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PREFACE:

This is the textbook for our course, *Risk Management, 2nd Edition*. It is one of the five, three-hour courses required by the California Bureau of Real Estate (BRE) for licensees renewing their license for the first time:

1. **Ethics**: Describes the real estate license law enforced by the BRE and the *Code of Ethics and Professional Conduct* as practiced by members of the National Association of REALTORS®.

2. **Agency**: Explains the common law of agency as applied to California real estate brokerage.

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

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

5. **Risk Management**: Instructs licensees on how to avoid disputes with their clients arising from professional errors and omissions.

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

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>BPC</td>
<td>The Business and Professional Code of California</td>
</tr>
<tr>
<td>BRE</td>
<td>Bureau of Real Estate (as of July 2013, the Bureau of Real Estate)</td>
</tr>
<tr>
<td>CAR®</td>
<td>California Association of REALTORS®</td>
</tr>
<tr>
<td>CC</td>
<td>Civil Code of California</td>
</tr>
<tr>
<td>HOA</td>
<td>Home Owners Association</td>
</tr>
<tr>
<td>MLS</td>
<td>Multiple Listing Service</td>
</tr>
<tr>
<td>NAR®</td>
<td>National Association of REALTORS®</td>
</tr>
</tbody>
</table>

You can find the California codes at [www.leginfo.ca.gov/calaw.html](http://www.leginfo.ca.gov/calaw.html). Unless otherwise stated, all cases cited herein are California cases. In citing cases, we specify only the names of the litigants and the year of the decision (the text of all decisions are available online).

The forms cited in this course are from CAR®.

In addition to the above terms and abbreviations, we also follow a few typographic conventions.

We use margin notes to display pictures, provide definitions, and for short notes.

Side bars like this one are used for long notes. Content in the margin notes, side bars, and in the appendices is not tested in the final exam.

Opinions of the author are displayed against a light green background and may be ignored.
First 15 pages only.
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INTRODUCTION

We recommend you take this course after you have completed our other three-hour courses (Ethics, Agency, Trust Funds, and Fair Housing). This course builds on topics described in these four other courses.

This three-hour course will help you, a California residential real estate agent, reduce the likelihood and intensity of disputes with your clients. Specifically, this course is concerned with disputes in which your clients claim damages resulting from your professional errors and omissions. This course is not concerned with disputes that arise from intentional wrongdoing such as fraud, theft, and illegal discrimination.

This course explains but does not focus on your legal responsibilities towards your clients. In the event of a dispute, your ability to prove your actions were legal is a defense – a good defense – but our focus is on how to avoid the dispute in the first place.

The topics covered in this course are mandated by the BRE (see these guidelines for details). Most of BRE’s 50 mandated topics are also covered in our other four three-hour courses: (1) Ethics, (2) Agency, (3) Trust Funds, and (4) Fair Housing.

A challenge in writing this course was to arrange the 50 topics into a logical sequence while keeping the course content to the minimum length allowed by the BRE – thirty pages. The first of the two sections in our 30-hour Consumer Protection Reader course, “Defensive Real Estate,” is an extension of this course.

This course was last updated June, 2013.

1.1 TERMS

Before beginning, we need to define a few terms.

By “dispute” we refer to any disagreement in which your client claims you owe him restitution for damages suffered as a result of your professional errors and omissions.

Disputes may be resolved directly by the parties involved via negotiation or through neutral third-parties via mediation, arbitration, or civil litigation.

By “clients,” we refer to buyers and sellers to whom brokers owe fiduciary duties based in statute, contract, or common law.

By “damages” we refer to any compensation awarded to the injured party including money judgments (dollars), injunctions, orders for specific performance, and declaratory relief.

By “brokers,” we refer to residential real estate broker and corporate licensees and their employees and agents.

Corporate Licenses: The BRE licenses corporations to act as brokers. Corporations appoint a licensee as its “designated officer” who must be a licensed broker when initially appointed.

Injunction: A court order prohibiting a party from a specific course of action.

Declaratory Relief: A judge’s determination of the parties’ rights under a contract or statute.
1.2 CLIENT SATISFACTION

Our basic premise:

If your client becomes unhappy with his purchase, you are at risk of being sued.

