After reading this chapter, you will be able to:

- recognize the types of arrangements, situations, and relationships that can give rise to conflicts of interest in real estate transactions;
- disclose the kinds of relationships and interests presenting a potential conflict of interest; and
- mitigate potential conflicts resulting from familial and investment relationships.

Conflicts of interest arise when a broker or his agent, acting on behalf of a client, has a competing professional or personal bias which hinders their ability to fulfill the fiduciary duties they have undertaken on behalf of their client.

In a professional relationship, a broker’s financial objective of compensation for services rendered is not a conflict of interest.

However, fees and benefits derived from conflicting sources must be disclosed to the client. This includes compensation in the form of:

- professional courtesies;
- familial favors; and
- preferential treatment by others toward the broker or his agents. [See first tuesday Form 119]
Similarly, the referral of a client to a financially controlled business, owned or co-owned by the broker must be disclosed by use of an **affiliated business arrangement (ABA)** disclosure. [See first tuesday Form 519]

A conflict of interest addresses the broker’s personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental **agency dilemma** for brokers; it is not a compensation or business referral issue.

Unless disclosed and the client consents, the conflict is a breach of the broker’s fiduciary duty of good faith, fair dealing, and trust owed to the client when the broker continue to act on the client’s behalf.

A conflict of interest, whether patent or potential, is disclosed by the broker at the time it occurs or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction. It reveals to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. The disclosure and consent does not neutralize the inherent bias itself. However, it does neutralize the **element of deceit** which would breach the broker’s fiduciary duty if left undisclosed.

Potential overlaps of allegiance or prejudice which cause a conflict that a broker or his agent must disclose include:

- the broker or his agent holds a direct or indirect **ownership interest** in the real estate, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing, or lending on the property;
- an individual related to the broker or one of his agents by blood or marriage holds a direct or indirect ownership interest in the property or is the buyer;
- an individual with whom the broker or a family member has a **special pre-existing** relationship, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold, or security interest in the property or is the buyer;
- the broker’s or his agent’s concurrent representation of the opposing party, a **dual agency situation** [See Agency Chapter 4]; or
- an **unwillingness** of the broker or his agent to work with the opposing party, or others, or their brokers or agents in a transaction.
Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a **pre-existing relationship** with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties, or any other socio-economic context; and
- that relationship might hinder his **ability to fully represent** the needs of his client.

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed.

Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third-parties arise. In practice, brokers, and especially agents, all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk.¹

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, they should disclose it. The existence of **any concern** is reason enough for a prudent broker to be prompt in seeking their client’s consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with his client.

Fundamentally, a broker who becomes aware he has a conflict of interest, but is reluctant to disclose it and seek the client’s consent, should consider rejecting or terminating the employment with that individual.

A seller’s broker must disclose their acquisition of any direct or indirect interest in the seller’s property. The broker must also disclose whether a family member, a business owned by the broker, or any other person holding a special relationship with the broker will acquire an interest in the seller’s property. [See first tuesday Form 527 §3.6]

For example, a broker’s brother-in-law makes an offer to buy property the broker listed. The purchase agreement states the broker is to receive a fee and that he represents the seller exclusively.

The broker does not disclose to the seller that the buyer is his brother-in-law.

The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker’s brother-in-law.

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest. Both escrows close and the broker receives their fee.

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¹ Calif. Business and Professions Code §10177(o)
The seller discovers the buyer was his broker's brother-in-law and the true buyer was an entity partially owned by the broker. The seller demands a return of the brokerage fee claiming the broker had a conflict of interest which breached the fiduciary duty he owed to the seller since it was not disclosed and the seller did not consent.

In this instance, the broker is not entitled to retain the brokerage fee he received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price he received. Alternatively, the seller may set the sale aside due to the failure of the broker's agency with the seller and the conflict of interest with the buyer.

A broker cannot act for more than one party in a transaction, including himself, without disclosing his dual agency and obtaining the client's consent at the time the conflict arises.² [See Agency Chapter 4; See first tuesday Form 527]

Also, a seller's broker has an affirmative duty to disclose to the seller his agency or other conflicting relationship he might have with the buyer. The duty to disclose exists even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when he is also acting as a broker on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner.³

Consider a seller who, acting on a broker's advice as to the estimated value of his real estate, retains the broker to find a buyer for the property. [See first tuesday Form 318]

The broker and seller enter into a net listing agreement.

Under the net listing, the seller agrees to take a fixed sum of money as the net proceeds for his equity should the property sell. The net listing further provides for the broker to receive all further sums paid on the price as his brokerage fee.

The broker arranges a sale of the property to his daughter and son-in-law. The seller is not informed of the broker's relationship with the buyers. On the close of the transaction, the broker receives his fully disclosed brokerage fee as the net proceeds remaining from the sale in excess of the net listing price.

On discovery of the broker's relationship with the buyer, the seller demands a return of the brokerage fee. The seller claims the broker's kinship with the buyer created an undisclosed conflict of interest which violated the fiduciary duty the broker owed to the seller. The broker claims the seller cannot recover the brokerage fee no matter who the buyer was since the seller only bargained to receive a fixed amount on the sale of his property under the net listing agreement.

² Bus & P C §10176(d)
³ Whitehead v. Gordon (1970) 2 CA3d 659
Whenever a broker is employed under any type of listing, the broker has an obligation to voluntarily disclose to his seller any special relationship they may have with the buyer and obtain the seller’s consent before proceeding. Thus, the seller can recover the brokerage fee he paid to the broker.  

A buyer’s broker must disclose to the buyer the nature and extent of any direct or indirect interest the broker or the broker’s agents hold in any property presented to the buyer.

For example, a buyer’s broker shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker does not inform the buyer of his indirect ownership interest in the property.

The buyer later decides to purchase the property owned by the LLC. An offer is prepared on a purchase agreement with an agency confirmation provision stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See first tuesday Form 159]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer.

Here, the broker has a duty to promptly disclose his ownership interest in the property to the buyer the moment the conflict arises. The conflict of interest in the broker’s ownership is a material fact requiring disclosure since the buyer’s decisions concerning acquisition of the property might be affected.

As a result of the nondisclosure, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, the buyer might have negotiated differently when setting the price and terms for payment. Alternatively, the buyer may have retained a different broker who was not compromised by a conflict of interest.

A broker acting solely as a principal in the sale of his own property is not restricted in his conduct by compliance with agency obligations. The broker selling or buying property for their own account acts solely as the seller or buyer. The licensee has no conflict due to the existence of their license since they is not holding themselves out as a broker or agent acting on behalf of another person in the transaction.  

However, when a broker-seller receives a brokerage fee on the sale of their own property, or on the purchase of their own property, the broker subjects themselves to real estate agency requirements.

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4 Sierra Pacific Industries v. Carter (1980) 104 CA3d 579
5 Robinson v. Murphy (1979) 96 CA3d 763
For example, a broker sells their residence. The residence is in violation of safety requirements for occupancy due to known defects in the foundation. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of the property, the broker-seller pays himself a brokerage fee, claiming to **exclusively represent himself** (which is not an agency and does not require a license).

The buyer later discovers he must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of his general agency duty owed to all parties in a real estate transaction to disclose known property defects.

The broker is unable to pay the money judgment. The buyer seeks payment from the **Real Estate Recovery Account**.

