State of California
Department of Real Estate

Professional Responsibility Examination

COURSE BOOKLET

January 2005

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INTRODUCTION

The Department of Real Estate (DRE) has prepared this Professional Responsibility Exam Course Booklet as a basis of study for the Professional Responsibility Examination. The booklet contains information designed to clarify those areas of the Real Estate Law and Commissioner's Regulations that are most frequently cited when formal disciplinary action is taken upon an individual or corporate real estate license.

The purpose of this course is to provide the reader with an opportunity to broaden his/her understanding of the responsibilities of a California real estate licensee within the context of the various types of real estate transactions for which licensure is required. It is hoped that successful completion of this course and the required examination will enable the reader to participate in the real estate profession with an enhanced awareness of conduct that is appropriate for a real estate licensee.

This course booklet contains excerpts from the Real Estate Reference Book, Real Estate Law Book, various Department publications, and Real Estate Bulletin articles. There are other resources you should consider reviewing in preparing for the Professional Responsibility Exam. The Real Estate Law Book, which contains the Business and Professions Code administered by the Department, as well as the Commissioner's Regulations, and the Real Estate Reference Book may be of assistance to you and are available for purchase from the Department of Real Estate. These books, as well as other Department publications, can also be downloaded from the DRE website at www.dre.ca.gov.

Since this course is designed solely to assist you in preparing for the Professional Responsibility Exam, it may not be used for continuing education credit.

GOVERNMENT REGULATION OF BROKERAGE TRANSACTIONS

As our country's development passed through the pioneering and homesteading stages to urbanization, people across the land found it increasingly difficult to "strike a deal" with strangers for land and homes. There was a real need for an intermediary to provide basic real estate knowledge and services and negotiate transactions. The real estate agent met this need and continues to fill this important role today.

Along with increasing opportunities to provide real estate services to the maturing nation came abuses of the public trust in the form of unethical, illegal or sharp practices by dishonest or incompetent agents operating in a climate of unorganized and often unscrupulous competition. Real estate practitioners themselves began to see the need for government regulation. The public's legitimate interest in the buying, selling, exchanging and financing of real property has led to regulation of the real estate business through the adoption of legislative and administrative controls.

California's Legislature passed the nation's first real estate licensing law in 1917. The courts declared that law to be unconstitutional, based on its conditions compared to the licensing requirements of the Insurance Commissioner. California then adopted the Real Estate Act of 1919, which the State Supreme Court upheld as a reasonable exercise of the power of the state to regulate the conduct of its citizens in the interest of the common good.

All fifty states and the District of Columbia have enacted statutes governing, to some degree, the licensing, regulation and conduct of real estate agents. This type of government regulation and supervision has its foundation in what is known as the police power.

The Police Power and the Real Estate Law

For many people, the phrase "police power" evokes images of police officers, jails and courtrooms. But the police power involves much more than the business of detecting crime and criminals and maintaining public order and tranquility. The following, excerpted from a United States Supreme Court case, gives a useful description of the police power:

"By means of it, the legislature exercises a supervision over matters affecting the commonweal and enforces the observance by each individual member of society of duties which he owes to others and the community at large. The possession and enjoyment of all rights are subject to this power. Under it the state may prescribe regulations promoting the health, peace, morals, education and good order of the people, and legislate so as to increase the industries of the state, develop its resources and add to its welfare and prosperity."

In short, police power is the power of the state to enact laws within constitutional limits to promote the order, safety, health, morals and general welfare of our society.

The police power does not vest arbitrary authority in any legislative body. Laws emanating from exercise of the police power must be necessary and proper for the protection or advancement of a genuine public interest. Neither state nor local authority may impose onerous, unreasonable or unnecessary burdens upon persons, property or business.

Legislation intended to protect the public safety, health and morals may impact the manner of conducting lawful occupations and businesses *without*, of course, taking away the right to be gainfully employed.

For many years, society has benefited from regulation of professions such as law, medicine and dentistry. More recently, many other professions, including real estate, have become subject to regulation beyond that of mere licensing.

The organized real estate industry has been among the strongest supporters of the real estate licensing law. The industry is aware that reasonable regulation of those engaged in the real estate business benefits the public by creating and maintaining professional standards and ethical practices in the conduct of real estate brokerage activities. This, in turn, benefits the industry by creating an orderly market place.

The Real Estate Law exists primarily for the protection of the public in real estate transactions involving the services of an agent. By requiring qualifications for licensing, the law enables the Commissioner to ascertain that persons acting in the capacity of a broker or salesperson meet certain standards of knowledge and honesty and, for the broker license, experience.

The Commissioner's authority is not arbitrary. For the Commissioner to find that an applicant for a license is not honest and truthful there must be facts which justify that conclusion. When an applicant has the qualifications required by law, the Commissioner must issue the license.

Subdivisions

With statutory authority, the Commissioner began regulating the sale or lease of subdivided lands in 1933. Like the 1919 licensing law, the subdivided lands provisions survived the State Supreme Court's test of constitutionality. The court held that the object of the law was the prevention of fraud and sharp practices in a type of real estate transaction particularly open to abuses. The court said the method of furnishing information to real property purchasers, which involved investigation and written disclosure of certain essential facts, was appropriate protection. We call this disclosure document a Public Report.

Law Codified

On August 4, 1943, the Legislature organized the statutory authority of the Department of Real Estate (DRE) into the two Parts of Division 4 of the Business and Professions Code (hereinafter, the Code). Part 1 (now Sections 10000 to 10580) is titled Licensing of Persons and may be cited as the Real Estate Law. Part 2 (now Sections 11000 to 11200) is titled Regulation of Transactions and may be cited as the Subdivided Lands Law. (Note that these laws are quite different in purpose and operation from real property law, law of agency, contract law, or other legal aspects of real estate ownership and conveyancing.)

Administration by Commissioner

The Commissioner's mission is to enforce the Real Estate Law and the Subdivided Lands Law in a manner which achieves maximum protection for persons dealing with real estate licensees and for purchasers of subdivided real property. Foremost among the Commissioner's specific duties are: the qualification of applicants and issuance of real estate licenses; the investigation of complaints and, where appropriate, pursuit of formal action against licensees; the investigation of nonlicensees alleged to be performing acts for which a license is required; and the regulation of the sale or lease of subdivision interests. The Commissioner also, through real estate broker and other license requirements, regulates dealings in mineral, oil and gas property and Prepaid Rental Listing Services.

The Real Estate Advisory Commission

The Commissioner appoints the ten members of the Real Estate Advisory Commission. Six are California real estate brokers and four are public members.

The Commission consults with the Commissioner and makes recommendations regarding the functions and policies of the Department and how the Department may best serve the people of the State and recognize the legitimate needs of the industry. After notice of time and place, the Commissioner presides at quarterly meetings of the Commission. At Commission meetings, licensees and members of the public may express their views and make suggestions.

When a Real Estate License Is Required

Sections 10131, 10131.1, 10131.2, 10131.3, 10131.4, 10131.45, and 10131.6 of the Business and Professions Code define the scope of a real estate broker's activity. Mortgage loan broker activities may be found in Sections 10131 (d) and 10240, et seq. of Article 7 (known as the Real Property Loan Law). Trust deed transactions and real property sales contract transactions requiring a license are defined in Sections 10131 (e) and Sections 10230-10236.2 (Article 5). Advance fee brokerage activities are defined in Section 10131.2. Mobilehome sales activities requiring broker licensure are described in Section 10131.6 and Prepaid Rental Listing Services provisions are found in Sections 10167-10167.17. Mineral, oil and gas property dealings requiring a broker license can be found in Sections 10131.4 and 10131.45. Section 10132 of the Code defines a real estate salesperson and the acts requiring licensure and employment by a real estate broker.

Without a license, an individual cannot receive compensation for the performance of any of the acts defined as being within the purview of a licensed broker or salesperson. In addition, the law provides penalties for a person who acts or purports to act as a real estate broker or salesperson without being duly licensed. The Commissioner may levy a fine against any real estate broker who is found in a disciplinary hearing to have compensated an unlicensed person for performing activities which require a real estate license. Furthermore, any person who compensates a nonlicensee for performing services which require a license is guilty of a misdemeanor and may also be fined by the courts. (Sections 10138, 10139, 10139.5 of the Code).

ENFORCEMENT OF REAL ESTATE LAW

A licensing and regulatory law is effective only to the extent of its enforcement. The Commissioner, as the chief officer of the Department, is duty bound to enforce the provisions of the Real Estate Law.

The Commissioner shall upon a verified written complaint, or may, upon the Commissioner's own motion, investigate the actions of any person engaged in the business or acting in the capacity of a licensee within this state, and has the power to suspend or revoke the real estate license. The Commissioner also has the authority to deny a license to an applicant if the applicant does not meet the full requirements of the law. Through a screening process (including the fingerprint record) of an applicant for a license, if it is ascertained that the applicant has a criminal record or some other record that may reflect on the applicant's character, an investigation is made by the Commissioner's staff. A formal hearing may be ordered to determine whether or not the applicant meets the requirements of honesty and truthfulness. The Commissioner also has the authority to require evidence of honesty and truthfulness of officers, directors and persons who own or control more than 10% of the shares of the applicant for a corporate real estate brokerage license.

Generally speaking, an investigation of a licensee is based upon a written statement from one who believes he or she has been wronged by a licensee who was acting in the capacity of an agent. The following investigative procedures are followed by the Commissioner's staff: statements are obtained from witnesses, if any; a statement may be obtained from the licensee involved; bank records, title company records and public records are checked as necessary. As part of the investigation, an informal conference may be called, and all parties concerned may be requested to attend for the purpose of determining the validity and seriousness of the complaint. If it appears that the complaint is of a serious nature and that a violation of law has occurred, an accusation is filed and there may be a formal hearing which could result in suspension or revocation of the license.

Formal Hearings

The formal hearing is conducted in accordance with procedures set forth in the Administrative Procedure Act. The accusation or statement of issues is served upon the affected licensee, who is informed of the rights of an accused. In the hearing, the Commissioner becomes the complainant, and brings the charges against the licensee. The original complainant usually becomes a witness. The licensee, known as the respondent in the hearing procedure, may appear with or without counsel. A record is made of the proceedings and the hearing is conducted according to rules of evidence. Testimony is taken under oath. An administrative law judge from the Office of Administrative Hearings hears the case. The Commissioner's case is presented by the Commissioner's counsel. The administrative law judge issues a proposed decision based upon the findings. The Commissioner may reject or accept the proposed decision, or reduce the proposed penalty and make an official decision. The respondent may petition for reconsideration, and has the right of appeal through the courts.

