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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 Department of Real Estate (DRE). We call these the “Five Mandatory Courses”:

1. **Ethics**: Describes the real estate license law enforced by the DRE 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**: Provides licensees with the knowledge needed to avoid costly disputes with their clients arising from professional errors and omissions in the performance of their duties.

The DRE requires each licensee to take the Five Mandatory Courses before renewing their licenses for the first time. When renewing for the first time, salespersons who received their original (i.e., first) license between October 1st, 2001 and September 30th, 2007 need only these five courses to fulfill their entire continuing education requirement while all other licensees renewing for the first time (brokers, corporations, officers, and salespersons who were awarded their first license on or after October 1st, 2007) need these five courses and an additional 30 hours of CE. Any licensee renewing after the first time, may take any or all of the Five Mandatory Courses again and receive full credit towards their 45-hour CE requirement.

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

- **BPC**: The Business and Professional Code of California.
- **CC**: The Civil Code of California.

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

The forms cited in this course are from the California Association of REALTORS®. We are aware that not all brokerage firms use these forms but we believe they are representative of the forms used in the industry.

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

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

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.
First 15 pages only.
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1 INTRODUCTION

This three-hour course is designed to help you, a California residential real estate agent, reduce the likelihood and intensity of disputes with your clients. Specifically, we are concerned with disputes in which your clients claim to have sustained damages resulting from your errors and omissions in the performance of your duties. We are not concerned with intentional wrongdoing such as fraud, theft, and overt racial discrimination.

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

Why is it more important to avoid the dispute than to follow the law?

- Proving you followed the law can be difficult or even impossible.
- Due to the complexity of residential real estate transactions, an unhappy client can usually find legal fault with some aspect of your conduct no matter how conscientious you may have been in following the law.
- Chance is often a significant factor in resolving disputes.
- If your dispute is resolved through litigation, the standard of proof needed for a client to prove you liable is low – he need only show that it is more likely you were liable than that you were not.
- Litigation is so expensive that in most cases even the prevailing party loses.

1.1 SCOPE

Before beginning, let’s define our terms and scope.

By “dispute” we refer to any process by which a client seeks damages from his agent. Disputes may be resolved directly by the parties involved via discussion and negotiation; or through the use of neutral third-parties using mediation, arbitration, or civil litigation; techniques we refer to as formal dispute resolution.

Strictly speaking, the word “litigation” refers to the process of suing a plaintiff in a court of law. However, in this course we use the terms “sue” and “litigation” to refer to both arbitration and civil litigation.

By “errors and omissions” we refer to losses claimed by clients for injurious acts made in good faith. These are the losses typically covered by professional liability insurance (aka: errors & omissions insurance).

By “clients”, we refer to buyers and sellers to whom brokers owe duties based in statutory, contractual, or common law.
By “residential real estate brokers” we refer to broker licensees or corporation licensees and their employees and agents. Unless we qualify the reference to “brokers” we mean “designated brokers” and their associates whether licensed as salespersons or brokers.

By “damages” we refer to any compensation awarded to the injured party for his losses. Most awards are money judgments but occasionally other forms of relief are awarded such as injunctions, orders for specific performance, and declaratory relief.

1.2 CLIENT SATISFACTION

Our basic premise is:

A transaction becomes risky when your client becomes unhappy with his transaction.

Your client may be unhappy with the condition of his home, the interest rate on his mortgage, his new neighbors and neighborhood. He may be disappointed, upset, resentful, regretful, or even outraged. His reasons may be logical or illogical; rationale or emotional. Practically speaking, it doesn’t matter why your client is unhappy, if he is unhappy you are at risk of being sued.

1.3 WHAT IS RISK?

We define risk narrowly. By “risk” we refer to the probability your client will become unhappy with his transaction as, for example, when your…

- buyer discovers his new home has significantly less square footage than he was led to believe.
- seller discovers he sold his house for a price 20% below its market value.
- buyer discovers his new neighbor boards dogs for a living.
- seller carries a second and learns after close of escrow that his buyer had been unemployed for six months.

When the buyer’s or seller’s expectations are not met, his easiest recourse may be to seek financial compensation from you. If you don’t agree, you have a dispute.

1.4 PREVIEW

In Section 2, we describe your legal responsibilities, including some of the common law, statutory, contractual and fiduciary duties of care owed to
your client and third parties. We also describe the legal rights your clients have to recover damages or obtain other remedies should you breach your duties. We conclude the section with a brief summary of dispute resolution methods including mediation, arbitration, litigation, and DRE license law.