Recovery is received from the **Real Estate Recovery Account** since the broker held himself out as **acting as a real estate broker** in the transaction by receiving a fee. The broker's license is then suspended. Before the broker can reactivate his license, he must reimburse the Recovery Account.6

### Conflicts in a real estate syndication

A potential conflict of interest also exists when a broker manages multiple **LLCs** which own like-type properties in the same market area.

Consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market. The two projects thus compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions by multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A potential conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in **first tuesday** Form 371, **Investment Circular** provision 6d, which states:

- The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC’s ownership of the property. The Manager’s other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business

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6 Prichard v. Reitz (1986) 178 CA3d 465
and ownership management decisions, he will not be involved in monitoring or marketing of the LLC’s property. [See first tuesday Form 371]

With this disclosure, the broker’s allegiance to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

A broker’s positive or negative bias toward the opposing party, or an indirectly involved third party in a transaction, must be disclosed and consented to by the client. This bias is known as a conflict of interest.

A conflict of interest is disclosed at the time the conflict arises. Timely disclosure allows the client to take the bias held by the broker into consideration during negotiations.

A licensee acting solely as a principal on their own behalf when buying or selling property need not disclose the existence of their real estate license.

A potential conflict of interest also exists when a broker manages multiple LLCs which own like-type properties in the same market area. A similar conflict exists when parallel transactions by multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.
Notes:
After reading this chapter, you will be able to:

• avoid the ethical implications of defacing signed documents; and
• prepare and analyze a counteroffer form.

counteroffer  defacing

A broker or agent may not alter a document once it is signed without that party’s prior consent.

Consider a broker who submits an offer to the seller which has been signed by a buyer. The seller is unwilling to accept all the terms contained in the offer. However, the seller will agree to sell if the buyer concedes to a larger down payment, a greater interest rate on the carryback note and a shorter escrow period.

The buyer’s broker strikes out the down payment amount, the interest rate and the escrow period entries on the purchase agreement form signed by the buyer. The seller’s changes are then entered by interlineation to replace the original entries. This activity is called defacing.

The seller signs the form where it provides for the seller’s signature, and initials and dates all the changes, an improper technique referred to as change and initial.

The original offer as altered on its face is then presented to the buyer for his approval. The buyer is to indicate approval by also initialing and dating the changes to form a binding agreement.
The altering of a signed document is *improper practice*. The broker needs to prepare, and have the seller sign, a separate *counteroffer form* containing the changes. The *counteroffer* is then presented to the buyer for consideration and acceptance.

Here, “acceptance” by the seller of the buyer’s offer by signing and altering a purchase agreement offer submitted by a buyer was not an acceptance at all. The alterations written on the buyer’s offer constituted a *rejection* of the buyer’s offer.

Any counteroffer arrangement constitutes a *new offer*. Good brokerage practice requires a new offer be presented on a separate form. By using a separate counteroffer form, the broker promotes clarity for interpreting just what has been agreed upon in the event of a dispute. More importantly, *defacing* of a signed document is avoided. [See Form 180 accompanying this chapter]

The change-and-initial method of preparing a counteroffer often creates uncertainty as to when and who placed which terms in the agreement. Also, the agreement is interpreted against the individual creating the uncertainty, typically the seller who countered by defacing and initialing a signed original document.¹

A counteroffer may be made when the original offer submitted is not acceptable and is either:

- rejected; or
- allowed to expire unaccepted.

A *rejection* can occur by a written rejection stating no counteroffer is forthcoming. It may also be rejected by submitting a *counteroffer* which is an alternative set of terms to the original offer. After a rejection has been communicated, the original offer can no longer be accepted to form a binding agreement. [See *first tuesday* Form 184]

The rejection on receipt of a purchase agreement offer by preparing and submitting a counteroffer takes place in one of two circumstances:

1. An incorporation into a *new offer* of all the terms in the offer submitted which are then modified by entering alternative or additional provisions on the counteroffer form.

   or

2. A preparation of an entirely *new offer* on a newly prepared purchase agreement form which is submitted as a counteroffer.

¹ Calif. Civil Code §1654
The counteroffer form has four sections, each with a separate purpose explained as follows:

1. **Reference to prior offer**: The purpose of a counteroffer is to reference a prior written offer and state the terms and conditions contrary or in addition to those in the original offer which are agreeable to the party countering.

2. **The agreement offered**: The offer submitted and rejected by a counteroffer has all its terms and conditions “incorporated” into the counteroffer. Terms which are additional to or in conflict with those of

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**FACTS:**

1. This is a counteroffer to an offer entitled:
   - [ ] Purchase agreement
   - [ ] Exchange agreement
   - [ ] Counteroffer

   1.1 dated _____________, 20______, at ______________________________________________, California,
   1.2 entered into by _________________________________________, as the _________________________,
   1.3 regarding real estate referred to as ________________________________________________________,

**AGREEMENT:**

2. The undersigned includes all the terms and conditions of the above referenced offer in this Counteroffer, subject to the following modifications:

   __________________________________________________________________________________________
   __________________________________________________________________________________________
   __________________________________________________________________________________________
   __________________________________________________________________________________________

3. This Counteroffer will be deemed revoked unless accepted in writing and delivered to the undersigned or their broker prior to the time of ________________ on _____________, 20______.

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**I agree to purchase this property as stated above.**

- [ ] See attached Signature Page Addendum. [R Form 251]
  - Date: _____________, 20______
  - Buyer's Name: _________________________________
  - Signature: _____________________________________
  - Buyer's Broker: ________________________________
  - By: __________________________________________
  - DRE #: _______________________________________  

**I agree to sell this property as stated above.**

- [ ] See attached Signature Page Addendum. [R Form 251]
  - Date: _____________, 20______
  - Seller's Name: _________________________________
  - Signature: _____________________________________
  - Seller's Broker: ________________________________
  - By: __________________________________________
  - DRE #: _______________________________________
the prior offer are then entered on the counteroffer to create the terms and conditions of the new offer. Any terms in conflict with the terms of the original offer override and become the terms of the counteroffer.

3. *Time for acceptance:* The counteroffer expires at the time and on the date stated for expiration. If no specific date is given, a reasonable time to accept is permitted, unless the counteroffer is first withdrawn.

4. *Signatures:* The party making the counteroffer signs and dates the offer. The brokers sign the counteroffer only to acknowledge their participation in the negotiations.

The rules for preparing and submitting a counteroffer, and those for accepting a counteroffer to buy and sell real estate, are the same rules applied to determine whether an offer made by a seller has been submitted to the buyer or an acceptance by the buyer has occurred to form a *binding agreement.*

Real estate agents instinctively consider submitting written offers from a buyer to a seller to comply with the rule requiring a written agreement, signed by the buyer and seller to form a real estate agreement. Likewise, they need to automatically submit written counteroffers from sellers to buyers when the seller will not accept all aspects of the buyer’s offer.

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**Ethics Chapter 2 Summary**

A broker or agent may not alter a document once it is signed, such as making change-and-initial alterations on behalf of a seller to a buyer’s purchase offer.

The altering of a signed document is improper, and often creates uncertainty as to when and who placed which terms in the agreement.

A rejection of an offer occurs in one form by a written rejection stating no counteroffer will be forthcoming, or by submitting an alternative offer consisting of terms different from those of the offer being rejected, called a counteroffer.