If the charges are not sustained at the hearing, they are dismissed. On the other hand, if the testimony substantiates the charges and they appear to be sufficiently serious, the license of the respondent is suspended or revoked. After a license is revoked, the person affected may not apply for reinstatement of the license until a minimum of one year has passed.

Representatives of the Commissioner also investigate persons or firms who appear to be operating improperly, or without benefit of a license, or who subdivide land without complying with the subdivision laws enforced by the Commissioner. If sufficient evidence of a violation is obtained, an Order to Desist and Refrain is issued, or a complaint is brought and the parties are prosecuted in a court of competent jurisdiction.

Violations

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

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

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

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

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

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

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

Secret profit. Section 10176(g). Secret profit cases usually arise when the broker, who already has a higher offer from another buyer, makes a low offer, usually through a "dummy" purchaser. The broker then sells the property to the interested buyer for the higher price. The difference is the secret profit.

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

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

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

Obtaining a license by fraud. Section 10177(a). Misstatements of fact in an application for a license; procurement of a license by fraud, misrepresentation, or deceit (e.g., failure to reveal a previous criminal record).

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

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

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

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

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

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

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

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

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

Restricted license violation. Section 10177(k). Violation of the terms, conditions, restrictions and limitations contained in any order granting a restricted license.

Inducement of panic selling. Section 10177(l). To solicit or induce the sale, lease, or the listing for sale or lease, of residential property on the grounds, wholly or in part, of loss of value, increase in crime, or decline in the quality of the schools due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry or national origin.

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

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

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

Other Penalty Sections

There are additional sections in the Business and Professions Code which provide for the revocation or suspension of licenses. These violations could be included under Section 10177(d) of the law. The following are brief summaries:

Sections 10137 and 10138 - employing or compensating any unlicensed person to perform acts requiring a license.

Section 10140 - false advertising.

Section 10140.6 - advertising of acts which require a license must contain a designation disclosing that the licensee is performing such acts.

Section 10141 - broker must cause notice of sales price to be given to both buyers and sellers within one month after the sale is completed.

Section 10141.5 specifies a broker's responsibility for recording trust deeds.

Section 10142 - licensee must give a copy of any contract to the party signing it at the time it is signed.

Section 10145 specifies licensee's responsibilities in handling trust funds.

Section 10148 requires retention and availability for inspection and copying of all listings, deposit receipts, cancelled checks, trust records, etc. for a three year period.

Section 10160 - brokers shall retain and make available for inspection the licenses of salespersons in the broker's employ.

Section 10161.8 - broker must notify DRE when a salesperson is employed or terminated.

Section 10162 - all active brokers must maintain a definite place of business in the State of California.

Section 10163 - brokers maintaining more than one place of business must first procure branch office license(s).

Section 10165 - failure to make licenses available for inspection and to maintain a place of business.

Section 10167 requires the licensing of individuals, other than real estate licensees, engaged in prepaid rental listing services and makes a willful violation of the law a misdemeanor.

Section 10176.5 - violation of any of the Civil Code Sections (1102, et seq.) which deal with use of the Real Property Transfer Disclosure Statement.

Section 10177.1 - suspension without hearing if license procured by fraud, misrepresentation, deceit, or by the making of any material misstatement of fact in the application for license.

Section 10177.2 violations while performing acts under Section 10131.6 (mobilehome sales).

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

Section 10177.5 - final judgment in a civil action against a licensee upon the grounds of fraud, misrepresentation or deceit.

Section 10178 - broker terminates a salesperson for cause and then fails to notify the Commissioner.

Section 10475 - automatic suspension of a real estate license if the Commissioner pays a claim against a licensee from the Recovery Account. No license reinstatement until full reimbursement to the fund, with interest.

Examples of Unlawful Conduct - Sale, Lease, or Exchange

In a sale, lease, or exchange transaction, conduct such as the following may result in license discipline under Sections 10176 or 10177 of the Business and Professions Code:

1. Knowingly making a substantial misrepresentation of the likely value of real property to:
   A. Its owner either for the purpose of securing a listing or for the purpose of acquiring an interest in the property for the licensee's own account.
   B. A prospective buyer for the purpose of inducing the buyer to make an offer to purchase the real property.
2. Representing to an owner of real property when seeking a listing that the licensee has obtained a bona fide written offer to purchase the property, unless at the time of the representation the licensee has possession of a bona fide written offer to purchase.
3. Stating or implying to an owner of real property during listing negotiations that the licensee is precluded by law, by regulation, or by the rules of any organization, other than the broker firm seeking the listing, from charging less than the commission or fee quoted to the owner by the licensee.
4. Knowingly making substantial misrepresentations regarding the licensee's relationship with an individual broker, corporate broker, or franchised brokerage company or that entity's/person's responsibility for the licensee's activities.

5. Knowingly underestimating the probable closing costs in a communication to the prospective buyer or seller of real property in order to induce that person to make or to accept an offer to purchase the property.
6. Knowingly making a false or misleading representation to the seller of real property as to the form, amount and/or treatment of a deposit toward the purchase of the property made by an offeror.
7. Knowingly making a false or misleading representation to a seller of real property, who has agreed to finance all or part of a purchase price by carrying back a loan, about a buyer's ability to repay the loan in accordance with its terms and conditions.
8. Making an addition to or modification of the terms of an instrument previously signed or initialed by a party to a transaction without the knowledge and consent of the party.
9. A representation made as a principal or agent to a prospective purchaser of a promissory note secured by real property about the market value of the securing property without a reasonable basis for believing the truth and accuracy of the representation.
10. Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, the nature and/or condition of the interior or exterior features of a property when soliciting an offer.
11. Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, the size of a parcel, square footage of improvements or the location of the boundary lines of real property being offered for sale, lease or exchange.
12. Knowingly making a false or misleading representation or representing to a prospective buyer or lessee of real property, without a reasonable basis to believe its truth, that the property can be used for certain purposes with the intent of inducing the prospective buyer or lessee to acquire an interest in the real property.
13. When acting in the capacity of an agent in a transaction for the sale, lease or exchange of real property, failing to disclose to a prospective purchaser or lessee facts known to the licensee materially affecting the value or desirability of the property, when the licensee has reason to believe that such facts are not known to nor readily observable by a prospective purchaser or lessee.
14. Willfully failing, when acting as a listing agent, to present or cause to be presented to the owner of the property any written offer to purchase received prior to the closing of a sale, unless expressly instructed by the owner not to present such an offer, or unless the offer is patently frivolous.
15. When acting as the listing agent, presenting competing written offers to purchase real property to the owner in such a manner as to induce the owner to accept the offer which will provide the greatest compensation to the listing broker without regard to the benefits, advantages and/or disadvantages to the owner.
16. Failing to explain to the parties or prospective parties to a real estate transaction for whom the licensee is acting as an agent the meaning and probable significance of a contingency in an offer or contract that the licensee knows or reasonably believes may affect the closing date of the transaction, or the timing of the vacating of the property by the seller or its occupancy by the buyer.

17. Failing to disclose to the seller of real property in a transaction in which the licensee is an agent for the seller the nature and extent of any direct or indirect interest that the licensee expects to acquire as a result of the sale. (The licensee should disclose to the seller: prospective purchase of the property by a person related to the licensee by blood or marriage; purchase by an entity in which the licensee has an ownership interest; or purchase by any other person with whom the licensee occupies a special relationship where there is a reasonable probability that the licensee could be indirectly acquiring an interest in the property.)

18. Failing to disclose to the buyer of real property in a transaction in which the licensee is an agent for the buyer the nature and extent of a licensee's direct or indirect ownership interest in such real property: e.g., the direct or indirect ownership interest in the property by a person related to the licensee by blood or marriage; by an entity in which the licensee has an ownership interest; or by any other person with whom the licensee occupies a special relationship.

19. Failing to disclose to a principal for whom the licensee is acting as an agent any significant interest the licensee has in a particular entity when the licensee recommends the use of the services or products of such entity.

Examples of Unlawful Conduct - Loan Transactions

Conduct such as the following when soliciting, negotiating or arranging a loan secured by real property or the sale of a promissory note secured by real property may result in license discipline:

1. Knowingly misrepresenting to a prospective borrower of a loan to be secured by real property or to an assignor/endorser of a promissory note secured by real property that there is an existing lender willing to make the loan or that there is a purchaser for the note, for the purpose of inducing the borrower or assignor/endorser to utilize the services of the licensee.

2. Knowingly making a false or misleading representation to a prospective lender or purchaser of a loan secured directly or collaterally by real property about a borrower's ability to repay the loan in accordance with its terms and conditions.

3. Failing to disclose to a prospective lender or note purchaser information about the prospective borrower's identity, occupation, employment, income and credit data as represented to the broker by the prospective borrower.

4. Failing to disclose information known to the broker relative to the ability of the borrower to meet his or her potential or existing contractual obligations under the note or contract including information known about the borrower's payment history on an existing note, whether the note is in default or the borrower in bankruptcy.

5. Knowingly underestimating the probable closing costs in a communication to a prospective borrower or lender of a loan to be secured by a lien on real property for the purpose of inducing the borrower or lender to enter into the loan transaction.

6. When soliciting a prospective lender to make a loan to be secured by real property, falsely representing or representing without a reasonable basis to believe its truth, the priority of the security, as a lien against the real property securing the loan, i.e., a first, second or third deed of trust.

7. Knowingly misrepresenting in any transaction that a specific service is free when the licensee knows or has a reasonable basis to know that it is covered by a fee to be charged as part of the transaction.
8. Knowingly making a false or misleading representation to a lender or assignee/endorsee of a lender of a loan secured directly or collaterally by a lien on real property about the amount and treatment of loan payments, including loan payoffs, and the failure to account to the lender or assignee/endorsee of a lender as to the disposition of such payments.
9. When acting as a licensee in a transaction for the purpose of obtaining a loan, and in receipt of an advance fee from the borrower for this purpose, failure to account to the borrower for the disposition of the advance fee.
10. Knowingly making a false or misleading representation about the terms and conditions of a loan to be secured by a lien on real property when soliciting a borrower or negotiating the loan.
11. Knowingly making a false or misleading representation or representing, without a reasonable basis for believing its truth, when soliciting a lender or negotiating a loan to be secured by a lien on real property, about the market value of the securing real property, the nature and/or condition of the interior or exterior features of the securing real property, its size or the square footage of any improvements on the securing real property.

Regulations

The Commissioner has the authority to adopt regulations to aid in the administration and enforcement of the Real Estate Law and the Subdivided Lands Law. The Regulations of the Real Estate Commissioner have the force and effect of the law itself. Licensees and prospective licensees should have a thorough understanding of the regulations.