Your client may be unhappy with the condition of his home, his interest rate, his new neighbors, or his new neighborhood. The reasons for his unhappiness may be logical or not; or reasonable or not. It doesn’t really matter: when your client is unhappy you are at risk of being sued.

1.3 WHAT IS RISK?

By “risk” we refer to the probability your client will become unhappy with his transaction. Examples of risky circumstances are your ...

- buyer discovers his new home has far less square footage than he was led to believe.
- seller discovers his house sold for considerably less than its market value.
- buyer hears roosters crowing in his neighbor’s yard.
- seller who carries a second learns his mortgagee is unemployed.

When your client becomes unhappy, he will do what is our human nature, he will blame you for his misfortune and demand restitution.

1.4 PREVIEW

In Section 2 we describe your responsibilities to your client and third parties and your client’s right to be compensated for injuries caused by your errors and omissions. We also describe dispute resolution methods and BRE’s enforcement tools.

In Section 3 we describe two major areas of risk: (1) the risk of negligent misrepresentation and (2) the risk of dual agency. We also describe several other areas of relatively smaller risk.
2 FIDUCIARY DUTIES

The Law of Agency describes your responsibilities to your client and third parties (your client’s counterparty and other stakeholders in the transaction).

There is no single book which describes the “Law of Agency.” Much of the Law is written into the California Codes but most of it is “common law.” Common law, sometimes called “judge-made law,” refers to all prevailing decisions by State appellate courts which clarifies existing law (both statute and common law).

Common law is sometimes clarified and enacted into statute by the State legislature. A well-known example is the Easton v. Strassburger (1984) decision. In that case the California Appellate Court ruled that listing brokers have a duty to visually inspect their properties for defects and disclose those defects to prospective purchasers.

The Easton decision created a new but ambiguous duty for listing brokers: the duty to investigate and disclose. Following the decision, brokers wondered if they could be held liable for latent defects, title defects, neighborhood nuisances, or defects concealed by the seller. To resolve these ambiguities, the California legislature clarified Easton by passing AB 1034 in 1986. That law was then encoded into the Civil Code at §2079.

The direction in which the common law of real estate agency is evolving is to hold brokers to increasingly higher standards of professionalism. While the broker of twenty years ago may have been merely a facilitator between buyer and seller, today he is almost a guarantor of the transaction.

To understand your common law duties, you must understand (1) when an agency is created, (2) the scope of your agency, (3) the standard of care you must render, and (4) your duties as a fiduciary.

2.1 WHO’S WHO

Terms of Cooperation: The commission split between the listing agent and the selling agent and other conditions required by the seller or agent concerning the sale.

The listing agent (aka, “seller’s agent”) is the agent who signs a listing agreement with the seller. Ordinarily the listing agent offers to cooperate with any agent who procures a buyer. His terms of “cooperation” are published in his realty board’s MLS.

The selling agent (not to be confused with the “seller’s agent”) is the agent who procures the buyer. If he represents only the buyer, we call him the buyer’s agent. If the selling agent does not represent the buyer but instead is a subagent of the selling agent, we call him the cooperating agent.

It is often the case that the buyer is unsure who his selling agent represents; that is, to whom his selling agent owes the fiduciary duties of utmost care, integrity, and loyalty. The most common possibilities are that the selling agent: (1) represents the buyer only, (2) the seller only, or (3) both buyer and seller. Less common possibilities are that the selling agent
represents (4) himself, or (5) a third party (e.g., a bank, a lender, an investor, an estate, an HOA).

To make the agency relationships clear to all involved parties, CC §2079 requires the use of the agency disclosure form (discussed later).

In this course we use the terms “agent” and “broker” interchangeably. We use the term "principal" to refer to the buyer, the seller, or to both buyer and seller. We use the term "counterparty" to refer to the buyer in relation to the seller, or to the seller in relation to the buyer.

2.2 LAW OF AGENCY

Originally, the California law of real estate agency was based on the traditional agency model. That model recognized agency only for the seller and left the buyer unrepresented.