**Ethics Chapter 2 Key Terms**

- counteroffer ........................................................................................................pg. 156
- defacing ................................................................................................................pg. 155
After reading this chapter, you will be able to:

• assess the conditions and circumstances a broker is to disclose in a real estate transaction;
• recognize a broker’s general or agency duties owed to others to inspect, confirm, and report the physical, financial, legal and regulatory conditions of a property; and
• identify circumstances when a broker can or cannot be held liable for failing to disclose property information in a real estate transaction.

A broker and their sales agents are to disclose the physical nature and condition of a property when first providing property information to individuals interested in making an offer to purchase. Thus, brokers and agents have a duty to timely disclose to all parties involved in a real estate transaction any significant physical aspects of a property that may affect the property’s market value or the buyer’s decision to purchase.

A broker has a general duty to all parties in any type of sales transaction to disclose to buyers at the earliest possible moment their awareness of any

Key Terms

- Annual Property Operating Data Sheet (APOD)
- “as-is” clause
- eminent domain
- further-approval contingency
- material fact
- public records
- Transfer Disclosure Statement (TDS)

Learning Objectives

- Property related disclosures
- Ethics, Chapter 3: Property related disclosures
property defects. The duty to disclose known conditions on one-to-four unit residential property requires the seller’s broker to provide prospective buyers or their agents with the seller’s Transfer Disclosure Statement (TDS).

To be effective, property disclosures including the TDS are to be provided to the buyer as soon as practicable – meaning as soon as possible – upon the commencement of negotiations and prior to making an offer.1 [See first tuesday Form 304; See Fair Housing Chapter 12]

If the disclosures are not timely made, the buyer may:

• cancel the offer on discovery of the broker’s failure to disclose prior to the buyer entering into a purchase agreement with the seller; or
• close escrow on the purchase and seek recovery of the costs to cure the untimely disclosure of known defects.

Any attempt to have the buyer of a one-to-four unit residential property waive their right to the mandated property disclosure statement (TDS) is unenforceable.2

For example, a seller’s broker is aware the seller’s residence fails to conform to building and zoning regulations. The defect, if known to a buyer, would likely affect the price they are willing to pay. The defect is more commonly known as a material fact.

The broker knows the buyer who is interested in making an offer is not aware of the violations and might reconsider the price he is willing to pay for the property if he learns of the violations. The broker decides not to disclose their knowledge of the defect.

In an attempt to cover the omission, the broker writes an “as-is” disclaimer into the purchase agreement. The “as-is” provision states the buyer accepts the property in its current “as-is” condition.

After the buyer acquires the property, the city refuses to provide utility services to the residence due to the building and zoning violations.

The buyer demands their money losses from the broker, claiming the broker breached their general agency duty to disclose conditions of the property known to the broker before the buyer agreed to purchase.

The broker claims the buyer waived their right to collect money damages when they signed the purchase agreement with the “as-is” disclaimer.

Does an “as-is” disclaimer shield the broker from liability for the buyer’s losses caused by the building and zoning violations?

No! The seller’s broker has a general duty owed to all parties to a transaction. The general duty requires the seller’s broker to disclose all property conditions known, or should have been known, to the seller’s broker due to their

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1 Calif. Civil Code §1102 et seq
2 CC §1102
mandated inspection that affect the value and marketability of the property. The duty is not excused by writing an “as-is” disclaimer into the purchase agreement in lieu of making the factual disclosures before an agreement is entered into with the seller. ³

Being up front with vital information has conquered the used car market, and was done solely for marketing reasons. Yet, real estate owned (REO) sales, trustee’s sales, short sales, and the agents that work those deals, have made a run in the opposite direction in spite of anti-fraud legislation. However, public policy prohibits the sale of one-to-four unit residential property “as-is.” Thus, most form publishers have eliminated the boilerplate “as-is” clauses from their purchase agreements.⁴

Editor’s note – Despite legislation requiring disclosures be provided to the buyer as soon as possible, the purchase agreement published by the California Association of Realtors (CAR) fails to make provision for the law requiring disclosure before entering into the purchase agreement. Furthermore, provisions (14)(A) and (14)(B) of CAR’s purchase agreement arbitrarily set time periods of seven days for the delayed delivery of these required reports and disclosures. Only then does the buyer discover if any intentional misrepresentation or deceit has been involved. Lack of a compliance provision in the form surely contributes to the general failure of agents to timely disclose.

Consider a buyer who makes an offer to purchase a residence. The seller’s broker is aware of a large structural crack in the foundation of the residence that is not apparent on a visual inspection. The broker delivers a TDS to the buyer’s agent, who in turn hands it to the buyer, stating the residence has no defective conditions. Based on the report, the buyer acquires the property. [See first tuesday Form 304]

More than two years later, the buyer discovers the crack. The buyer claims the seller’s broker is liable for the cost of repairing the foundation since he failed to disclose the crack. The broker claims the buyer’s action is barred by the two-year statute of limitations for misrepresentation since he only owed the buyer the statutory duty to disclose defects which would be revealed by a visual inspection.

Is the broker liable to the buyer for intentionally misrepresenting the existence of the crack known to the broker, in spite of the two-year statute of limitations for negligent misrepresentations?

Yes! The buyer’s claim is not time-barred under statutes requiring the broker to visually inspect and disclose observable defective property conditions. Liability is imposed on the broker for their intentional misrepresentation, by omission, of their actual knowledge of a condition of the property not readily visible when they stated defective conditions did not exist in the seller’s TDS.⁵

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³ Katz v. Department of Real Estate (1979) 96 CA3d 895
⁴ CC §1102.1
⁵ Williams v. Bennet Realtors (1997) 52 CA4th 857
Consider a broker who is the exclusive agent of a buyer in the purchase of a one-to-four unit residential property. Without first receiving a survey or title report to verify their representations, the broker advises their buyer about the amount of acreage and the extent of an easement on the property.

The buyer enters into a purchase agreement and acquires the property in reliance on the broker’s verbal representations about the size and easement on the property. A further-approval contingency calling for the buyer to confirm the representations is not included in the purchase agreement.

More than two years after closing, the buyer discovers the acreage and easement representations made by the broker are false. The property was worth less than the price paid.

The buyer seeks to recover the difference in property value from the broker. The broker claims the buyer’s recovery is barred by a two-year statute of limitations for breach of a broker’s agency duty to inspect and disclose defects on one-to-four unit residential property.

The buyer claims their action is not time-barred since the two-year statute of limitations only applies to negligent misrepresentations, not to the recovery of a loss caused by the broker’s intentional misrepresentations about facts related to the property’s physical condition.

Is the buyer entitled to recover their loss in property value?

Yes! The broker intentionally misrepresented the property’s size and easement without first confirming what they consisted of. The two-year statute of limitation only applies to a broker who inspects the property and, as a result of the inspection, negligently fails to disclose facts that a reasonably diligent on-site inspection would have revealed.

Here, the broker made representations as fact without first verifying the information. Nor did the broker advise the buyer of their source of information and that the information was not verified. Thus, a three-year statute of limitations for intentional misrepresentation applies, commencing on the date the buyer discovers the falsity of the broker’s representation.\(^6\)

Now consider a broker who markets real estate through the Multiple Listing Service (MLS). The property’s square footage is listed in the MLS as an approximation based on unverified information. The broker conducts a visual inspection of the property.