AGENCY

The primary purpose of this section is to provide a general understanding of the concepts of agency and fiduciary duty so that real estate licensees may better fulfill their responsibilities to the public.

The concepts of agency and fiduciary duty are quite old, being derived from Common Law. According to Civil Code Section 2295 (enacted in 1872), "An agent is one who represents another, called the principal, in dealings with third persons. Such representation is called agency." In an agency relationship, the principal delegates to the agent the right to act on his or her behalf, and to exercise some degree of discretion while so acting.

CREATION OF AGENCY RELATIONSHIPS

A principal and agent can create an agency relationship by:

- agreement between them;
- by ratification;
- by estoppel; or
- as the result of the conduct of the parties and the agent's inherent relationship with third parties (i.e., ostensible or implied agency).

(Regarding ratification and estoppel, see the discussion titled "AUTHORITY OF AGENT" below.)

Actual Agency

Most often, a real estate broker and a principal in a real property or real property secured transaction place the broker in the capacity of *agent* by an express agreement. This is called an actual agency. (Civil Code Section 2299)

A broker has a duty to know and understand the agency relationship being constructed. The broker must be certain that the employment agreement with the principal (typically termed a "listing") is in a correct form and is constructed according to the circumstances and in a fair manner. An agency agreement must be in writing for the agent to enforce a commission claim based upon a breach of contract. [Civil Code Section 1624(d)]

Elements of an Agency Agreement

An agency agreement/listing typically includes:

1. the names of the parties;
2. effective identification of the property;
3. terms and conditions of the anticipated sale, lease or loan;
4. the amount of commission or other compensation to be paid;
5. the expiration date of the agency (An exclusive listing *must* include a definite, specified date of final and complete termination.); and
6. signatures of the parties to the listing.

In addition, an agency agreement/listing concerning the sale of residential property of one to four units, or a mobilehome, must contain, immediately before the commission clause, a statement in

ten point boldface type or larger that commission amounts are not set by law but are negotiable between seller and broker. Business and Professions Code Section 10147.5 sets forth the exact wording which must be used. A real estate broker may deem it prudent to include such a statement in all transactions where the broker is acting within the course and scope of the real estate license.

Types of Listing Agreements

The four kinds of listing agreements most commonly used are:

- the open listing;
- the exclusive agency listing;
- the exclusive right to sell listing; and
- the net listing.

Open listing. An open listing is the least restrictive of the four principal kinds of listing agreements, and is distinguished by the fact that the owner retains the right to revoke the listing at any time, to sell the property him or herself, or to list the property with another broker. Open listings often generate questions regarding a real estate broker's claim to a commission because the sale of the property by either the owner or any subsequently hired agent could defeat the original broker's right to a commission.

Exclusive agency. An exclusive agency is an agreement by which the owner agrees to employ a particular real estate broker to solicit prospective buyers, tenants/lessees, or lenders. Under an exclusive agency listing, the broker's right to a commission is protected as against other brokers for the duration of the listing agreement. However, under an exclusive agency agreement, the owner retains the right to sell, encumber or rent/lease the property on his or her own and, in that event, the owner can terminate the agency agreement and the broker has no claim to a commission or other compensation.

Exclusive right to sell. The exclusive right to sell listing affords a real estate broker the greatest protection and makes him or her the sole agent for the sale of the property. The broker is entitled to a commission provided only that the property is sold during the listing period, regardless of who procures the buyer. Under an exclusive right to sell agreement, the owner relinquishes both the right to list the property with other agents and the right to defeat the broker's claim for a commission by selling the property him or herself. An exclusive right listing may also be used in a rental or loan transaction.

Net listing. A net listing is one which contemplates the seller realizing certain net proceeds. The real estate broker's commission is any sum received in excess of the seller's net. For example, if the seller enters into a net listing with a broker for a $100,000 net, the broker would receive no commission if the net proceeds of the sale are $100,000 or less. On the other hand, if the net proceeds of the sale are $125,000, the broker is entitled to a commission of $25,000. This type of listing has more to do with the type of compensation than with whether it is exclusive or not.

Unilateral and bilateral agreements. An agreement can be classified as either unilateral or bilateral. A unilateral agreement is one in which one party makes a promise to induce some act or performance by the other party, but the latter can act or not act as he chooses. For example, in an open listing the seller agrees to pay compensation to a real estate broker who procures a buyer, but there is no obligation on the part of any broker to do so.

A bilateral agreement is one in which a promise by one party is given in exchange for a promise by the other party. For example, an exclusive right to sell listing includes a broker's promise to use due diligence in attempting to find a buyer. In exchange, the seller promises to pay the broker a commission if the broker is successful.

Multiple Listing

A multiple listing service (MLS) is a means by which information concerning individual listings is distributed to all participants and subscribers of the service. For example, assume a seller lists property for sale with a broker. Pursuant to the listing, the broker transmits to the MLS information about the property which includes information such as the type of property, its size, location, listed price and other relevant information as well as the compensation offered to other brokers who procure a buyer. The MLS publishes the information in a database and sometimes in book format.. Other brokers throughout the region are thereby made aware of the listing and can show the property and contact the listing agent on behalf of prospective buyers.

When a resultant sale closes, the listing broker makes good on his unilateral offer to split the commission with the selling broker.

Ostensible or Implied Agency

An agency relationship can result from the conduct of the parties even though there is no express employment agreement and regardless of the source of compensation. Agency relationships created from the actions or conduct of the parties are known as ostensible or implied agencies.

For example, a listing broker can unintentionally become the agent of the other principal to a transaction by leading the buyer to believe they are negotiating on behalf of or advocating the interest of the buyer when presenting the offer to the seller, or when processing the transaction to close of escrow. [To act as an undisclosed agent of the other principal (i.e., without the informed consent of both parties), may subject the broker to administrative discipline and/or loss of commission, and may be grounds for rescission of the transaction. [Business and Professions Code Section 10176(a) and (d)]

(See also "AUTHORITY OF AGENT" below.)

Compensation

Compensation is not essential to the creation of an agency. One may undertake to act gratuitously as an agent and still be held to certain standards demanded of an agent for compensation. Under the Real Estate Law, one who acts as a gratuitous agent does not need a real estate license. However, in any transaction subject to the Real Estate Law, and where there is an *expectation* of compensation, regardless of the form, time, or source of payment, a license is required. (Business and Professions Code Sections 10130, et seq.)

Compensation, or the expectation of compensation, is viewed broadly. For instance, benefits arising out of a joint venture relationship, or even out of the sharing of overhead, have been held to be sufficient compensation to establish licensed activity.

AUTHORITY OF AGENT

An agent has authority to:

- Do everything necessary, proper or usual in the ordinary course of business to effect the purpose of the agency; and

- Make representations as to facts, not including the terms of the agent's authority, on which the agent's right to use his or her authority depends, and the truth of which cannot be determined by the use of reasonable diligence on the part of the person to whom the representation is being made. (Civil Code Section 2319)

Actual authority is that authority a principal intentionally confers upon the agent, or intentionally, or by want of ordinary care, allows the agent to believe that he or she possesses. (Civil Code Section 2316) Ostensible authority is that authority a principal intentionally, or by want of ordinary care, causes or allows third persons to believe that the agent possesses. (Civil Code Section 2317) Ostensible authority is sometimes referred to as apparent or implied authority.

Express Authority

Again, express authority is created by a contract which completely and precisely delineates those activities the agent is authorized to undertake. For example, if the principal authorizes the agent to acquire a particular single-family residence for $100,000, the agent has express authority to do precisely that and nothing else. The agent would not have express authority to purchase the house for $105,000 or to purchase a different house.

Implied Authority

Implied authority exists because it is often impractical or even impossible for the principal to specifically delineate every aspect of the agent's authority. Implied authority may be derived from express authority and exists to the extent that it is reasonably necessary to accomplish the objectives of the agency. In the example above, the agent had express authority to purchase a particular property at a certain price. The agent might have implied authority to set time limits for performance of the agreement, receive notifications from the seller, waive conditions in the agreement and possibly undertake efforts to obtain financing for the buyer.

Implied authority cannot conflict with express authority but it may exist where there is no relevant grant of express authority. The determination of whether implied authority has been given usually involves determining the custom and practice of the community and whether the specific act was reasonably necessary for achieving the objectives for which the agency relationship was created.

Apparent Authority

Apparent authority depends not upon the express or implied agreement between principal and agent, but upon the reasonable expectations of third parties who have been led to believe that the agent is authorized to act on behalf of the principal. Apparent authority is distinctly different from actual or express authority and is sometimes referred to as ostensible authority by *estoppel*. Ostensible authority by estoppel arises when the principal, by words or conduct, leads a third party to believe that another person is his agent.

In other words, apparent or ostensible authority will arise and the principal could be estopped to deny the existence of the agency, or the scope of the agent's authority, when the principal's actions have created the appearance of authority in the agent and a third party reasonably relies, to his/her detriment, upon this authority. The most common causes of questions concerning apparent authority are the principal's placement of a limitation upon the normal and ordinary authority of the agent and failure to communicate this limitation to a third party dealing with the agent.

Liability of principal to third parties. The principal is liable to persons who have sustained injury through a reasonable reliance upon the ostensible, whether implied or apparent, authority of an agent. The act of the agent can never alone establish ostensible authority, but silence upon the part of the principal who knows that an agent is holding himself or herself out as vested with certain authority may give rise to liability of the principal.

Emergency Broadens Authority

An agent has expanded authority in an emergency, including the power to disobey instructions where it is clearly in the interests of the principal, and where there is no time to obtain instructions from the principal. An example of this authority occurs in the relationship between a property manager and an owner when an immediate repair or replacement is required to protect the property and to provide necessary services to the tenant.

Restrictions on Authority

An agent who is given the power to sell real property for a principal also possesses the power to give the usual covenants of warranty unless there are express restrictions in this regard in the agent's agreement with the principal. Also, an agent can never have authority, either actual or ostensible, to do an act which is known or suspected by the person with whom the agent deals to be a fraud upon the principal. Unless specifically authorized, an agent has no authority to act in the agent's own name except when it is in the usual course of business for the agent to do so.

An agency to sell property does not carry with it the authority to modify or cancel the contract of sale after it has been made. A limited agency as created between a seller and a real estate broker to sell the property ordinarily empowers the real estate broker to find a buyer, but does not authorize the agent to enter into a contract to convey title to the property on behalf of the principal.

An agent who has authority to collect money on behalf of his or her principal may endorse a negotiable instrument received in payment only where the exercise of this power is necessary for the performance of the agent's duty and where the principal has specifically granted the power to endorse the instrument. Where an agent is expressly authorized to collect money, the agent may accept a valid check and the agent's receipt of the check on behalf of the principal will be considered payment to the principal.