In the traditional agency model, the agency relationship is established between the listing broker and the seller via a listing agreement. In that agreement, the seller authorizes the broker to market his property to other brokers via the MLS and to extend agency to cooperating brokers for a share of the sales commission. In this model, the cooperating broker is called the “selling broker” and is the agent of the seller. The cooperating broker therefore has “fiduciary” duties to the seller and not to the buyer.

Most of the Code is quoted and discussed in our Ethics course.

The traditional agency model was the norm in the early 1900’s when NAR® first published its Code of Ethics. Although the model worked well for REALTORS®, it created problems for buyers and sellers because …

1. buyers were left unrepresented,
2. sellers were vicariously liable for the negligent actions of both their listing broker and all cooperating brokers, and
3. courts imposed unintended dual agency status on both the listing and cooperating brokers after the fact.

To mitigate these problems, NAR® modified its Code and the California legislature enacted laws to give agency protection to buyers.

2.3 AGENCY DISCLOSURE

Before rendering any service, the law (CC §2079.14) requires you to make a formal declaration of your intended agency relationship with your client using the Agency Disclosure Form (CAR® Form AD). The form’s wording is exactly specified in CC §2079.16. CAR® publishes the form under the title “Disclosure Regarding Agency Relationships” and provides two slightly different versions; one subtitled “Listing Firm to Seller”; the other “Selling Firm to Buyer.”
The Disclosure has three purposes: (1) to formally declare your agency relationship with respect to your principal, (2) to inform your principal of your agency duties, and (3) for the selling agent to clarify his agency relationship with the seller.

The AD must be completed in these three situations.

**Case #1: Before signing a listing agreement ...**
Execute the AD with your seller prior to signing your listing agreement.

**Case #2: Before representing the buyer ...**
Present the AD to your buyer when he seeks your services in more than a “casual, transitory, or preliminary manner” (CC §2079.14 (d)).

**Case #3: Before presenting an offer ...**
Present an AD to the seller.

**Case #4: When you change from a single agent to a dual agent ...**
When your relationship with a client changes, execute a revised AD with your client. If the change in your representation status is from single to dual agency, you will have to first obtain your client’s consent to this change and then have him sign a revised AD acknowledging your change from a single to a dual agent (this may be accomplished using CAR’s purchase agreement form).

There are many ways in which your representation status with a buyer or seller may change. Here are some examples:

1. As a buyer’s agent, your buyer wishes to make an offer to a seller you happen to already represent.
2. As a listing agent, a licensee from your brokerage presents you an offer from his buyer.
3. As a buyer’s agent, your buyer wishes to make an offer to an owner whom you subsequently induce to sell with you acting as his agent.
4. Your buyer decides not to buy a home but to list his home with you.
5. As a listing agent, you decide to make an offer to purchase your seller’s home.
6. You start your relationship with the seller as his single agent, switch to dual agency when you find him a buyer, and switch back to single agency when your buyer decides not to purchase your seller’s property.

The first page of the Disclosure explains the duties you owe to your client’s counterparty (i.e., “diligence, care, honesty, good faith, and disclosure”) and the higher fiduciary duties you him (“utmost care, integrity, and loyalty.”). The wording for the second page of the Disclosure (taken directly from CC §2079.14) describes in very small print how to handle exceptional situations as when the buyer’s agent doesn’t deal face-to-face with the seller, when a party refuses to sign the form, or when the buyer’s agent doesn’t write the offer.
One contingency not covered by the form is the situation in which the selling broker represents neither the seller or buyer as would occur if two unrepresented parties (perhaps a FiSBO and his next door neighbor) hired a licensee for the narrow purpose of completing the paperwork needed for the transaction. CC §2079.20 permits exceptions:

Nothing in this article prevents an agent from selecting, as a condition of the agent’s employment, a specific form of agency relationship not specifically prohibited by this article if the requirements of §2079.14 and §2079.17 are complied with.

The cleanest way to establish buyer’s agency is to use a buyer agreement such as CAR®’s Buyer Broker Representation Agreement (Form BR). This form: (1) makes clear to your buyer the duties you owe him, (2) defines your agency as exclusive or non-exclusive, and (3) limits the duration of your agreement.