A buyer enters into a purchase agreement for a price based on the square footage represented in the MLS, a fact known to the broker. The purchase agreement prepared by the broker includes a disclaimer stating the MLS marketing information is an approximation and advises the buyer to obtain an appraisal of the property. A further-approval contingency provision is not included allowing the buyer to confirm the disclosure, adjust the price or cancel the transaction.

\(^6\) Field v. Century 21 Klowden-Forness Realty (1998) 63 CA4th 18
The buyer closes escrow without first obtaining an appraisal of the property as advised. Later, the buyer discovers the property has significantly less square footage than approximated in the MLS marketing information. The price paid for the property exceeded the value received.

The buyer seeks to recover their lost property value from the broker. The buyer claims the broker, based on their visual inspection, should have known that the square footage listed in the MLS was incorrectly exaggerated.

The broker claims he is not liable for the buyer’s reduction in property value since the buyer has a responsibility to determine the exact square footage and property value before closing, as advised in the purchase agreement.

Is the broker liable for the difference in property value?

Yes! Based on the visual inspection conducted by the broker, the broker should have known their representation of the square footage was an exaggeration which might be relied on by a buyer to set the price for the property.

Further, buyers and sellers have no duty to comply with a broker’s advisory disclaimer. A further-approval contingency to be satisfied by an appraisal needed to be included in the purchase agreement, not a disclaimer, since the broker knew the size was of concern to the buyer.

A broker and their agents need to accurately represent the title restrictions, potential use, and any conditions, covenants and restrictions (CC&Rs) controlling real estate to a prospective buyer or tenant.

For example, a seller’s residence has a detached garage which has been converted into an apartment. The seller lists their property for sale with a broker.

The apartment is in violation of zoning ordinances. The broker does not visually inspect the property to confirm it is complaint with building codes or verify the rental activities comply with zoning ordinances known to him.

The broker induces a buyer to pay a price for the residence exceeding its fair market value (FMV), representing as an incentive the existence of rental income from the apartment. The purchase agreement does not contain a further-approval contingency to confirm the rental income will be available, and if not, providing the buyer the right to cancel the agreement.

After escrow closes, the city notifies the buyer the garage apartment is being rented in violation of zoning ordinances. The buyer is forced to quit renting out the apartment, suffering a loss in value of the property.

Here, the broker is liable for the part of the purchase price the buyer paid in excess of the FMV of the residence. The broker failed to determine the accuracy of their rental income disclosure by first determining whether zoning conditions limited the buyer’s use of the property.

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8 Barder v. McClung (1949) 93 CA2d 692
Consider an owner who contacts a broker to arrange an exchange of their property for other real estate the owner seeks to acquire.

The broker locates replacement property. The broker investigation uncovers the second trust deed encumbering the replacement property contains a **due-on-sale clause**. The clause states the lender can call the trust deed loan due and payable after the closing of a sale unless the lender consents. The due-on-sale clause is a title condition that may affect a buyer’s ability to retain ownership and use of the property. However, the broker does not disclose their knowledge of the existence of the due-on-sale clause in the trust deed.

The owner agrees to take title to the replacement property subject to the existing second trust deed. No contingency existed to provide for the further approval of a beneficiary statement and trust deed conditions.

After escrow closes, the second trust deed lender discovers the transfer to the owner and calls the loan under the due-on-sale clause.

The owner fails to pay the loan balance that is now due on the second. The owner ultimately loses the property at the second trust deed lender’s foreclosure sale.

Here, the broker is liable for the owner’s loss of equity due to the foreclosure. The broker failed to disclose their knowledge about the existence and legal consequences of the due-on-sale clause in the second trust deed taken over by their client. The broker is thus liable for the value of the equity lost in the replacement property as established by the price set by the broker in the exchange agreement, not the property’s lesser FMV. \(^9\)

A broker’s duty to disclose a known potential **future use** of a property extends beyond disclosure of title and zoning conditions.

For example, a buyer is interested in purchasing undeveloped property for commercial development. The property is located next to a maintenance yard owned by the state.

The seller’s broker has been previously contacted by the state regarding its intent to someday acquire the property to expand the maintenance yard through **condemnation**, also known as **eminent domain**.

During purchase negotiations, the buyer asks the seller’s broker if the state is interested in the property. The seller’s broker informs the buyer the state has no interest in acquiring the property.

The buyer enters into a purchase agreement with the seller. During escrow, the buyer has plans drawn and obtains the necessary permits for development and construction on the property.

Just before escrow closes, the buyer discovers the state intends to acquire the property through **condemnation**.

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\(^9\) **Pepitone v. Russo** ([1976] 64 CA3d 685

**eminent domain**

The right of the government to take private property for public use. The government pays the owner the fair market value of the property taken.
The buyer proceeds to take title to the property and later grants the property to the state in a condemnation proceeding.

Here, the seller’s broker is liable for the out-of-pocket losses incurred by the buyer for their lost use of the property. The broker is also liable for punitive damages for the intentional failure to disclose the state’s interest in acquiring the property. The buyer relied on the broker’s information regarding the state’s activities when he determined whether the property was suitable for their future development plans.10

A broker and their agents need to advise a prospective buyer or tenant of any known material facts that may affect the value or desirability of the purchased or rented property.

Four categories of conditions contribute to or detract from the value of property:

- physical condition of soil and improvements;
- land use and title conditions;
- operating income and expenses; and
- location hazards and surrounding area impact.

For example, a buyer seeks property for investment purposes. The broker recommends an apartment complex as the source of spendable income and equity buildup for the buyer.

The broker analyzes the suitability of an income property which is for sale by preparing an Annual Property Operating Data Sheet (APOD) and reviewing it with the buyer. [See first tuesday Form 352]

However, the property’s scheduled rental income is represented to be far greater than the actual income. Additionally, the broker represents the property is in excellent physical condition. However, the property requires extensive renovation due to deferred maintenance.

The broker makes these representations based on information received from the seller. The broker does not investigate maintenance, expense, and income records of the property to check the accuracy of the seller’s representations. Further, the broker does not advise the buyer the seller is the source of the property information.

At the urging of the seller, the buyer is dissuaded from inspecting the property by the broker.

Relying solely on the broker’s representations as to the operating income and condition of the property, the buyer purchases the property.

After closing, the buyer realizes the operating income is far less than the scheduled income stated on the property operating statement. The buyer

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10 Storage Services v. Oosterban (1989) 214 CA3d 498
discovers tenants are delinquent in the payment of rent and incurs extensive deferred maintenance expenses. These conditions collectively reduce the projected net spendable income, and in turn the property’s market value.

Eventually, the buyer defaults and loses the property in foreclosure.

A broker marketing property as an income-producing investment owes a duty to a buyer to research and disclose whether the property produces adequate income to meet expenses. Alternatively, the broker may include a contingency provision in the purchase agreement calling for the buyer to confirm the representations or cancel the agreement prior to closing.