Ratification of Unauthorized Acts

Occasionally, a person may act as agent without authority to do so, or an agent may act beyond the scope of the agent's authority. The alleged principal may not be bound by such acts. A principal may under certain circumstances *ratify* the acts of the agent and thus become bound. Not only must the principal intend to ratify, but:

1. The agent must have professed to act as a representative of the principal.
2. The principal must have been capable of authorizing the act both at the time of the act and at the time of ratification.
3. The principal must have knowledge of all material facts unless ratification is given with the intention to ratify no matter what the facts are.
4. The principal must ratify the entire act of the agent, accepting the burdens with the benefits.
5. The principal must ratify before the third party withdraws.

Generally, an act may be ratified by any words or conduct showing an intention on the part of the principal to adopt the agent's act as the principal's own. Once ratified, the legal consequences are the same as though the act had been originally authorized.

Duty to Ascertain Scope of Agent's Authority
No liability is incurred by the principal for acts of the agent beyond the scope of the agent's actual or ostensible authority. A third party who deals with an agent and knows of the agency is under a duty to ascertain the purpose and scope of the agency.

Power of Attorney
A power of attorney is a written instrument giving authority to an agent. The agent acting under such a grant of authority is generally called an "attorney in fact." A *special* power of attorney authorizes the attorney in fact to do certain prescribed (limited) acts on behalf of the principal. Under a *general* power of attorney, the agent may transact all of the business of the principal. Powers of attorney are strictly construed and ordinarily where an authority is given partly in general and partly in specific terms, the general authority is limited to acts necessary to accomplish the specific purposes set forth.

Authority to Receive Deposits
Virtually all listing agreements now give express authority to the broker to accept an earnest money deposit on behalf of the seller. The authority granted a listing broker also applies to any subagents of the seller. The authority, however, would not apply to a broker who is acting only as an agent of the buyer.

Except for a check to be held uncashed until acceptance of the offer, as discussed below, a broker must place funds accepted on behalf of another into the hands of the owner of the funds, into a neutral escrow depository or into a trust fund account in the name of the broker as trustee at a bank or other financial institution not later than three business days following receipt of the funds by the broker or the broker's salesperson.

In those cases where a down payment has been paid to the broker and not deposited in escrow, title to such payment vests in the seller when the seller accepts the purchase contract. Further, where an agreement for sale of real property provides that a deposit with the broker is to become a part of the down payment when the seller puts in escrow a deed evidencing good title, the deposit becomes the seller's property when the deed is put in escrow. Similarly, money received by seller's agent under a deposit receipt with a valid liquidated damages clause is generally (in the case of the buyer's breach) not recoverable by the buyer.

The rationale behind this rule is that money received by a broker as agent or subagent for the seller belongs to the seller when the offer has been accepted. In general, the broker may not return the funds to the buyer without the consent of the seller.

Check. A broker who accepts a check (or promissory note) as an earnest money deposit must make full disclosure to the seller.

If a buyer has given a check to the broker as an earnest money deposit with written instructions to hold the check until acceptance of the offer, the buyer's instructions should be followed. But the seller must be informed in writing that the buyer's check is being held and not negotiated. This disclosure should be given to the seller no later than the actual presentation of the offer to the seller.

During the time between receipt of the check by the broker and acceptance of the purchase offer by the seller, the broker must record receipt of the check on broker's trust fund records and hold the check in a safe place. (Real Estate Commissioner's Regulations 2831 and 2832)

California law has held that a post-dated check may be considered the equivalent of a promissory note. Therefore, a broker should not accept a post-dated check from a buyer since this may result in mischaracterization of the form of earnest money deposit without adequate disclosure to the seller.

As our society more often uses electronic transfer of funds, other forms of earnest money deposits may well be used in real property transactions. Full and complete disclosure to the seller is required of the form, amount, and disposition of the earnest money deposit.

Promissory note. While checks are universally accepted as equivalent to cash in business transactions, promissory notes are not. The maker of a check represents that sufficient funds are in the bank account upon which the check has been drawn, and failure to have such money may be a crime. The maker of a note does not represent that he or she has sufficient money to pay as the note requires, and failure to pay is generally not a crime.

A broker violates the Real Estate Law if he/she directly or impliedly misrepresents to broker's principal/seller that a purchaser has given cash or a check as an earnest money deposit when in fact the broker has accepted a non-negotiable promissory note.

Escrow depository. When a buyer deposits earnest money directly into a neutral escrow, the delivery is conditional. While it may be argued that the buyer retains title to the money until the conditions have been performed, the escrow holder will generally not return the earnest money deposit to the buyer without concurrence of the seller. If a transaction does not close as agreed, it is the obligation of buyer and seller to insure that all funds deposited into escrow are given to the person who is entitled to the money.

If the buyer and seller are unable to resolve a dispute regarding an earnest money deposit, the escrow holder may file an interpleader action seeking declaratory relief from the court. The cost of such action will typically be deducted from the earnest money deposit.

If buyer and seller perform as agreed, the escrow holder becomes the agent of the seller as to the purchase money and the agent of the buyer as to the deed. At closing, the escrow holder delivers the money to the seller and the deed to the buyer.

Dismissal of Broker/Stakeholder From Suit

A real estate broker may be named as a defendant in a law suit for recovery of money the broker is holding as a trustee in a transaction. If the only relief sought against one of several defendants is payment of a stated amount of money, such defendant may, after notice to the other parties, apply to the court for an order of discharge from liability and dismissal from the action. Again, this is known as an interpleader action. The defendant broker must deposit with the clerk of the court the money in dispute. The court may then dismiss the suit as to defendant broker.

A broker need not wait to become a defendant in a lawsuit. If there is a fund disputed by two or more persons, the holder of the fund may file an interpleader action and deposit the fund with the court. The pleading would allege that the holder has no interest in the fund, and it would require the other parties to litigate their claims. The holder of the fund may be awarded attorney fees and costs.

Commingling
An agent who places a client's money in the agent's personal bank account is guilty of commingling and risks attachment of the funds for personal claims against the agent. Except for a check to be held until acceptance, a real estate broker must, within three business days of receipt, place all funds received on behalf of principals in a trust account, neutral escrow depository or into the hands of the principal who is entitled to them. If the broker fails to do so, the broker's license may be subject to disciplinary action by the Commissioner. A salesperson should immediately deliver all deposits into the hands or into the control of salesperson's broker, or as may be instructed by the broker.

Agency Disclosure Form
Sections 2079.13, et seq. of the Civil Code establish an agency disclosure format for sale transactions involving residential property improved with one to four dwelling units. This disclosure format also applies to leases of such residential property for longer than one year and to sale of a mobilehome under authority of a real estate broker's license. A "sale" includes an exchange of the property, or a sale by real property sales contract as defined in Civil Code Section 2985.

The agency disclosure form sets forth disclosure obligations and describes certain duties a licensee owes to a principal in a real property transaction, whether the broker is the seller's agent, the buyer's agent, or a dual agent. The text of the form is set forth in Section 2079.16 of the Civil Code. Sections 2079.13 through 2079.15, inclusive, and 2079.17 through 2079.24, inclusive, must be printed on the back of the form.

The listing broker (or his or her agent, whether salesperson or broker associate) must deliver the form to the seller before entering into a listing agreement. The selling broker (or his or her agent) must provide the form to the seller as soon as practical and before presenting the offer. If the selling broker does not deal face to face with the seller, the form may be delivered by the listing broker. The agency disclosure form may also be delivered to the seller by certified mail. The selling broker must deliver the form to the buyer as soon as practical before the buyer signs the offer to buy. If the offer is not prepared by the selling broker, the form must be delivered to the buyer no later than the next business day following receipt of the offer from the buyer. [Civil Code Section 2079. 14 (d)]

(A broker associate is a real estate broker who has entered into a written contract to act as the salesperson/agent of another broker in connection with acts requiring a real estate license and to function under the employing broker's supervision. As used in this chapter, the term "salesperson" includes "broker associate.")

A broker must obtain a receipt from the principal receiving the disclosure. When the disclosure form is delivered by certified mail, no further receipt is required. If a seller or buyer refuses to sign the receipt, the broker or his or her agent must "set forth, sign, and date a written declaration of the facts of the refusal." (Civil Code Section 2079.15)

The disclosures are essentially as follows:

- the duty of utmost care, integrity, honesty and loyalty in dealings with the agent's principal;
- the duty to exercise skill and care in performance of the services rendered by the agent;
- the duty to act honestly and without fraud or deceit and to act fairly and in good faith; and

- the duty to disclose all material facts known to or which should be known to the agent affecting the value or desirability of the property not known to or readily observable by the parties to the transaction.

Disclosure and Confirmation of Actual Agency Relationships

As soon as practicable, a listing agent must disclose to the seller whether the listing agent is acting exclusively as the seller's agent, or as a dual agent representing both the seller and the buyer.

As soon as practicable, a selling agent must disclose to the buyer and seller whether the agent is acting exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and seller. The term "exclusively" is generally understood to mean the agent acting for the principal in that transaction as contrasted with the dual agency in the same sales contract and does not mean the listing or selling agent does not have other clients. It does not preclude, for example, the listing broker from representing other sellers or the selling agent from representing other buyers.

The disclosed agency relationships must be confirmed in writing, either in the purchase agreement or in separate writings executed or acknowledged by seller, buyer, and agent(s), prior to or coincident with execution of the contract.

These disclosure requirements and the form of the written confirmations are contained in Civil Code Section 2079.17.

Statutory Limitations and Definitions

In addition to establishing disclosure requirements, Civil Code Sections 2079.13, et seq. impose various limitations on the conduct of, and add definitions regarding the performance of, the *agency* role of the real estate broker acting in a sale transaction. Among such limitations and definitions are the following:

1. A listing broker who is also a selling broker is a dual agent and cannot be the agent of the buyer only. (Civil Code Section 2079.18)
2. The source of compensation to a broker does not in and of itself determine who is that broker's principal. (Civil Code Section 2079.19)
3. A real estate broker functioning as a dual agent may not disclose to the seller that the buyer is willing to pay more than the buyer's written offer to purchase, nor may a dual agent disclose to the buyer that the seller will take less than that which is set forth in the listing agreement, without the express written consent of the party authorizing the disclosure. (Civil Section 2079.21)
4. A listing broker may also be the selling agent without necessarily becoming a dual agent. (Civil Code Section 2079.22)

Section 10176(d) of the Business and Professions Code requires that a licensee may act for more than one party to <u>any</u> real estate transaction <u>only</u> with the knowledge or consent of all parties to the transaction.