Dual agency requires the consent of both the buyer and seller; however, in signing CAR®’s residential listing agreement (Form RLA), the seller pre-authorizes his listing agent to act as a dual agent should his agent procure the buyer.

The listing agent must keep the Disclosures for three years. This is required for all documents signed by the agent or obtained by the agent in connection with any real estate transaction (BPC §10148).

As a fiduciary, you are required to perform your duties as you would expect your client to perform those same duties had he your knowledge, experience, and resources. As an agent, you must be selfless in your devotion to your client’s interests. Should you fail to meet this standard, you risk being sued for “breach of fiduciary duty.”

If sued for breaching your fiduciary duties, your client would certainly use your signed agency disclosure form to support his claim that you owed him the fiduciary duties of utmost care, integrity, and loyalty. If you were unable to produce the form, the court would most likely assume that you were in fact the plaintiff’s agent.

BRE’s license discipline includes suspension, restriction, or revocation of your license. The BRE also may impose fines.

If the BRE investigates a complaint from your principal, the BRE would demand to see your agency disclosure. If you were unable to produce it, the BRE would likely subject you to license discipline.

Take care not to declare yourself your principal’s agent if you do not intend or if he does not expect to receive fiduciary duties from you. To do otherwise is to needlessly risk being sued for “breach of fiduciary duty” should your principal subsequently become unhappy with his transaction.

Suppose, for example, you hold an open house. At your open house investor appears who wishes you to immediately submit an all-cash offer to your seller. As the law requires, you first complete an Agency Disclosure Form in which you inadvertently elect dual agency.

When you execute the AD, you have no idea why the investor wants to purchase your seller’s home nor do you ask because you do not consider him your client – only a third-party who wants to make an all cash offer at list for your seller’s home.
Two months after the sale, you are served with a lawsuit from the investor in which he claims that he lost a considerable amount of money owing to your failure to inform him that your seller’s home was subject to a zoning restriction which precluded second story homes. His cause of action is that you breached your fiduciary duties by failing to inform him of the zoning restriction. His complaint cites the AD you signed in which you elected dual agency. He argues that it was your responsibility as his agent to know his reasons for purchasing the home and that as real estate professional familiar with the local market, you would have known (or should have known) that he would not be permitted to add a second story.

### 2.4 Vicarious Liability

With the traditional agency model the seller is legally responsible for not only the negligent acts of his listing agent but also those made by cooperating brokers. This legal responsibility for the acts of another is known as **vicarious liability**. It arises out of the common law doctrine of *respondeat superior* – the responsibility of the superior for the acts of subordinates.

If Alice from Brokerage A cooperates with Bob from Brokerage B to sell Chuck’s house and if Alice innocently misrepresents Chuck’s house as 4000 sq. ft. when it is truly 3000 sq. ft., then Chuck (the seller) would be vicariously liable to the buyer for Alice’s misrepresentation. So even though Chuck may have never met Alice (the cooperating broker), he is liable for her misrepresentation.

Vicarious liability applies only to the negligent acts performed by subordinates made in good faith and within the scope of the superior’s agency.

Suppose Alice had lied when she claimed Chuck’s home had 4000 sq. ft.; then she alone, not Chuck, would be liable for her fraud (assuming, of course, that Chuck had no knowledge of Alice’s deception).

Similarly, a brokerage is vicariously liable for the professional errors made by its agents.

Suppose George works under Sam’s broker’s license and both are sued by George’s seller for negligence. If the court awarded the seller $100K and found George (agent) 99% liable and Sam (broker) only 1% liable, the seller could demand that Sam (broker) pay the entire $100K judgment even though George was judged to be 99 times more liable than Sam.

It is a common practice for attorneys to sue any party with money or insurance no matter how small a role that party may have had in causing his client’s injuries. Under “joint and several liability,” (aka, "Deep Pocket Doctrine") plaintiffs are legally entitled to collect their entire money judgment from any single defendant regardless of that defendants degree of liability

If a brokerage is found vicariously liable for an error made by one of its employees, and if the brokerage is a sole proprietorship, vicarious liability

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In California, money judgments may be collected from any liable defendant regardless of that defendant’s degree of liability. The legal principal which allows this practice is named “joint and several liability.”