In Section 3, we describe the major areas of risk; namely, the risks of 1) a buyer purchasing a home with undisclosed material defects (“negligent misrepresentation”) and 2) the risks in representing both buyer and seller (“dual agency”). We also discuss several minor but significant areas of risk such as the risks of preparing defective contracts, improper trust fund handling, negligent advice, and inadvertent illegal discrimination.

2

FIDUCIARY DUTIES

When you sign a contract to represent a customer, you create an agency relationship between you and your client (aka, “principal”). Your legal responsibilities to your client are described in the Law of Agency.

There is no single book in which you can find the “Law of Agency”. Much of this law can be found in the California Codes but the better part of it is “common law”. Common law, sometimes called “judge-made law”, refers to all prevailing decisions made by State appellate courts concerning the interpretation of existing law (statute and common law).

Most of our State’s agency laws are in CC §§2295-2369; these sections are entitled “Agency”.

First 15 pages only.

Common law is sometimes clarified and then codified by the legislature into statutory law (i.e., “code law”). The best known example of this clarification and codification process in California real estate law is Easton v. Strassburger (1984). In that case the California Appellate Court ruled that agents were liable to buyers for material defects which they should have known existed and failed to disclose to buyers. Prior to Easton, only the seller was considered liable for undisclosed material defects.

The Easton decision rocked the brokerage profession because it created a new but ambiguous duty for brokers: the duty to investigate and disclose. Could brokers really be held liable for latent defects, for defects in title, for neighborhood nuisances, for defects concealed by the seller? To resolve these questions, the California legislature clarified Easton by passing a law (AB 1034) in 1986 which was subsequently incorporated into the Civil Code beginning 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 a buyer and seller; today he is almost a guarantor of the transaction.

To understand your common law duties, you must understand 1) at what point you assume an agency relationship, 2) the scope of your agency, 3) the standard of care you are legally required to render, and 4) your duties as a fiduciary. All these topics are discussed in the below subsections.
2.1 **WHO’S WHO**

When discussing agency, we need to be clear on terms used to describe the agents involved in a transaction.

*Terms of Cooperation:* The split of the commission between the listing agent and the selling agent and any 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. Usually he publicizes his terms of cooperation in the MLS however he may negotiate special terms with any individual agent.

The **selling agent** (not to be confused with the “seller’s agent”) is the agent who procures the buyer. If he represents the buyer he may be called the **buyer’s agent**.

If the selling agent does not represent the buyer, we refer to him as the **cooperating agent**. If the cooperating agent’s involvement is approved by the seller, then he represents the seller; otherwise he represents the listing agent and may also be called a **subagent** of the seller.

The buyer is often unsure whether the licensee who shows him property and guides him through the transaction is his agent, the seller’s agent, both his agent and the seller’s agent (aka: **dual agent**), or simply just another salesman whose only duty is to make a sale. 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 often use the terms “agent” and “broker” interchangeably.

2.2 **LAW OF AGENCY**

The California law of real estate agency is based on the **traditional agency model** modified by a few California statutes.

The traditional real estate agency model recognizes agency only for the seller and leaves the buyer unrepresented. In this model an agency relationship is established between the listing broker and the seller by the execution of a listing agreement. In that agreement, the seller authorizes the broker to market his property to other brokers using the MLS and to extend agency to cooperating brokers usually for an equal share of the sales commission. In this model, the cooperating broker is called the “selling broker” and is legally the agent of the **seller** – a surprise to most buyers. The cooperating broker therefore has the common law duties of loyalty and good faith to the **seller** and not to the buyer.

The traditional agency model came into common use in the early 1900’s with the creation of NAR®’s **Code of Ethics**. Since at that time only NAR® members could access the MLS and because NAR® members pledged to follow the **Code**, the traditional agency model became very well established across the nation.

The traditional agency model works well for REALTORS® but creates problems for buyers and sellers because...
1. buyers are left unrepresented,
2. sellers are vicariously liable (see next section) for the actions of cooperating brokers, and
3. courts have imposed unintended dual agency status on both the listing and cooperating brokers after the fact.

To mitigate these problems, the California legislature enacted laws to modify the traditional agency model. The most important of these laws were placed into three sections of the California Civil Code:

1. §1102 mandates disclosures for residential real estate transactions,
2. §1103 mandates the disclosure of natural hazards, and
3. §2079 imposes duties owed to third parties and mandates the use of an agency disclosure form (C.A.R.’s Form AD).