When applying Section 10176(d), it is prudent for licensees to get written consent and not rely on knowledge of the parties alone.

More on Dual Agency

Dual agency arises where the listing broker who is the actual agent of the seller becomes also the actual agent, or ostensible or implied agent, of the buyer.

Dual agency also commonly arises when two salespersons associated with the same broker undertake to represent two or more parties to a transaction. The real estate broker is then a dual agent.

Although dual agency is a common practice in California, a real estate broker who represents both parties must act with extreme care.

In any dual agency situation, the broker owes fiduciary duties to both principals. Dual agents face a particular difficulty with the elements of fiduciary duty which involve loyalty and confidentiality. Typical examples arise in connection with the negotiation of price and terms between seller and buyer and negotiation of loan amount and terms between lender and borrower.

The Legislature recognized this conflict when enacting Section 2079.21 of the Civil Code. That section states, in part: "A dual agent shall not disclose to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. A dual agent shall not disclose to the seller that the buyer is willing to pay a price greater than the offering price, without the express written consent of the buyer."

A form of dual agency which has not been specifically addressed in the disclosure statutes is a broker's presentation of offers on behalf of two different buyers. This can easily happen when a broker is showing the same property to two prospective buyers and both buyers want the broker to write an offer on the property. The situation becomes even more complex if buyer A is in contract and buyer B makes a back-up offer. Buyer A's position is almost certainly weakened and buyer A would have reason to claim that the real estate broker breached fiduciary duties and obligations by participating in the offer by buyer B. A broker should not represent two buyers on the same property without the clear, informed and unequivocal consent of both parties.

Subagency

Real property transactions frequently involve cooperation between two brokers. The legal principles which govern the field of subagency are particularly complex. This is due, at least in part, to the different relationships which exist between the brokers and the principals to the transaction.

A critical element in determining relationships between the parties is whether the principal has agreed to allow the listing broker to delegate some portion of his or her authority to another. A listing usually provides that the listing broker may cooperate and share commissions with other brokers to carry out the purpose and scope of the agency.

When another agent is appointed by the listing broker *with* the express or implied authority of the principal, the second broker becomes the subagent of the principal. On the other hand, where the listing broker appoints another broker *without* the consent of the principal, the second broker becomes the agent of the listing broker.

The acts, errors and/or omissions (negligence) of a cooperating broker who is the authorized subagent of the seller may be imputed to the seller. For example, certain negligent acts of the cooperating broker may be imputed to the seller and the seller may be liable to third parties under the legal theory of respondeat superior.

Likewise, when the cooperating broker is the agent of the listing broker, the negligent acts of the cooperating broker may be imputed to the listing broker and the listing broker may be liable to third parties, again under the legal theory of respondeat superior.

(Remember, pursuant to Civil Code Section 2079.19, the payment of compensation does not *necessarily* determine the nature of the agency relationship between the parties.)

Delegation of Duties

Agents commonly delegate certain of their duties and their responsibilities to others. Unless specifically forbidden by the principal, the general rule is that such delegation is allowed.

The powers which may be delegated by an agent to others are generally limited to the following:

- purely mechanical acts;
- acts the agent cannot do alone and the subagent can lawfully perform; and
- acts which common practice has established may be delegated or which the principal authorizes to be delegated.

(Civil Code Section 2349)

When delegating a power to another, the agent must exercise care in delegating the authority and in choosing and appointing the delegee. Although an agent may not be authorized to assign a *duty of performance* to another, the agent may nevertheless be authorized to delegate the *actual performance* of such duty to others, and thereby discharge the duty through performance of the delegee. Although most agency agreements do not require the *personal performance* of the original agent, the original agent will typically remain liable for the acts delegated to others.

DUTIES OWED TO PRINCIPALS

An agency relationship creates a fiduciary duty owed by the agent to the principal within the course and scope of the agency and the authority granted by the principal. The fiduciary duty owed by real estate brokers to their principals has been compared by the courts to the duty owed to the beneficiaries by a trustee under a trust.

Fiduciary duties include: loyalty; confidentiality; the exercise of utmost care (and in certain fact situations, reasonable care); full and complete disclosure of all material facts; the obligation to account to the principal; the obligation to act fairly and honestly and without fraud or deceit; and the duty to "explain" and "counsel" about that which has been disclosed, thereby helping the principal make an informed and considered decision to buy, sell, lease, exchange, borrow or lend.

A salesperson owes a duty to the principal equivalent to the duty owed by the real estate broker for whom the salesperson acts.

Loyalty and Confidentiality

A real estate broker owes duties of loyalty and confidentiality to the broker's principal. The broker is prohibited from personally profiting by virtue of the agency relationship, except through receipt of compensation for services rendered by the broker in accordance with the terms of the employment agreement. This fiduciary duty is the most significant aspect of the agency relationship.

A broker may not unite his or her role as an *agent* with his or her *personal* objectives in a transaction without disclosure to, and consent from, the principal. The act of an agent within the

course and scope of the agent's authority is the act of the principal. In exercising that authority, the agent is dealing with property or other matters of grave concern to the principal. As a fiduciary, a real estate broker performing as an *agent* is bound by law to exercise, among other duties, the utmost good faith, loyalty and honesty.

Fair and Honest Dealing

A real estate broker who is the agent of a principal owes a duty of fair and honest dealing to the other party to the transaction. This duty includes the obligation to make a complete and full disclosure of all material facts. A real estate broker owes this duty of full disclosure even though the broker is not the agent and fiduciary of the party to whom the disclosures are made. This is a duty which the courts have held to exist by reason of the agent's status as a real estate broker. (*Lingsch v. Savage* 1963 213 Cal. App. 2d 729, 736)

The duty of disclosure may also be found to exist by way of the agent's fiduciary obligation to the party on whose behalf the disclosures are being made. Any misrepresentation or material concealment on the part of the agent may afford the other party grounds for rescission or damages.

General Disclosure Duties

In a fiduciary relationship, it is the duty of the agent to make full disclosure of all material facts relating to the subject matter of the agency. For example, the courts have held that negotiating a sale to the real estate broker's wife without making a full disclosure to the principal is a violation of the duty to disclose all material facts. A later case was concerned with the failure of the real estate broker to disclose to the seller that the buyer was the broker's mother-in-law.

The court stated that where a seller's real estate agent is obligated to disclose to the agent's principal the identity of the buyer, and where the buyer is not the agent but has with the agent such blood, marital or other relationship which would suggest a reasonable possibility that the agent could be indirectly acquiring an interest in the property, such relationship is a material fact which the agent must disclose to the agent's principal.

An agent's duty includes full disclosure and explanation of facts necessary for the principal to make an informed and intelligent decision. In *George Ball Pacific, Inc. v. Coldwell Banker & Co.* (1981 117 Cal. App. 3d 248), the court found that the broker had made an inaccurate representation when he arranged a lease without knowing whether the lessor owned the property being leased.

Reasonable Care and Skill

An agent has a duty to use reasonable care and skill (and depending upon the fact situation, utmost care) to obey directions of the employer, and to render an accounting to the principal. The language in Civil Code Section 2079.16 requires "a fiduciary duty of utmost care, integrity, honesty and loyalty." The reasonable care and skill standard applies to the party in the transaction who is not the agent's principal. Whether the standard is utmost or reasonable will depend upon the fact situation and the relationship between the agent and the principal. A gratuitous agent (i.e., one who is not paid for the agent's services) cannot be compelled to perform the undertaking, but such an agent who actually enters upon performance must obey instructions and is bound to exercise the utmost good faith in dealing with the principal.

Although real estate brokers as agents and fiduciaries are obligated to fully disclose to a principal all material facts which might influence the principal's decision concerning any real property or

real property secured transaction, they should be aware of a California Attorney General's opinion (Op. 69/263). This Opinion explains that *race, creed or color is not a material fact* and should not be disclosed, even though the furnishing of such information is at the request of the principal.

Inspection and Disclosures

Listing and selling brokers have an affirmative duty to conduct a reasonably competent and diligent inspection of the residential property listed for sale, and to disclose to prospective purchasers all facts materially affecting the value or desirability of the property that such an investigation would reveal.

After the *Easton v. Strassburger* decision, Civil Code Sections 2079, et seq. were enacted to describe this duty of inspection as follows:

1. A real estate broker has a duty to the buyer of residential real property of one to four units (including manufactured homes) to conduct a reasonably competent and diligent visual inspection of the property offered for sale and disclose to the buyer all facts materially affecting the value or desirability of the property that such an investigation would reveal, if the broker has a written listing contract with the seller to find a buyer or is a broker who acts in cooperation with such a broker to find a buyer.
2. This duty also applies to leases of such residential property with an option to buy and to real property sale contracts as defined in Civil Code Section 2985.
3. The standard of care owed by a broker 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 real estate license.
4. The inspection to be performed does not include areas that are reasonably and normally inaccessible to such an inspection. If the property is a unit in a planned development, condominium or stock cooperative, the inspection does not include more than the unit offered for sale, if the seller complies with Section 1368 of the Civil Code, which requires a seller of such properties to furnish the buyer with copies of covenants, conditions, and restrictions, by-laws, delinquent assessments and penalties, etc.
5. In no event shall time for commencement of legal action for breach of duty imposed by this article exceed two years from the date of possession, which means the date of recordation, the date of close of escrow, or the date of occupancy, whichever comes first.
6. The inspection to be performed also does not include an affirmative inspection of areas off the site of the subject property, or public records or permits concerning the title or use of the property.

Transfer Disclosure Statement. The results of the brokers' inspections will be included on the Real Estate Transfer Disclosure Statement required by Civil Code Section 1102.3.

Professional liability insurance. Section 11589.5 of the Insurance Code provides that no insurer who provides professional liability insurance for persons licensed under the Real Estate Law shall exclude from coverage under that policy liability arising from breach of the duty of the licensee arising under Article 2 (starting with Section 2079) of Chapter 3 of Title 6 of Part 4 of Division 3 of the Civil Code. (An insurer may exclude coverage of liability arising out of a dishonest, fraudulent, criminal, or malicious act, error, or omission committed by, at the direction of, or with knowledge of the insured.)

Buyer's duty. Nothing in this disclosure law relieves a buyer or prospective buyer of the duty to exercise reasonable care to protect themselves including those facts which are known to or within their diligent attention and observation.

No Secret Profit or Undisclosed Compensation

The courts have unequivocally held that an agent *cannot*:

- acquire any secret interests adverse to the principal;
- make a secret personal profit out of the subject of the agency; or
- conceal the agent's interest in the property being conveyed or encumbered.

If an agent is aware of the amount at which a property may be sold and purchases at a lower amount, reselling and pocketing the difference, the agent will be compelled to disgorge the secret profit.