Brokers cannot merely pass on statements made by the seller as to the property’s condition and income and expenses generated by the property without first reviewing them for apparent inaccuracies. When property information is passed on to others, the broker needs to advise them about the source of the information and any known need for further investigation into their accuracy. Thus, the broker is liable to the buyer for the buyer’s lost property value.11

A completed APOD is to be prepared by the owner when an agent is listing income property. As the seller’s representation of the property operations, the APOD is to be attached to the listing agreement as an addendum signed by the seller. [See first tuesday Form 352]

In addition to income and expense information provided in the APOD, the broker needs to investigate and inspect the property for:

- quality of income;
- deferred maintenance;
- desirability of location; and
- any title or zoning conditions which might interfere with the buyer’s intended use of the property.

Another fact affecting the value and desirability of the property is the existence of due-on-sale clauses in trust deeds of record. Similarly critical is whether the lender will call or recast the loan by adjusting rates and rescheduling payments so sellers and buyers have alternatives for financing the sale and purchase of a property.

A broker has a duty to investigate the accuracy of all representations he makes to buyers or lenders regarding a property’s physical condition, use and operating expenses. However, no investigation is needed when he discloses the source of the information and the fact he has not independently investigated or confirmed the representations, but only if the broker has no reason to believe they are inaccurate.

11 Ford v. Cournaic (1973) 36 CA3d 172
A broker of one-to-four unit residential property is relieved of the responsibility of verifying the representations regarding property conditions he receives from others and passes on to buyers as long as the source of information is disclosed to the buyer.

The source of information is typically the seller, the seller’s broker or a home inspector.12

For example, a seller’s broker hands a buyer of one-to-four unit residential property a TDS signed by the seller. The statement includes an additional comment by the broker on observable cracks in the walls, noting the seller identified them as cosmetic. The broker does not know they are not just cosmetic.

After closing, the buyer of the property incurs repair costs due to unstable soil. The buyer claims the seller’s broker is liable for the costs since he failed to independently verify the seller’s claims regarding the cracks in the walls. The broker claims he is not liable since he had no duty to verify the seller’s representations of property conditions unknown to him.

Here, the broker is not liable for the buyer’s losses. The broker only has a duty to inspect and disclose material facts observable or known to him, not to independently verify the claims of their disclosed source.13

Consider a buyer who purchases a unit in a common interest development (CID). The seller of the property does not disclose to either brokers or the buyer the existence of pending litigation between the homeowner’s association (HOA) and the developer of the CID regarding soil subsidence in the common area.

Both the seller’s broker and the buyer’s broker conduct visual inspections of the property. Neither broker discovers any visible defects nor are any defects known to either of them.

After purchasing the property, the buyer learns of the litigation and the soil subsidence in the common areas. The buyer claims the brokers’ failure to discover and disclose the pending litigation is a breach of their statutory duty to investigate and disclose the condition and marketability of the property.

Are the brokers responsible for their failure to investigate the records and disclose these material facts to the buyer?

No! The brokers of a one-to-four unit sale have no duty to investigate public records and disclose pending litigation or soil subsidence not known to them. Further, the brokers were unaware of the existence of either the litigation or the soil subsidence. While a broker has a duty to investigate and confirm all representations he makes about a property or provide for the buyer to do so, the broker is not held accountable for representations by sellers which are outside their realm of knowledge.14

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12 CC §§2079 et seq.
14 Padgett v. Phariss (1997) 54 CA4th 1270
Consider a broker who acts as a relocation agent. As planned by the broker and seller, the broker purchases the seller’s one-to-four unit residence and later resells the property to a buyer.

The broker hands the buyer the seller’s TDS which the broker received from the seller. In it, the seller does not disclose the existence of noise conditions in the surrounding area that affect the property’s value. The broker is not aware of the noise conditions and does not add them to the TDS.

On occupying the property, the buyer discovers the undisclosed noise conditions which reduce the value of the property for less than the price paid.

The buyer seeks to recover the lost value from the broker who sold him the property. The broker claims he is not obligated to the buyer for the lost value since he was unaware of any noise conditions. The buyer claims the broker is liable since he has a duty to investigate and verify the representations made by the seller on the TDS.

Here, the broker is not liable to the buyer for the lost value resulting from undisclosed noise in the area surrounding the property. The existence of the condition was outside the realm of the broker’s knowledge.15

15 Shapiro v. Sutherland (1998) 64 CA4th 1534

Brokers and agents are to disclose to all parties involved in a real estate transaction all significant physical aspects of a property which may affect the property’s market value or a buyer’s decision to purchase. Property disclosures will be made to the buyer before offers are prepared and prices agreed to. If not timely made, a buyer may cancel the transaction or close escrow and seek recovery of the costs to cure the belatedly disclosed defects.

A broker is obligated to disclose the physical condition of soil and improvements of a property, the land use and title conditions, the operating income and expenses of the property, and location hazards and the impact of the surrounding area. Further, the actual legal size and boundaries of a property need to be disclosed by a broker. A broker needs to also accurately represent the title restrictions and potential future use of real estate to a prospective buyer or tenant.

A broker marketing property as an income-producing investment owes a duty to a buyer to research whether the property produces adequate income to meet expenses.

A broker has a duty to investigate the accuracy of all representations he makes to buyers regarding a property’s physical condition, use and operating expenses, unless he discloses the source of their information and the fact he has not investigated or confirmed the representations.
The brokers of a one-to-four unit sale have no duty to investigate public records and disclose any pending litigation or physical condition not known to them and not observable upon visual inspection.
After reading this chapter, you will be able to:

- understand the need to properly represent loan terms and conditions to a borrower;
- avoid unethical loan broker behavior when soliciting employment from a borrower; and
- properly manage advance fees as trust funds received from a borrower.

**Key Terms**

**advance costs**

**advance fees**

The essential terms of a real estate loan are to be disclosed to the borrower by a broker soliciting or arranging a mortgage loan.

For example, a real estate broker advertises they can arrange loans with a low monthly payment schedule. In fact, loans of the type advertised are not available, a “bait and switch” advertising trick. A borrower, seeking a loan with the low payment schedule advertised by the broker, retains the broker to perform these services.

The borrower asks specific questions of the broker concerning the interest rate, late charges, due date, the final balloon payment and loan closing costs.

The broker tells the borrower the balloon payment will be “small.” The broker further misrepresents the probable interest rate and the day of the month on which late charges are incurred. The broker provides the borrower with “approximations” of the closing costs that are significantly lower than the actual closing costs. The broker also fails to accurately disclose other important loan aspects, such as the monthly payments are interest only, or that late charges are equal in amount to the monthly interest payment.
Further, the financial disclosure statement the broker prepares and hands to the borrower is lengthy and contains complex wording. Instead of reading the disclosure statement, the borrower relies on the broker's oral representations and signs the loan documents.

On closing, the borrower ends up with a mortgage with less favorable terms than verbally represented by the broker. The borrower incurs additional and unexpected expenses, such as high late charges, an early due date and graduated monthly payments. The additional expenses ultimately create an excessive financial burden for the borrower. The borrower defaults on the loan and the secured property is sold at a foreclosure sale.

Later, the borrower discovers the broker was aware of the actual loan terms and costs for origination before the borrower signed the loan documents.

The broker's failure to disclose the actual interest rate, the exact amount of the late charge, the size of the balloon payment and the actual closing costs breached the broker's agency duty owed to the borrower.