2.3 AGENCY DISCLOSURE

We refer only to C.A.R. forms since their forms are used by the vast majority of brokers. Other form suppliers include Peninsula Regional Data Service (used in San Francisco and the Silicon Valley) and First Tuesday.

CC §2079.14 requires you to make a formal declaration of agency to the buyer and seller. The form is exactly specified in §2079.16 and reproduced as C.A.R. Form AD “Disclosure Regarding Agency Relationships”. The form requires both the listing and the selling broker to specify if he is the agent of the buyer, the seller, or if he represents both the buyer and seller.

The purpose of the agency disclosure is to make clear to the buyer and seller the duties owed to them by the listing and selling brokers. For example, if neither the listing nor selling broker is the buyer’s agent or a dual agent, then the buyer is a mere “third party” to the brokers. By this statute (§2079.16) both brokers owe third parties only the following duties:

(a) Diligent exercise of reasonable skill and care in performance of the agent’s duties.

(b) A duty of honest and fair dealing and good faith.

(c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of the parties.

Only if a broker actually represents the buyer or seller does the broker also owe his client the fiduciary duties of “utmost care, integrity, honesty, and loyalty”. These additional duties are considerably more burdensome than the three duties owed to third-parties. Taken together they impose upon the agent the legal requirement to use all his knowledge, skills, and experience for the benefit of his client.

Disclosure of the agency relationship is crucial in resolving later disputes concerning liability. A plaintiff must prove that the defendant broker owed him a fiduciary duty before he can prove that the higher fiduciary standards of care applied and were breached. A timely, complete, and proper
documented disclosure of agency relationships is an important tool for reducing the risk of plaintiffs alleging breach of fiduciary duties.

The distinction between fiduciary and non-fiduciary duties should be clearly understood by the broker when filling out the agency disclosure form. We recommend that dual brokers and cooperating brokers not declare dual agency or buyer’s agency unless they are committed to selfless loyalty to each of their clients and are prepared to make every act benefit their client(s). To unnecessarily accept agency is to unnecessarily expose oneself to subsequent liability (see below subsection, “Duties”).

CC §2079 requires the seller’s broker to make his agency disclosure before entering into the listing agreement and for the buyer’s broker to make his agency disclosure to both the buyer and seller when the buyer “seeks the services of an agent in more than a casual, transitory, or preliminary manner with the object of entering into a real property transaction”. The buyer’s agent must always make his disclosures before writing an offer.

When the seller’s agent and the buyer’s agent are the same person or licensees from the same brokerage (i.e., a “dual agent”), then the agent need give only one form to the seller (before the listing agreement) and another to the buyer (before the purchase offer). All forms must be acknowledged by the buyer or seller and copies retained for three years.

§2079.14 also describes how to handle certain exceptional situations as when the buyer’s agent doesn’t deal face-to-face with the seller, when a party refuses the form, and when the buyer’s agent doesn’t write the offer.

One contingency not covered by §2079.14 is the situation in which the selling broker represents neither the seller or broker 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 does permit 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 C.A.R.’s Buyer Broker Representation Agreement (Form BR). This form: 1) makes clear to the buyer the duties owed to him by his broker, 2) defines the agency as exclusive or non-exclusive, and 3) limits the duration of the agreement.

Dual agency requires the consent of both the buyer and seller; however, C.A.R.’s listing agreement (Form RLA), provides for this consent in advance (see Agency Relationships). An undisclosed dual agency is legal grounds for rescission of the agency agreement and restitution of your commission even if there is no injury.

C.A.R.’s purchase agreement (Form RPA-CA) allows the selling broker to avoid using a separate confirmation form by confirming the agency relationships using the agency confirmation portion of its listing agreement.
2.4 VICARIOUS LIABILITY

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

In the traditional agency model (discussed above), the seller is legally responsible for all negligent acts performed by his listing broker and all cooperating brokers, provided that the negligent acts occurred in the performance of their agency duties. This sort of legal responsibility for the acts of another is called vicarious liability. It arises out of the common law doctrine of respondeat superior – the responsibility of the superior for the acts of his subordinates.

If Alice from Brokerage A cooperates with Bob (the listing broker) from Brokerage B to sell Chuck’s house and Alice makes the innocent misrepresentation that the square footage of Chuck’s house is 4000 sq. ft. when in fact it is 3000 sq. ft., then Chuck (the seller) is vicariously liable to the buyer for Alice’s innocent misrepresentation. Thus, in this situation, Chuck, who may never have set eyes on Alice (the cooperating broker), can be held financially liable for Alice’s innocent representation.