Claiming or receiving a secret profit or any form of undisclosed compensation is cause for discipline under Business and Professions Code Section 10176(g). The obligation to disclose all compensation regardless of the form, time, or source of payment is imposed upon real estate licensees whether acting in a real property or real property secured transaction.

Obligations of Real Estate Salespersons

A real estate salesperson is the agent of a broker and is subject to the same duties and obligations arising out of the fiduciary relationship between the broker and the broker's principal.

A salesperson must disclose to the broker's principal all the information the salesperson has which may affect the principal's decision. Failure to fulfill this obligation could result in disciplinary action against the salesperson's license and may result in disciplinary action against the license of the employing broker. Moreover, a broker will generally be held liable for damages for acts and omissions of the broker's salesperson.

DUTIES OWED TO THIRD PARTIES

Warranty of Authority

If an agent acts in the name of the agent's principal with authority given by the principal, the principal is bound by the agent's act. When the agent acts without authority or in excess of the agent's authority, the agent may be held liable for resulting damages for having breached the agent's implied warranty of authority. While the agent warrants the agent's own authority, the agent does not impliedly warrant the authority of the principal (e.g., the principal's authority or capacity to contract).

Regarding Contracts

When a contract is negotiated and executed by an agent in the name of the principal, the agent will not ordinarily be held liable for performance of the contract. If, however, there is a lack of authority on the part of the agent, the agent is liable for performance of the contract as a principal. The agent could also be personally liable for performance of the contract if the agent fails to reveal the name of the principal or the fact that the agent is acting in an agency capacity.

The manner in which an agent signs a contract with a third party on behalf of the agent's principal may be significant in determining whether the agent has any personal liability to the

third party. Ordinarily, an agent should enter the name of the principal as the contracting party and should then sign the instrument "by" himself or herself as agent for that principal.

Regarding Torts

Torts are private wrongs committed upon the person or property of another and arising from a breach of duty created by law rather than by contract. An agent is liable to third parties for the agent's own torts whether the principal is liable or not. Where a person misrepresents his or her authority to act as agent for another, such person may be liable in tort to the third party who relies on the representation to the third party's detriment.

Real estate brokers and their salespersons are constantly making representations to prospects concerning property being offered for sale. A representation may be merely an expression of opinion or "puffing" on the part of the licensee but it may be reasonably understood by a prospective buyer to be a representation of fact and thus a part of the contract if agreement is reached.

Material representations which are false or misleading may result in liability of the real estate broker. The same may be said with respect to failure on the part of the broker to disclose material facts about the property to a prospective buyer. In addition to incurring liability for damages to the buyer, a broker guilty of overt misrepresentations or failure to disclose material facts may be subject to license discipline by the Department of Real Estate.

Misrepresentation: Fraud v. Negligence

Misrepresentation may be either fraudulent or negligent. The principal may be vicariously liable in damages for the broker's misrepresentations even where the principal was not the source of the erroneous information conveyed by the broker acting as the principal's agent.

Certain misrepresentations, even though made by an agent with no bad intent, are defined by law as actual fraud if they are positive assertions of that which is not true made in a manner not warranted by the information of the person making the representation, notwithstanding that such person believes it to be true. Constructive fraud, as defined in the California Civil Code, includes any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or anyone claiming under him or her, by misleading another to his or her prejudice, or to the prejudice of anyone claiming under him or her.

Thus, in the area of misrepresentations, the dividing line between fraud and negligence is often blurred and yet there may be a significant difference in the agent's exposure in damages depending upon whether the misrepresentation is found to be negligent or fraudulent. If found by a court or jury to be fraudulent, punitive damages can be awarded against the person making the misrepresentation. Remember, a real estate broker acting as an *agent* in a real property or real property secured transaction may make no representation without a reasonable basis for believing the representation is true; may assert no half-truths; and may not assert a series of independent truths which when interconnected are expressly or inferentially misleading.

Furthermore, if a fraud judgment is entered against a real estate broker based on the broker's performance of acts for which a real estate license is required, disciplinary action may be taken against the broker based solely on the civil judgment. (*California Real Estate Loans, Inc. v. Wallace* 1993 18 Cal. App. 4th 1575) If, on the other hand, the broker's misrepresentation is found to be no more than negligent, a case against the broker for negligence would have to be

heard at the administrative level where the standard of proof required in order to discipline is convincing proof to a reasonable certainty as opposed to the preponderance-of-evidence standard in a civil negligence action.

Nondisclosures

Civil liability of a real estate broker for misrepresentation and the possibility of disciplinary action against the licensee may arise from the broker's failure to disclose as well as from overt misstatements. Liability for failure to disclose may result where the broker has knowledge of facts materially affecting the value, desirability, or intended use of the property, and which facts the broker does not convey to the prospective buyer knowing that the buyer does not have the same information.

Cases imposing a duty of disclosure oftentimes involve concealment by the seller of latent defects in the property. These cases have held that the real estate broker acting as an agent of the seller and the seller have a duty to disclose facts materially affecting the value, desirability, or intended use of property, if the broker knows that the buyer is unaware of these facts and they are not within the buyer's diligent attention, including inspection of the property. The courts have sometimes referred to such non-disclosure as negative fraud.

"Puffing"

Even in some situations where a licensee honestly believes that representations to the prospective buyer are nothing more than "puffing" or "sales talk," a problem may develop if the impression made upon the buyer is that the representation is one of fact. Persons of limited expertise and sophistication may tend to rely upon such statements and to purchase property as a result of such reliance.

A statement by a licensee that a house was "in perfect shape," while obviously not literally true, has been described by an appellate court as a representation of a material fact.

Torts of the Principal

While an agent is personally liable for torts which the agent commits, regardless of the liability or absence of liability of the principal, the agent cannot be held liable for torts committed by the principal. For example, if the principal supplies the agent with false information concerning the property and the agent passes this information along to a prospective buyer in reasonable reliance upon its truth, the agent is not liable to the buyer for what amounts to republishing the misrepresentation.

RIGHTS OF AGENT

Compensation - Performance Required Under Employment Contract

Generally. To be entitled to a commission in a sale transaction a broker must:

- produce a buyer ready, willing and able to purchase upon the terms and at the price stipulated by the seller; or
- secure from a prospective buyer an offer upon terms and conditions which the seller subsequently accepts.

In the first situation, a real estate broker's right to compensation is based upon the written listing. The listing agreement requires that the broker produce an offer by a buyer ready, willing and able to purchase on the seller's listing terms. A ready and willing buyer denotes one who is

prepared to enter into a binding contract while an able buyer is one who has the financial ability to consummate the transaction at the proper time.

From the broker's standpoint, a listing agreement is very much result oriented. The broker's right to a commission is not dependent upon the amount of work put into finding a buyer and negotiating a "meeting of the minds" of buyer and seller. If the broker expends *no* time and effort on behalf of the principal and yet is able to produce a buyer who is ready, willing and able to purchase on the terms specified in the listing contract, the broker is the procuring cause and has earned the compensation.

Lawful condition. The payment of a commission under a listing contract may be made dependent on any lawful condition. A seller may be relieved from the obligation to pay a commission if it appears from the language of the contract that payment was contingent upon the happening of a condition that did not occur. The burden is on the broker to establish that he or she has earned a commission. If the fulfillment of a condition is prevented by the fraud or bad faith of the seller, or through collusion between the seller and other parties, the broker may recover compensation even if the condition has not been met.

If broker performs within time limit broker is entitled to commission. Revocation of a broker's authorization cannot operate to deprive the broker of the compensation contracted for, or its equivalent in damages, for nonperformance of the owner's contract if, within the time specified in the listing agreement, the broker has found a buyer ready, willing and able to purchase upon the price and terms in the listing. The principal will not be relieved from liability by a capricious refusal to consummate a sale where the principal's voluntary act precludes the possibility of performance on the principal's part. This is based upon the familiar principle that no one can avail himself or herself of the nonperformance of a condition precedent who has occasioned its nonperformance. It is also well settled that a principal cannot discharge an agent pending negotiations by the agent with a prospective buyer, then effect a sale to that buyer without liability to the agent.

Agreement between brokers. An agreement between brokers cooperating in the sale of real property for a division of the commission is not illegal nor against public policy. It will be construed and enforced the same as other contracts not required to be in writing but no partnership or joint venture is created by such an agreement.

Right of principal to secure buyer. Where the listing is an open one, sale by the owner of the property to a person who has not been referred to the owner by the broker does not violate the listing agreement and creates no liability to the broker on the part of the owner. If there is no termination date in an open listing, the owner may not seek to take advantage of a failure on the part of the broker to produce a person willing to purchase on the terms of the listing by attempting to deal directly with the agent's prospect.

An agency contract which provides that the agency is irrevocable for a fixed time does not prevent the owner from selling the property within that time to a person with whom the agent has had no prior negotiations.

Commission as negotiated. The amount of commission is set out in a broker's contract of employment. In the absence of any evidence of incapacity to read or any fraud to prevent the reading of it, the party signing the written contract is bound by its express terms and conditions. Ordinarily, the compensation of the broker is negotiated at a certain percentage of the purchase

price obtained by the owner. If no amount of compensation is mentioned in the contract of employment, the law recognizes an implied promise on the part of the owner to pay the usual or customary commission charged in the neighborhood for like services.

Both the listing agreement and the deposit receipt usually expressly provide for payment of a commission if the owner accepts an offer procured by the broker at a price which is less than the price specified in the listing agreement.

Listing agreement - no deposit receipt contract. When agency is executed. A broker has earned a commission when, within the life of the contract, the broker has fulfilled the terms of the agency contract. As stated before, a buyer produced must be ready, willing and able to purchase upon the terms and conditions specified in the listing. The readiness and willingness of a person to purchase real property may be shown by an offer to purchase from that person. Unless such person has made an offer to the seller to enter into such a contract, this person cannot be regarded as a person ready, willing and able to buy. The buyer and seller must be brought into communication with each other. Merely putting a prospective purchaser on the track of property which is on the market does not entitle the broker to the commission contracted for and even though a broker opens negotiations for the sale of the property, the broker will not be entitled to a commission if the broker ultimately fails to induce the prospective buyer to make an offer on the property. The obligation assumed by the broker is to achieve a "meeting of the minds" of the buyer and seller as to the price and other terms for the transaction.

Deposit receipt contract—no listing. On occasion, the only written agreement containing a promise to pay a commission to the broker is in the contract to purchase between buyer and seller. In order to protect a right to a commission, the broker should attempt to obtain a separate agreement for the payment of a commission even if it is a listing that is written up to terminate within hours after an offer is presented. If a seller refuses to enter into such a separate agreement, the broker will have to rely upon the deposit receipt agreement. Then, a question may arise concerning the seller's obligation to pay a commission if the sale of the property is not consummated. Whether or not there is an enforceable obligation on the part of the seller will often depend upon the wording of the commission clause in the deposit receipt.

