is so careless or unqualified that to allow the licensee to handle a transaction would endanger the interests of clients or customers.

Supervision of salespersons. §10177(h)
Disciplinary action may result if a broker fails to exercise reasonable supervision over the activities of the broker's salespersons.

Violating government trust. §10177(i)
Using Government employment to violate the confidential nature of records thereby made available.

Other dishonest conduct. §10177(j)
Any other conduct which constitutes fraud or dishonest dealing.

Restricted license violation. §10177(k)
Violation of the terms, conditions, restrictions and limitations contained in any order granting a restricted license.
Inducement of panic selling. §10177(l)
To solicit or induce the sale, lease, or the listing for sale or lease, of residential property on the grounds, wholly or in part, of loss of value, increase in crime, or decline in the quality of the schools due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry or national origin.

Before the passage of the California Fair Employment and Housing Act in 1963 and the federal Fair Housing Act in 1968, panic selling was legal. See our course, Fair Housing.

Violation of Franchise Investment Law. §10177(m)
Violation of any of the provisions of the Franchise Investment Law (Division 5 commencing with §31000) of Title 4 of the Corporations Code or any regulations of the Corporations Commissioner pertaining thereto.

Violation of Corporations Code. §10177(n)
Violation of any of the provisions of the Corporations Code or of the regulations of the Commissioner of Corporations relating to securities as specified in §25206 of the Corporations Code.

Failure to disclose ownership interest. Section 10177(o)
Failure to disclose to buyer the nature and extent of ownership interest a licensee has in property which is the subject of a transaction in which the licensee is an agent for the buyer. Also, failure to disclose such ownership on the part of licensee’s relative or special acquaintance or entity in which licensee has ownership interest.

What is not a cause of action for the Commissioner to revoke a license: A) being named a defendant three or more times in a civil case, B) failure to disclose that licensee owns the property he is selling, C) informing a neighborhood that Rastifarians are moving in, D) using REALTOR® after one’s name without being a member of NAR®.

2.2 OTHER PENALTY SECTIONS OF THE BPC

There are additional sections in the BPC which provide for the revocation or suspension of licenses. Many of these violations could be included under §10177(d) of the law. The following are brief summaries of violations sited, other than §10176 and §10177 (described above) by the DRE for disciplinary action in four quarterly issues of the Real Estate Bulletin during 2003:

The top ten most common violations found in DRE audits (see http://www.dre.ca.gov/topten.htm) are indicated with their rank appearing in column 2 of the below tables.

Violations of the DRE Regulations

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<th>Description</th>
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<tr>
<td>2715</td>
<td>Failure to maintain current business or mailing address with DRE.</td>
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<tr>
<td>2725</td>
<td>Failure of broker to exercise reasonable supervision over the activities of his salespersons.</td>
</tr>
</tbody>
</table>
2726  Failure to have broker/salesperson agreements.

2731  2 Failure to obtain a license for a fictitious business name.

   This regulation states that a licensee shall not use a fictitious name in the conduct of any activity for
   which a license is required unless the licensee is the holder of a license bearing the fictitious name.

2732  Making unauthorized use of a fictitious business name.

2752  Failure of a broker to notify DRE of a salesperson’s employment.

2831  3 Failure to properly maintain trust fund records.

   This regulation specifies minimum standards for the accounting of trust fund records (these are
   thoroughly discussed in our course, Trust Funds).

2831.1  4 Failure to provide a separate record for each beneficiary or transaction.

   This action is a specific infraction of the above-mentioned 2831 regulation.

2831.2  5 Failure to reconcile trust fund accounts.

   This action is a specific infraction of the above-mentioned 2831 regulation.

2832  7 Failure to properly handle trust funds.

   This regulation specifies that all trust funds be promptly deposited into a trust and specifies other
   procedural details such as how interest is to be allocated.

2832.1  6 Failure to properly account for multiple beneficiaries.

   This regulation requires that the balance of the bank account used for the trust fund not be smaller than
   the total liability of the trust fund (i.e., incur a trust fund shortage). For example, if the broker’s trust
   fund accounting report indicates that the broker owes his beneficiaries $1,000 but only $400 is found in
   the trust fund account, then there is a shortage of $600. The regulation allows the broker an exemption
   providing all trust fund owners have given their written authorization that the shortage is with their
   consent.

2834  8 Improperly making a trust account withdrawal.

   This regulation specifies that only the broker, as trustee, or his designated sub-agents may make a
   withdrawal from a trust account.

2835  9 Commingling the broker’s personal funds in a trust account.

   Brokers are permitted to have no more than $200.00 of their own money in a trust fund account.

2840  Failure to give borrower the Mortgage Loan Disclosure Statement.

2846.5  Failure to comply with annual trust fund accounts review requirements.

2950(d)  Failure of broker handling escrow to deposit trust funds in a trust account.

   See 2.6.2 below for a discussion concerning the escrow services brokers may perform.

2950(g)  Failure of broker to disburse funds with written instructions.

2950(h)  Failure of broker handling escrow to deposit trust funds in trust account.

2951  Failure to properly keep records for broker-handled escrows.

2970  Failure to submit advance fee material for review.

   See note for BPC §10085 in below table for an explanation of “advance fee material.”
2972  Failure to properly account for advance fees.

**BPC Violations**

490  Having been convicted of a crime related to the qualifications, functions, or duties of a licensee.

10085  Failing to submit advance fee materials

> Advance fee agreements are contracts to collect fees before a service is rendered. The Commissioner requires that all such agreements or advertisements which promote services performed under such agreements be submitted to the DRE for approval at least ten days prior to their use.

10130  Performing real estate brokerage without a license.

10137, 10138  Employing or compensating an unlicensed person to perform acts requiring a license.

> See the article at 2.6.3 below for an important exception – paying a commission to an out-of-state broker.

10140  Falsely advertising land or subdivision.

10140.6  Failing to disclose advertiser’s status as a licensee when advertising unlisted properties.

10142  Failing to give a copy of a contract to the party signing it at the time it is signed.

10145  Violating licensee’s fiduciary duty to properly handle trust funds.

10146  Failing to deposit an advance fee into a trust account.

10148  Failing to retain documents pertaining to real estate transactions.

> This law requires brokers to maintain all listings, deposit slips, canceled checks, trust records, and other documents executed by the broker for at least three years and to make these records available to DRE auditors during business hours.

10159.2  Failing to supervise the licensed acts of a corporation by the licensee designated as its corporate officer.

10159.5  Failing to obtain license with fictitious business name.

10160  Failing to retain the licenses of salespersons in the broker’s employ.

10161.8  Failing to notify DRE when a salesperson is employed or terminated.

10162  Failing to maintain a place of business in the State.

> This law requires each licensed broker to maintain an office where he displays his license and transacts all business. His office address must correspond to that on his real estate license.

10163  Failing to procure branch office licenses.

10177.4  Receiving compensation for referring customers to escrow, pest control, home warranty, title insurer or underwritten title company, or controlled escrow company.

> Escrow companies are classified as “Licensed” or “Controlled.” Licensed escrow companies are licensed by the Department of Corporations and most follow their regulations. Controlled escrow companies are non-licensed businesses owned by real estate brokerages, mortgage brokerages,