If Alice had fraudulently claimed that Chuck’s home had 4000 sq. ft., then only Alice would be personally liable.

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

Suppose that Alice’s misstatement was actually made when she told the buyer her home had 4000 square feet; then she, not the seller, would be personally liable for fraud. Or suppose a Good Samaritan salesperson conducts a garage sale for her disabled seller and negligently sells an original Picasso for $5.00. The Good Samaritan’s broker could not be held vicariously liable since the act of conducting a garage sale is not normally within the scope of real estate agency (it could be written into the listing agreement). In this case, the Good Samaritan salesperson would be personally liable.

A major advantage for a broker to incorporate is that the broker’s corporation assumes vicarious liability for professional errors made by the broker and all other licensees working under the brokerage’s corporate license.

2.5 SCOPE OF AGENCY

Should you exceed the scope of the authority granted to you by your principal, you legally assume personal liability for the consequences. Moreover, damages caused by actions outside the scope of your authority are not covered by professional liability insurance.

For the listing broker, this authority should be described in the listing agreement. For example, C.A.R.’s listing agreement (Form RLA) gives the broker the authority to:

- sell a home at a particular price within a specified time period;
Before taking any action you believe in your principal’s interest but which may not be within the scope of your authority, you should first obtain written permission from your principal; otherwise, you risk being held solely liable for the action.

Actions which might not be within your scope of authority would include any action not ordinarily taken by real estate agents. For example, taking out a billboard to advertise your principal’s home or inviting a television reporter to film the inside of your principal’s home. True, these may be legitimate marketing activities but if they were to have the consequence of attracting a home burglar or violating the seller’s privacy, you could be held personally liable by your client for damages.

Liability for any action outside the scope of your agency is not vicariously extended to your principal even if the action was unquestionably taken solely for your principal’s benefit.

## 2.6 Standard of Care

In order for your client to prevail in any negligence lawsuit against you, he must show you owed him a duty to provide a level of care and attention to his real estate concerns that you failed to provide. Examples of duties a listing broker owes his seller are the duties to 1) obtain fair market value, 2) exercise care during home showings, and 3) provide competent advice in evaluating offers.

The set of duties owed by a broker to his client is called “the standard of care”.

According to CC §2079.2, the standard of care for a broker performing his fiduciary duties for his principal or his statutory duties for a third party buyer who is not his principal...

... 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 you are a professional real estate broker and as such are expected to know more about these disciplines than your clients. For example, to obtain a broker’s license the DRE requires that you must take or have taken at least eight college-level courses which include individual courses in real estate practice, real estate law, appraisal, real estate finance, and real estate economics. Consequently as a broker licensee you are expected to know the basics of these disciplines and to use that knowledge to protect your clients.
One source often cited by plaintiffs in civil actions against brokers as a standard of care is NAR®’s Code of Ethics (see Barbara Nichols’ article, “Commit to the Code” in REALTOR® Magazine Online). Some of the most relevant sections of the Code are:

**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:
- A buyer’s broker refers his client to a home inspector without making any effort to check the home inspector’s credentials.
- The listing broker fails to disclose his knowledge that many homes in the seller’s subdivision have foundation problems.
- A selling broker encourages his buyer to make a full-price offer but fails to provide comps.
- A buyer’s broker fails to read the preliminary title report which states that the seller’s home is burdened with easements which will interfere with the buyer’s intended use of the property.

**Article 2:** “REALTORS® shall avoid exaggeration, misrepresentation, or concealment of pertinent facts relating to the property or transaction.”

Possible violations:
- The listing broker makes the unfounded claim that the seller’s neighborhood hasn’t suffered any burglaries in 10 years.
- The broker fails to notify his buyer that the seller is an investor known for shoddy remodeling and repairs.

**Article 9:** “REALTORS®, for the protection of all parties, shall ensure whenever possible that agreements shall be in writing, and shall be in clear and understandable language expressing the specific terms, conditions, obligations, and commitments of the parties.”

Possible violations:
- A broker fails to get contract changes such as inspection period extensions or closing dates in writings signed by all parties.
- A buyer’s broker fails to include a loan contingency in the purchase agreement.

**Article 11:** “The services which REALTORS® provide to their clients and customers shall conform to the standards of practice and competence which are reasonably expected in the specific real estate disciplines in which they engage…”

Possible violations:
- The listing broker fails to advise his seller to check the credit of a buyer before carrying back a second.