Both listing agreement and deposit receipt contract. A broker's right to a commission usually flows from an employment contract/listing. The execution of a contract to sell is nevertheless significant in that it evidences the fact that the agent has produced an offer that is acceptable to the owner.

Sale to broker's prospect after termination of listing. A broker's negotiations during the life of a listing with a prospect who ultimately purchases the property does not necessarily entitle the broker to a commission. Special circumstances may nevertheless dictate that the agreed commission be paid to the broker. For example, where the sale is consummated directly by buyer and seller after expiration of the listing on the same terms as proposed through the broker or with only a price reduction to the buyer, there is every reason to believe that the broker was the procuring cause of the sale and is entitled to the agreed compensation.

A broker may include a protective clause in a listing agreement. Under this clause, the seller agrees to pay a commission to the broker if the property is sold within a certain time period after expiration of the listing to a person with whom the broker negotiated while the listing was in effect. Ordinarily, a listing contract which includes such a protective clause requires that the

broker give to the owner, within a prescribed number of days after expiration of the listing, a list of prospective purchasers with whom the broker has negotiated.

Even if the broker did not negotiate with anyone during the term of the listing, the seller may waive expiration of the contract by encouraging the broker to continue efforts to find a buyer. If the broker continues in reliance upon such a waiver and does produce an offeror to whom the property is ultimately sold, broker may be entitled to a commission.

Breach of contract v. tort theory. The obligation to pay compensation to the broker must be in writing. The broker's right to compensation and the amount are usually set forth in the listing agreement. A real estate broker can act upon a letter received from an owner, whether voluntarily sent by the owner or in answer to the broker's solicitation. When relying upon letters, the broker should be very careful to see that the letter contains an employment clause or authorizes the broker to find a buyer and describes the compensation the broker is entitled to receive as a result of accomplishing the purpose and scope of the agency.

Statutory and case law have been interpreted to mean that a broker is not entitled to recover a commission under a breach of contract theory unless there is a signed agreement between the broker and the principal. The agreement can be a listing agreement, some other form of agency agreement, or the agreement to pay the commission may be set forth in the purchase agreement itself.

TERMINATION OF AGENCY

Ordinarily, an agency may be terminated by the acts of one or both of the parties or by operation of law. An agency is also terminated by the expiration of its term, the accomplishment of the purpose for which the agency was established, the extinction of its subject matter, or the death or incapacity of either principal or agent.

When Principal May Revoke Agency

Because the relationship between a principal and agent is a personal one, founded on trust and confidence, the principal has an absolute power under the law to revoke the agency at any time.

Nevertheless, while the principal in most circumstances has an absolute *power* to revoke, the principal does not necessarily have the *right* to do so and may be liable for breach of contract if revocation is without good cause. If the agency was created by a recorded instrument containing a power to convey or execute instruments affecting real property, revocation of the agency is not effective unless it is in writing, acknowledged, and recorded in the same place as the instrument creating the agency.

Effect of Termination

According to Civil Code Section 2355, notice of termination of an agency relationship must be given to third persons if the agency is terminated as a result of expiration of the term, extinction of the subject matter, or the agent's death, incapacity or renunciation. If the agency is in fact terminated in any of the ways enumerated in Section 2355, the former agent is still an ostensible agent as to those third persons who have not received notice of termination. If the agency is terminated through the death or incapacity of the principal or by the principal's express act of revocation, it is effective as to third persons even though they have no notice.

Time When Revocation Can Be Made

As a rule, unless a real estate broker's authority is coupled with an interest in the property, the broker's authorization may be revoked at any time by the principal. A real estate broker's right to earn a commission under a listing agreement is not considered to be an interest in the contract which precludes termination by death, incapacity or revocation on the part of the principal. This is true even if the broker is given a particular time within which to perform under the terms of the listing agreement. On the other hand, the courts have recognized circumstances where the contract of agency is irrevocable because the licensee has an interest in the property which is the subject matter of the agency.

The principal's termination of the agency relationship by revocation may give a real estate broker a right to damages for breach of contract or to compensation pursuant to the terms of the listing agreement. Withdrawal of the property from the market by the owner prior to expiration of the listing is an example of a de facto revocation which may give the broker a cause of action for agreed compensation under the listing contract. The California Supreme Court has held that a clause in an exclusive listing contract providing for payment of a commission to a real estate broker on withdrawal of the property from sale by the principal does not constitute an unenforceable penalty under California law. If the listing is an open one, a sale negotiated by the owner or by a broker terminates the listing and notice of termination need not be given to brokers other than the broker who has presented the offer which has been accepted.

In the event an open listing specifies no fixed term of employment, the listing normally may be revoked by the owner at any time without liability prior to production of a ready, willing and able buyer by the broker. If a fixed term is specified, it is possible that, despite revocation by the owner, the commission will be earned if the broker produces such a buyer within the specified time.

Exclusive listing agreements must contain a definite, specified date of final and complete termination. If the listing does not contain a definite termination date, the listing is unenforceable by the real estate broker and the claim, demand or receipt of any fee under the agreement by the broker may be a basis for license discipline. See Section 10176(f) of the Business and Professions Code.

SPECIAL BROKERAGE RELATIONSHIPS

From time to time a broker may have occasion to make a sale of property included in the estate of a decedent. Less frequently, a broker may represent a Board of Education or the State of California.

Probate Sales

The representative of the estate of a decedent may initiate a probate sale by seeking offers to purchase directly or through one or more brokers. (Probate Code Section 10150) The executor or administrator may sell the real property of an estate where it is found to be in the best interests of the estate. Whether the sale is public or private, it must be advertised by publication or posting of notice. (Probate Code Sections 10300, et seq.) Acceptance of an offer by the estate representative is subject to probate court confirmation. The representative of the estate of the decedent may, with court permission, grant an exclusive right to sell the property for a period of not to exceed 90 days. (Probate Code Section 10150)

The broker's compensation and the court confirmation procedure are set forth in Probate Code Sections 10160, et seq. Initial information concerning the property, the broker's compensation, and the court confirmation procedure, if any, can be furnished by the attorney for the estate. If a bank or trust company has been appointed representative, interested persons may apply directly to the trust office of the institution for information. If a public administrator is the estate representative, inquiry may be made at that office. The broker should ask about the Independent Administration of Estates and whether the administrator is entitled to sell the property without the court's confirmation but with notice to all beneficiaries. (Probate Code Sections 10400, et seq.)

An offer to purchase must be for a price which is not less than 90% of the property's appraised value (appraisal date within one year of sale) and it must conform to statutory requirements, the rules of the local superior court governing probate sales and the terms stated in the public notice of sale. The court will attempt to establish that the executor or administrator of the estate has exposed the property to the market. (Probate Code Sections 10160, et seq.)

When an offer has been received which the representative has accepted subject to court confirmation, the representative will petition the court to confirm the sale. When the court has set the matter for hearing, any interested person may bid at the time of the hearing. To open the bidding there must be an increase over the bid returned to the court for confirmation which is at least 10% of the first $10,000 bid and 5% of the bid in excess of $10,000. Once the bidding has been opened, the court in its discretion may permit the bidding to continue on lesser raises until it declares a bid to be the highest and best obtainable. The sale will then be confirmed by the court to the maker of that bid. (Probate Code Sections 10000, et seq.)

The person making the offer returned to court for confirmation, and the broker representing that person, should attend the confirmation hearing whether or not that person plans to participate in higher bidding for the property. All prospective bidders and brokers should be familiar with local rules of court governing advance bidding, deposits required and similar matters. Ordinarily, after court confirmation of a sale, normal escrow procedures are used to consummate the transaction on the terms and conditions approved by the court.

Payment of commissions to brokers participating in probate sales is generally within the discretion of the probate court, subject to certain standards prescribed by statute. For example, Section 10162 of the Probate Code provides that the compensation of the agent producing a successful bidder shall not exceed one-half of the difference between the amount of the bid in the original return and the amount of the successful bid, provided that the limitation shall not apply to any compensation of the agent holding a contract with the estate representative pursuant to Section 10150 of the Probate Code.

It is important that the broker who procures the offer which is accepted by the estate representative and returned to court for confirmation have a written contract with the representative. In the case of an overbid in open court at the confirmation hearing, it is a matter of importance to the broker that the court be informed that a licensed broker has produced the bid in question. If a purchaser not represented by an agent has his overbid confirmed, the listing broker may receive a full commission on the original bid only. (Probate Code Section 10162.5)

In its order confirming the sale, the court will set forth the amount of commission to be paid and the division of the commission if more than one broker is to be compensated. (Probate Code Sections 10160, et seq.) Needless to say, where an agent is also the purchaser, the court will

carefully examine "the substantiality" of the agent's acts in putting together "the best deal" for the estate, especially where the agent expects a commission. (*Estate of Levinthal v. Silberts* 1980 105 Cal. App. 3d 691)

Board of Education Sales

The Education Code provides that the governing body of any school district may pay a commission to a licensed real estate broker who procures a buyer for real property sold by the board. The sealed bid for the property must be accompanied by the name of the broker to whom the commission is to be paid and by a statement of the rate or amount of the commission.

In the event of a sale on a higher oral bid to a purchaser procured by a qualified licensed real estate broker, other than the broker who submitted the highest written proposal, the board will allow a commission on the full amount for which the sale is confirmed.

Note: One-half of the commission on the amount of the highest written proposal will be paid to the broker who submitted it, and the balance of the commission on the purchase price to the broker who procured the purchaser to whom the sale was confirmed.

State of California Sales

From time to time, the State of California has real property for disposal. When bids received for this property, after advertising, do not equal its appraised value, the Department of Finance may authorize employment of a licensed real estate broker to effect the sale on a commission basis. This procedure does not apply to surplus real property of the State Division of Highways.

LICENSEE ACTING FOR OWN ACCOUNT

A real estate licensee will sometimes act in a real property transaction for his or her own account. Because of professional background and contacts, a licensee is oftentimes more aware than most people of investment and profit opportunities in such transactions. An effort to exploit these opportunities to personal advantage may involve legal or ethical matters to be carefully considered by the licensee. When acting for his or her own account, a broker or salesperson is obliged to act honestly and fairly, in good faith, and without fraud or deceit. These duties and obligations are expected of all parties to agreements.