The borrower can recover all his money losses caused by the broker's misrepresentation and for failing to discuss important provisions in the loan documents.\(^1\)

As the borrower's broker arranging a loan, a licensee must fully and accurately disclose all essential facts of the loan transaction which might affect the borrower's decision to participate in the transaction.\(^2\)

The broker's duty to disclose, and their obligation to deal fairly with borrowers, commences on their first contact with prospective borrowers to solicit employment. Thus, the broker will disclose essential facts before entering into a listing agreement.\(^3\)

Even after the broker is employed as the agent of the borrower, their duty to disclose and provide accurate representation is not completely fulfilled by merely providing the loan documents to the borrower. The provisions in the documents must be discussed with the client to ensure the client has an understanding sufficient to make a well-informed decision regarding the loan.\(^4\)

Mortgage borrowers and holders of trust deed notes frequently retain the services of a broker to represent them. The service they render is to locate a lender or trust deed investor who will make a real estate loan or buy or lend on a trust deed note.

Typically, the loan broker solicits these borrowers and note holders seeking to represent them by locating institutional or private money lenders or...
investors and arranging the financing sought. When soliciting employment as a loan broker, the broker may not represent the existence of a willing lender when one does not exist.

Consider a real estate owner who contacts a broker to arrange a trust deed loan.

The owner informs the broker of their desired loan terms. The broker is asked if they know of a lender willing to originate such a loan. The broker does not now know of a lender who would be willing to make the loan sought by the owner, but states they can arrange funding for this type of loan.

Based on these representations, the owner enters into a loan broker listing with the broker. [See Form 104 accompanying this chapter]

The broker’s attempts to locate a lender are unsuccessful.

The owner later discovers the broker never knew of a real estate lender who would originate a loan on the borrower’s terms. The owner files a complaint with the Bureau of Real Estate (BRE), claiming the broker had a duty to honestly represent the fact no lenders were known by the broker who made loans on the terms sought at the time the owner employed the broker.

The broker’s false claim that a lender existed is cause for the BRE to revoke or suspend the broker’s license. 5

Also, the broker could be fined up to $10,000, imprisoned up to six months or both. 6

“Free” is a word commonly exploited in sales promotions to induce a buyer to believe they will receive something without paying for it, usually an extra portion of the product sought. However, there are rarely “free lunches” as most everything “free” comes with a cost.

A specific service rendered by a broker or agent which contributes to arranging a transaction may not be represented as provided “free” when the broker will be compensated by way of receiving a fee on closing the transaction.

For example, a broker wants to induce a seller to enter into an exclusive right-to-sell listing to employ the broker and their agents to market the property and locate a buyer.

The broker offers “free advertising” in the marketing of the seller’s real estate, without any charge of the cost to the seller. Believing the advertising incentive is an extra service or a cost normally charged separately from the broker fee, the seller enters into an exclusive listing agreement with the broker. No other broker offers this service for “free,” giving this broker a competitive advantage.

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5 Calif. Business and Professions Code §10177(d)
6 Bus & P C §10185
However, a seller’s broker is duty bound to advertise the seller’s property no matter who is to pay the advertising costs, whether the broker or seller. Advertising is part of the *due diligence* imposed on a broker to take all reasonable steps to locate a buyer when employed under an exclusive right-to-sell listing.

The broker, by use of the “free advertising” gimmick, has represented an activity as free that a diligent broker is *obligated to provide* for a client — again, no matter who agrees to pay for it. The advertised activity is not free, but is offered in expectation of receiving compensation under the listing — when a buyer is located through advertising.\(^7\)

The broker’s bargain under an exclusive listing agreement consists of fulfilling one essential duty — the diligent pursuit of their client’s real estate goals. Advertising is a fundamental and integral part of this duty. Thus, the broker cannot represent as “free of charge” a brokerage activity normally performed in a transaction on which they are to be paid a fee.

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**Advance fees are trust funds, until earned and disbursed**

An *advance fee* is a fee received by a broker for soliciting borrowers or lenders to arrange loans or sell trust deed notes before brokerage services are performed and the fee earned. The advance fee arrangement also applies to real estate sales and leasing transactions.\(^8\)

Any fees received by a broker in advance of rendering the services to be performed are *trust funds*. Thus, *advance fees* will be deposited into the broker’s trust account, separate from the broker’s business or personal funds.\(^9\) [See Trust Funds Chapter 2]

Further, the broker is to use a **BRE-approved advance fee form** or obtain BRE approval of a different advance fee form the broker seeks to use.\(^10\)

After depositing the funds into the trust account, the broker may withdraw from the deposit and disburse a fee to themselves after:

- the broker has *completed the services* to be rendered to arrange the loan for the borrower;
- the broker has handed the borrower an *accounting* for the services performed arranging the loan; and
- *five days* have passed after the borrower has received the accounting.\(^11\) [See Trust Funds Chapter 2]

In the interim before earning the advanced fee, the broker is to make a *full accounting* to the borrower at least every calendar quarter for the withdrawal and expenditure of any advance fees deposited in the trust account. The accounting includes the itemization of services rendered, amounts disbursed, payees, dates, etc.\(^12\)

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\(^7\) *Coleman v. Mora* (1968) 263 CA2d 137
\(^8\) *Bus & P C §10026*
\(^9\) *Bus & P C §10145*
\(^10\) *Bus & P C §10085*
\(^11\) *Bus & P C §10146*
\(^12\) *Bus & P C §10146*
Advance fees are distinguishable from **advance costs**. **Advance costs** are deposits handed to the broker to cover out-of-pocket costs incurred on behalf of the depositor while performing brokerage services, such as a loan appraisal for a borrower. [See Trust Funds Chapter 3]

For example, a borrower seeking to purchase nonresidential real estate employs a broker to help them obtain a loan.

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**DATE:** _______________, 20______, at _____________________________________________________, California.

Items left blank or un checked are not applicable.

1. **RETAINER COMMITMENTS:**
   1.1 Owner hereby retains and grants to Broker the exclusive right to locate a lender and arrange a loan to be secured by the property described herein, for the period of this listing beginning on _____________, 20______ and terminating on _____________, 20______.
   1.2 Broker to use diligence in the performance of this employment. Owner to cooperate with Broker to meet the objectives of this employment.
   1.3 Owner hands $_______________ to Broker for deposit into Broker’s trust account for application to Owner’s obligations under the attached Listing Package Cost Sheet. [See ft Form 107]

2. **ADDENDA to this agreement include:**
   2.1 □ Credit Application [See ft Form 302]
   2.2 □ Loan Purpose Statement [See ft Form 328]
   2.3 □ Acknowledgement of Changing Conditions [See ft Form 203-1]
   2.4 □ See Addendum for additional provisions [See ft Form 250]
   2.5 □ ______________________________________________________
   2.6 □ ______________________________________________________

3. **BROKERAGE FEE:**
   
   NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.

   3.1 Owner agrees to pay Broker ___________ of the principal amount of the loan sought or obtained, IF:
   a. Anyone procures a lender on the terms stated in this agreement, or on any other terms accepted by Owner during the period of this listing.
   b. The property is withdrawn as collateral, or title is made unmarketable as collateral by Owner during the retainer period.
   c. Owner terminates this employment of Broker during the retainer period.
   d. Within one year after termination of this agreement, Owner or his agent enter into negotiations, which later result in a transaction contemplated by this agreement, with a lender whom Broker or a cooperating broker negotiated with during the period of this listing. Broker to identify prospective lenders by written notice to the owner within 21 days after termination of this agreement.