Negligent acts are acts which result from a failure to use reasonable care. Lies, frauds, and thefts are *not* negligent acts.

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attaches to the broker/owner; if the brokerage is a corporation, vicarious liability attaches to the corporation.

Put another way, if a plaintiff is awarded a money judgment against a sole proprietorship, the proprietor must pay the judgment from his personal assets (assuming the proprietor does not carry insurance). If instead, a plaintiff is awarded a money judgment against a corporation, the corporation must pay the judgment from its assets. Thus, the personal assets of a broker operating under his own corporation are shielded from damage claims arising out of negligence lawsuits against his corporation.

For example, if Sally is the designated officer for her own corporation, Sally’s Real Estate Inc., and if SRE is found 1% liable for a professional error made by one of SRE’s employees, call him “Dave Deadbeat,” then the plaintiff could collect his entire one million dollar judgment from either SRE or Dave Deadbeat.

If Sally’s personal net worth is 25 million dollars, SRE’s is 25 cents, and Dave Deadbeat’s is minus 25 thousand dollars, both SREI and Dave Deadbeat are essentially judgment proof. The plaintiff could place a one million dollar lien against SRE’s future income (and/or Dave Deadbeat’s future income) but Sally could easily thwart this by bankrupting SRE or starting a new corporate brokerage.

Note: There are many ways the plaintiff’s attorney might “pierce” Sally’s “corporate veil” to find his way into Sally’s deep pocket.

2.5 Scope of Agency

When you exceed the scope of the authority granted by your principal, you assume sole liability for the consequences. Moreover, damages caused by actions you take outside the scope of your authority are not covered by professional liability insurance.

The listing broker’s authority is normally described in his listing agreement with his seller. For example, CAR®’s listing agreement (Form RLA) gives the broker the authority to:

- sell a home at a particular price within a specified time period;
- exercise reasonable effort and due diligence to achieve the sale;
- order reports and disclosures, advertise, and market the home;
- list the home on the MLS and Internet; and
- use a key safe/lockbox.

Before taking any action which might be outside the scope of your authority, you should obtain your client’s written authorization to take that action; otherwise, you risk assuming sole liability for any damages which might result from that action.
Suppose that without your seller’s consent you decided to promote your seller’s home by renting an elephant to be tethered to a tree in your seller’s front yard. Now suppose the elephant got loose and trampled a neighbor’s yard to smithereens. If the neighbor sued both you and your seller, it is likely the judge would grant your seller’s motion to dismiss him from the suit on the grounds that the rental of the elephant was taken without his consent and was outside the scope of the authority he granted you.

If, then, you were subsequently found 100% liable for the damage caused by the elephant, your E&O carrier would not pay any money judgment awarded to the neighbor. Your insurer would argue that the elephant’s rental was outside the normal scope of a broker’s authority and hence not covered by your policy.

### 2.6 STANDARD OF CARE

For your client to prevail in any negligence lawsuit brought against you, he must show you owed him a duty which you failed to provide. Examples of duties a listing broker owes his seller are: (1) obtain fair market value, (2) exercise care during showings, and (3) provide competent advice in evaluating offers.

The sum total of all duties a broker owes his client is called the “Standard of Care.”

The legal definition (CC §2079.2) of Standard of Care …

… *is the degree of care that 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 license …*

Although you may not be an appraiser, real estate attorney, structural engineer, geologist, or home inspector; as a broker you are expected to know much more about their disciplines than your clients. For example, to obtain a broker’s license the BRE requires you to have at least two years experience and to pass eight college-level real estate courses including real estate practice, real estate law, appraisal, real estate finance, and real estate economics. Consequently, a real estate broker is expected to know the fundamentals of these disciplines and to use that knowledge to protect his clients.

NAR’s *Code of Ethics* is often cited as a Standard of Care in civil actions against brokers (see Barbara Nichols’ article, “Commit to the Code” in *REALTOR® Magazine Online*). Some of the most relevant sections of the *Code* are discussed below.

**Article 1:** “When representing a buyer, seller, landlord, tenant, or other client as an agent, REALTORS® pledge themselves to protect and promote the interests of their client.”

Possible violations:

*For an annotated copy of the Code, see our Ethics course.*