   3.2 Should this agreement terminate without Owner becoming obligated to pay Broker a fee, Owner to pay Broker the sum of $_______________ per hour of time accounted for by Broker, not to exceed $________________.

4. **LOAN TERMS:**
   
   4.1 Loan sought is $______________, payable as follows:
   a. Interest at an annual rate of no more than ______ %, □ fixed, □ ARM type ____________________.
   b. Payments due □ monthly, or □ ___________ months, amortized over _____ years.
   c. Final/balloon payment due _____________, 20______.
   d. Late charge ____________________________
   e. Prepayment penalty ________________________
   f. Loan escrow with _______________________
   g. A lender's ALTA policy purchased by Owner in the amount of the loan.
   Title Company _______________________

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5. REAL ESTATE SECURING THE LOAN:

5.1 Type __________________________________________________________________________________
Address __________________________________________________________________________________
Referred to as _____________________________________________________________________________

5.2 The priority for the lien securing the loan sought will be □ first, or □ second.

5.3 Encumbrances of record:
   a. A first loan in the amount of $____________, payable $____________ per month, until paid, 
including interest at _____%, □ ARM type ____________, due ____________, 20_____, impounds 
being $____________ monthly. 
   Lender: ____________________________________________________________________________

   b. A second loan in the amount of $_____________, payable $_______________ per month, until paid, 
including interest at ______%, □ ARM type ___________, due ____________________, 20_____.
   Lender: ____________________________________________________________________________

   c. Other encumbrance, bond, assessment or lien in the amount of $______________.
   Lienholder __________________________________________________________________________

5.4 My purchase price on _______________ was $_______________.
Since the purchase of the property, I have invested in repairs and improvements approximately $__________.

5.5 The current fair market value is $_____________.
Property taxes for the year 20______ were $______________.

5.6 The property is occupied by __________________________________________________________
at a rental rate of $______________ per month, under a:
 □ rental agreement; or
 □ lease agreement which expires ____________, 20_____.
   a. □ See attached Rental Income Rent Roll. [See ft Form 325] _____________________________

6. PERSONAL PROPERTY INCLUDED AS COLLATERAL:

6.1 Referred to as: ______________________________________________________________________
____________________________________________________________________________________
____________________________________________________________________________________
____________________________________________________________________________________

6.2 Encumbered for the amount of $______________, payable $______________ monthly, including interest at 
_____%, due ____________, 20______.
Lender ________________________________________________________________________________

7. GENERAL PROVISIONS:

7.1 Broker is authorized to disclose, publish, discuss, and disseminate among prospective lenders
the financial information supplied by Owner or credit agencies.

7.2 Owner warrants all necessary permits have been obtained for any additions, alterations, repairs, 
installations or replacements to the structure or its components, except ____________________________.
   a. □ See attached Condition of Property Disclosure. [See ft Form 304]

7.3 Owner authorizes Broker to cooperate with other agents and divide with them any compensation due.

7.4 Before any party to this agreement files an action on a dispute arising out of this agreement which 
remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding 
mediation administered by a neutral dispute resolution organization and undertake a good faith effort 
during mediation to settle the dispute.

The broker tells the borrower the broker fee must be paid in advance as 
compensation for their initial time spent preparing the loan package and 
negotiating with the lender.

The borrower writes a check to the broker for $1,000, indicating on the check 
the money is in payment for services to be rendered arranging the loan.
The broker deposits the client’s check into their **general business account**. The broker believes the funds are theirs to spend as they sees fit.

Later, the borrower, having received no billing or accounting, demands an accounting of the funds. The broker is unable to provide the borrower with any documentation as to what services were rendered, how much time was spent or when and to whom the funds were disbursed.

Further, the broker cannot even prove the funds were spent on services rendered on the borrower’s behalf.

Here, the broker received a deposit for a fee they had not yet earned. They failed to place the deposit into their trust account for disbursement after the fee was earned and accounting given to the client. The broker also failed to account for time spent working on the borrower’s behalf before placing the funds in their general account.¹³

A broker’s failure to account to their client for advance fees paid for arranging a real estate loan may result in the suspension of the broker’s license. The broker may also be liable to the borrower for triple the borrower’s damages for misappropriation of trust funds.¹⁴

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¹⁴ *Burch v. Argus Properties, Inc.* (1979) 92 CA3d 128
A loan broker must make a meaningful disclosure about the essential terms of a real estate loan when soliciting a borrower or arranging a loan with a lender. This duty to disclose, and obligation to deal fairly with borrowers, commences on the broker’s first contact with prospective borrowers.

Further, a broker may not represent that a specific service is provided for “free” when that service is part of an entire transaction in which the broker will be compensated by receipt of a fee.

The loan broker’s duty of fair dealing also extends to discussing documents and complex loan terms with the borrower. The broker must ensure the borrower has an understanding sufficient to make a well-informed decision regarding the loan.

A broker arranging a real estate loan who receives fees from the borrower before brokerage services are rendered treats the fees as trust funds. These trust funds may not be disbursed until they are earned and an accounting provided to the borrower. Fees advanced to a loan broker from a borrower are subject to rules requiring BRE-approval of the advance fee agreement used, quarterly accounting to the borrower, and penalties for misuse of the trust funds.
When property prices rise, **kickbacks** in real estate sales become infectious. Although **kickbacks**, often in the form of **referral fees**, were banned by the *Real Estate Settlement Procedures Act (RESPA)* in 1974, they remain under the radar in many forms and for many reasons. In fact, they continue to be one of the most pervasive RESPA violations.

**Referral fees** become illegal kickbacks when received by a broker or agent who negotiated a fee-generating home sale when that broker or agent renders no service to the other provider in exchange for the referral fee beyond the referral. Referral fees of the kickback variety are improper and attack the efficiency of the real estate market. Worse, kickbacks increase the *cost of doing business*, the cost of which is always passed on to buyers and sellers in the sales transactions.

Kickbacks absolutely result in the elimination of better and cheaper competition. Instead of being directed by agents to legitimate lenders, escrows, title insurers or other types of third-party service providers, buyers are referred to those businesses providing kickbacks to the broker or agent.

Kickbacks to brokers and agents representing sellers and buyers in a home sales transaction are openly undertaken in an illegal effort by a third-party service provider to garner a larger share of the available business. This is
a corrupting business policy. Legitimate operators find it difficult, if not impossible, to compete with fraud without themselves stooping to the same corrupt kickback practices.

Any person who violates RESPA may be fined up to $10,000 or imprisoned for up to one year, or both. RESPA violators are liable, to the person charged for the settlement service, for three times the amount paid for the settlement service. In addition, RESPA violations are often combined with other private lawsuit claims such as antitrust violations, exposing violators to additional civil liability.¹

The mere referral-steering of a client is not a service rendered in exchange for a kickback, but is a service owed the client to care for, protect and give them advice in the sales transaction.

Any payment between brokers or agents and third-party service providers, over and above the fee received from the seller on the sales transaction, may only be received in exchange for performing a significant portion of the services rendered by the provider paying the agent an additional fee. However, brokers and agents rarely perform services on behalf of service providers beyond the referral (which was done on behalf of the client, not the provider), and therefore cannot receive a referral fee – the kickback.

Referral fees are not the only form of kickback which violate RESPA.

**Indirect kickbacks** commonly provided by third-party services in exchange for referrals from brokers and agents include:

- entry into a “referral contest” drawing for referring a lead;
- paying for sporting events or theater tickets;
- throwing a party for anyone who referred business;
- paying the admission to a real estate seminar/education;
- paying for real estate listing advertising; and
- paying for subscriptions to 800 numbers and call-capture numbers.

However, promotional and educational activities are allowed if:

- they are not conditioned on the referral of business; and
- they do not involve the payment of expenses (rent, IT services, supplies, equipment, etc.) incurred by a broker or agent in a position to refer business.²

Another classic example of kickbacks is found in so called “closed offices,” where brokers ban third-party service providers from competing legitimately for business with their one chosen service provider – their “preferred” lender or title insurer.

In addition, lenders may not pay a fee to a real estate broker representing a principal in the sale the lender is to finance, unless the broker has performed

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¹ 12 United States Code §2607(d)
² 12 Code of Federal Regulations §1024.14(g)(vi)
a significant service on behalf of the lender. For instance, a broker may receive a second fee, the so-called referral fee, if they render significant loan origination services.

**Referral fees** are allowed between two brokers if the broker receiving the referral fee is not providing another service in the home sales transaction such as financing, insurance, escrow, etc.

Compensation for a referral permitted by or between brokers under RESPA includes:

- payments to the buyer’s broker by the seller’s broker, and referral arrangements between real estate agents and brokers;

- payment to any person of a bona fide salary or compensation or other payments of goods or facilities actually furnished or for services actually performed, such as finders used by a broker; and

- an employer’s payment to its own employees for any referral activities.³

However, brokers and agents must adhere to specific Bureau of Real Estate (BRE) rules and codes when paying or accepting referral fees from other brokers or agents. Agents are prohibited from accepting a fee or other benefit from any person other than their employing broker. Agents are also forbidden from paying a fee to any other broker or agent without first directing the payment through the agent’s employing broker.⁴

Most importantly, as a fiduciary matter, brokers and their agents must advise their clients of the dollar amount of any compensation received from service providers related to the real estate transaction in which their client is involved. If the compensation (monetary or otherwise) is not disclosed, agents and their employing broker are subject to their client recovering all fees received, as well as license suspension or revocation. However, fees prohibited by RESPA cannot be legalized by disclosure or consent of the client.⁵

Bottom line, referral fees are prohibited between brokers and third-party providers with one exception. In order for a broker or agent to receive a referral fee when they are receiving a fee on a home sales transaction, a tangible service besides the referral must be performed for the business paying the referral fee.

Consider a group of local real estate trade associations who each operate their own multiple listing service (MLS). Each association provides their own MLS support services to their subscribers. They also set the price for these support services independently, based on cost.

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³ Calif. Business & Professions Code §10177.4; 12 USC §2607
⁴ Bus & P C §10137
⁵ Bus & P C §10176(g)
Some are efficient and very successful at providing these services, incurring less than $10 in total costs per subscriber monthly. Others are inefficient and incur costs of $50 per subscriber monthly to provide their MLS support services.

The associations then form a separate corporation in which they are shareholders in order to create and operate a county-wide MLS. The MLS corporation as the new regional MLS independently contracts with each association to provide MLS support services for the subscribers produced by that association.

To assure the continued viability of those smaller associations with disproportionately higher operating costs for their inefficient service, the associations collaborate to set the minimum fee all associations will charge at $25 per subscriber monthly.

The less efficient associations by agreement are paid a fixed monthly cash subsidy on top of the support services fee paid by the subscribers they generate since those associations are operating at a loss. With the fee fixed for services, the efficient associations agree not to charge less and compete to deprive the less efficient associations of subscribers.

When competitive organizations, such as neighboring associations, join together to eliminate their separate MLS database operations in favor of a single county-wide MLS which is more effective and efficient, can they then collude to set the fee charged for the MLS services each will provide? Further, can they ban any discounting or rebates by the efficient and more competitively operated associations?

The simple answer is no. Price fixing is illegal!

The fee which reimbursed the associations for the cost of their MLS support services cannot be legally set by agreement between the competing associations. This is particularly the case when the larger, more efficient associations received millions of dollars in excess MLS support services fees over the actual cost they incurred to provide those services.

This arrangement provided the large associations with huge financial rewards at the improper expense of their subscribers.6

It was the likelihood that some of the associations would go out of business under an efficient county-wide MLS which led to the price being fixed at a supracompetitive and illegal level. This led to the banning of competitive pricing by each association for providing the MLS subscriber services the brokers need by agreeing to no discounts or rebates to their broker-subscribers.

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6 Freeman v. San Diego Association of Realtors (9th Cir. 2003) 322 F3d 1133
However, if competition or economic darwinism had been properly allowed to occur, the more efficient associations would have brought about the demise of the less productive associations to the financial benefit of all of the MLS users.

Many real estate licensees wrongly believe they must join the National Association of Realtors (NAR), the California Association of Realtors (CAR) or the local Association of Realtors (AOR) branch of CAR to practice real estate in California. Licensees all too often equate these trade union leviathans to the Bureau of Real Estate (BRE) due to their past close liaison via past Real Estate Commissioners.

Other licensees have a slightly better grasp on the implications of membership or non-membership in the real estate trade union versus BRE licensing to protect members of the public. Still, many brokers and agents mistakenly believe that union membership is necessary in order to access their local MLS.

This impression is not unfounded. Before 1976, most real estate trade union boards owned and required all access to the MLS to bundle into membership in their association. Such practice was prohibited in 1976.7

Association membership cannot be a prerequisite to MLS access. However, an association is allowed to exact a “reasonable fee” from nonmembers for MLS access. However, the bundling continues with the AORs claiming ownership of data generated by all the published listings, giving access only to their card-carrying members.

To access an AOR-owned MLS, an individual must:

• have a valid California real estate license;
• be a broker, or a sales agent under a broker who is a member of the MLS;
• apply for access to the MLS; and
• pay a fee, which varies by AOR.

If an agent’s broker is not a member of an AOR, the agent is not required to be a member of an AOR. However, if a broker is a member of an AOR, their agents needs to also be members of the AOR in order to access the broker’s MLS.

No other restrictions apply. Real estate agents and brokers can continue to access an MLS without paying excessive and unnecessary dues or entangling themselves in a trade union’s bureaucracy, codes and arbitration rules.

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7 Marin County Board of Realtors, Inc. v. Palsson (1976) 16 C3d 920
Real estate sales transactions are increasingly subject to duplicate charges for integral services, imposed on both buyers and sellers by brokers, lenders, escrow agencies and title companies during periods of rising property values. These are known as kickbacks or referral fees based on who ultimately receives them and what they do in exchange for the fee.

A referral fee is a fee paid by one service provider to another for referring a client to them. Any payment between brokers or agents and third-party service providers, over and above the fee received from the seller on the sales transaction, may only be received in exchange for performing a significant portion of the services rendered by the provider paying the agent an additional fee. Referral fees become illegal kickbacks when received by a broker or agent who negotiated a fee-generating home sale when that broker or agent renders no service to the other provider in exchange for the referral fee beyond the referral itself.

Subscribers to a Multiple Listing Service (MLS) do not need to be members of a trade association in order to post listings and access the MLS database.

**Key Terms**

- Kickback ................................................................. pg. 179
- Referral fee .............................................................. pg. 181