In certain fact situations, a broker or salesperson acting as a principal has additional duties to the other party to the transaction. An example is a broker or salesperson acting as a principal in a transaction who is also an arranger of credit pursuant to Civil Code Sections 2956 - 2957. Licensees who are principals in such transactions must prepare and complete a seller financing disclosure statement to be delivered to the other principal.

Oftentimes, complaints to the Department of Real Estate result from the efforts of licensees to secure profits in real property transactions by purporting to act as principals. In this connection, they have resorted to the use of options, net listings, guaranteed sales, and other types of agreements which combine features of a listing with an obligation or right imposed upon or given to the licensee to act as a principal. The use of options, net listings, and guaranteed sales is neither illegal nor unethical in California so long as a full disclosure of the licensee's involvement in the transaction and the legal effect of such an agreement is explained to the person(s) with whom the licensee is transacting business. The other party to the transaction must

be advised and understand that the licensee may be acting as a principal, and potentially as both an agent and a principal in the transaction, rather than simply as an agent.

When a real estate licensee is acting only as a principal in a transaction, the other party should be aware that dealings with the licensee are at "arms-length" and not that of an *agent* and principal.

Since the broker or salesperson holds himself or herself out as a real estate licensee, the broker or salesperson must be careful when acting as a principal only, or as both an *agent* and a principal. It is easy for the public to misunderstand the role of the licensee because the contacts between them usually arise out of the marketing activities of the licensee. For example, office signs, signs on properties, stationery, newspaper advertisements and business cards are all illustrations that the broker or salesperson is acting or intending to act in a licensed capacity. Therefore, care must be taken to dispel the agency image if the licensee chooses to act as a principal only in a real property or real property secured transaction.

Also, it is important for the licensee to disclose and explain fact situations where the licensee may be acting both as a principal and an *agent.* An example of such a fact situation occurs when a licensee lists his or her property on a multiple listing service, soliciting buyers through that medium, and the real estate firm with whom the licensee is associated later becomes the agent of the buyer. Another example is a real estate broker who undertakes, on behalf of a borrower, to solicit a lender to make a loan. If the broker later decides to make the loan him or herself or with broker-controlled funds, clear disclosure of the broker's changing role should take place.

It is particularly important for a licensee who starts out as an agent in a transaction and then switches status to that of a principal to make a clear and distinct disclosure of the change before the transaction is consummated. It is advisable to create a written record of the disclosure. In fact, it may not be possible to discharge the responsibilities inherent in the agency relationship in the middle of a transaction. The usual result is that the licensee will be acting both as a principal and as an *agent* of the other principal in the transaction. The licensee must be scrupulous in informing the other principal of the inherent conflicts of interest when the licensee is acting as a principal.

Various court decisions indicate that the burden of proof under these circumstances is upon the licensee to show that the principal was fully informed of this change of status. Obviously, such disclosures must be made in writing. [Civil Code Section 2079.17 and Business and Professions Code Sections 10176(a) and (d)] Vague or ambiguous disclosures will not be sufficient notice of a change of status by the licensee from *agent* to principal only.

Option to purchase by the broker as an agent. A somewhat similar situation arises when a broker who is employed as an *agent* to find a buyer of real property obtains an option to purchase the property which runs concurrently with the agency. In such a case, the broker cannot ignore the interests of the principal and the broker may not take advantage of the fiduciary relationship with the principal.

The law is well summarized in *American Jurisprudence*: "If a broker employed to sell property is also given...an option to purchase the property himself, he occupies the dual status of agent and purchaser and he is not entitled to exercise his option except by divesting himself of his obligation as an agent by making a full disclosure of any information in his possession as to the prospect of making a sale to another."

Disclosure of conflicts and profits by the broker as an agent. In the language of *The Restatement of Agency*: "Before dealing with the principal on his own account … an agent has as a duty, not only to make no misstatements of fact, but also to disclose to the principal all relevant facts fully and completely. A fact is relevant if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent to the agent to enter into the particular transaction on the specified terms. Hence, the disclosure must include not only the fact that the agent is acting on his own account but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal." [Restatements (Second) of Agency § 390]

The very nature of combining listings, options, and guaranteed sale agreements places a licensee in a position where he or she must exercise the utmost caution to avoid violating the fiduciary duties and obligations owed to the principal. Additional problems arise in this context because the Real Estate Law and general principles of agency require that the licensee make full disclosure to the principal of any compensation, commission or profit claimed or taken by the licensee with respect to the transaction. [Business and Professions Code Section 10176 (g)]

UNLAWFUL EMPLOYMENT AND COMPENSATION

It is unlawful for any licensed real estate broker to employ or compensate, directly or indirectly, any person for performing any of the acts for which a license is required who is not a licensed real estate broker, or a real estate salesperson licensed under the broker employing or compensating him or her; provided, however, that a licensed real estate broker may pay a commission to a broker of another state. No real estate salesperson shall be employed by or accept compensation from any person other than the broker under whom he or she is at the time licensed. It is unlawful for any licensed real estate salesperson to pay any compensation for performing any of the acts within the scope of the Real Estate Law to any real estate licensee, except through the broker under whom he or she is at the time licensed. (Business and Professions Code Section 10137)

The prohibition against sharing commissions with unlicensed persons applies only to a payment made by a licensee to a nonlicensee as compensation for the performance of acts for which a real estate license is required. Thus, payment of a portion of a commission by a licensee to a principal in the transaction does not constitute a violation of Section 10137, but if there is a commission rebate to the buyer in the transaction that fact must be disclosed by the agent to the seller who has paid the commission. (Business and Professions Code Sections 10138, 10139, and 10139.5)

BROKER - SALESPERSON RELATIONSHIP

Broker - Salesperson Employment Contract

Commissioner's Regulation 2726 requires that a real estate broker have a written agreement with each of his or her salespersons, whether licensed as a salesperson or a broker under a broker-salesperson arrangement. An employment contract between broker and salesperson may be instrumental in establishing the relationship between them, but only to the extent that the provisions do not conflict with the relationship as mandated by the Real Estate Law, other statutes, and applicable case law. The details of the association, including supervision, duties and compensation, must be spelled out in the contract and adhered to in practice.

Employer - Employee

An employee is defined in the Labor Code as one who renders personal service to the employer and who performs the service under the direction and control of the employer. An employee works for his or her employer, while an agent not only does this but also acts for and in the place of the principal for the purpose of making agreements and thus bringing the principal into legal relationships with third persons. Thus, a filing clerk in an office or a machinist in a factory would be an ordinary employee. A broker normally would not be classified as an employee. For purposes of the Real Estate Law and the Civil Code, a real estate salesperson is an employee of the real estate broker under whom he or she is licensed. If the broker is a corporation, the salesperson is an agent of the corporation, not of the supervising qualifying broker in his or her individual capacity. (*Walters v. Marler* (1978) 83 Cal.App.3d 1,147 Cal. Rptr. 655)

Independent Contractor

An independent contractor is one who, in rendering services, exercises an independent employment or occupation and is responsible to the principal only for the results of his or her work. For the most part, an independent contractor sells final results rather than time, and the methods of achieving those results are not subject to the control of the principal. An independent

contractor may also be an agent of the principal. For instance, a real estate broker is typically an independent contractor acting as an *agent* of the principal for a defined limited purpose.

An important factor in establishing independent contractor status is that the contractor determines the method of accomplishing the work for which the contractor has been engaged. Salespersons are usually characterized as independent contractors of the broker for purposes of state and federal income tax reporting and sometimes for certain other purposes such as Workers' Compensation Insurance coverage. (See, for example, Unemployment Insurance Code Section 650 and 26 U.S.C. Section 3508.) Accordingly, salespersons are agents and employees of the supervising broker in connection with dealings with the public but may, at the same time, be independent contractors for income tax reporting and certain other purposes.

To maintain independent contractor status for income tax reporting and related labor law purposes, it is necessary for the supervising broker to specify in contracts with salespersons that the associates are independent contractors and not employees for income tax reporting purposes. However, the real estate broker must distinguish between the implementation of independent contractor status of salespersons for tax reporting, Workman's Compensation, or other labor-related purposes and the broker's duty to supervise those salespersons under the Real Estate Law. Moreover, the independent contractor status does not diminish the broker's responsibilities and civil liabilities for the conduct of the broker's salespersons. (Business and Professions Code Sections 10032, 10132, 10177(h) and 10159.2)

Liability

Even though an employer or principal may not be personally at fault, they can be held liable in damages for the negligent conduct of their employees or agents who act within the general course and scope of their employment or agency. This liability finds its most notable illustrations in cases involving automobile accidents of employees while driving on the employer's business. If the wrongdoer is an independent contractor for all purposes, the person who hired him or her would not ordinarily be liable for injuries caused by the negligence of the independent contractor. Brokers may wish to consider carrying general liability and errors and omission insurance covering their salespersons and office personnel regardless of their contractual and employment relationships with the supervising broker.

Workman's Compensation

Under the California Workman's Compensation Act, a broker may be required to carry workers' compensation insurance covering salespersons and failure to carry such coverage may result in the broker's liability. Brokers should contact the Department of Industrial Relations concerning coverage requirements and the penalties for failure to maintain coverage.

Social Security and Income Taxes

A similar situation arises under the Federal Insurance Contributions Act and the Internal Revenue Code. A broker may submit to the District Director of Internal Revenue employment agreements and detailed data as to operating methods and obtain a ruling whether the salespersons are considered employees under these laws. The existing exemptions available to real estate brokers have extended primarily to brokerage sales and related services. Real estate brokers who are engaged in a broad list of licensed and nonlicensed activities may wish to review with legal counsel the effect of these activities upon the available exemptions from employer and employee relationships for tax reporting purposes. (26 U.S.C. Section 3508; IRS Rev. Rulings 76-136 and 76-137; and California Attorney General Opinion 59 Ops. A.G. 369)

The consequences of mischaracterizing the relationship in this context are serious. For example, if the IRS rules that the salespersons are employees for income tax reporting purposes, the supervising broker may be liable for income taxes due from the salespersons which should have been withheld by the broker and paid to the IRS. Interest and penalties will typically be added. Supervising brokers should obtain the advice of a CPA and/or qualified tax attorney when establishing policies and procedures in this regard.

Unemployment Insurance

For purposes of maintaining unemployment insurance coverage, the California Unemployment Insurance Act excludes from the definition of employee brokers and salespersons paid solely by commission. (Unemployment Insurance Code Section 650) If the IRS rules in a given fact situation that salespersons are employees of the supervising broker for income tax reporting purposes, EDD is likely to follow the IRS ruling and impose the same relationships.

Personal Income Tax - Additional Information

In recent years, the IRS has challenged the exemption available to real estate licensees under 26 USC Section 3508 when the activities involved are other than general sales brokerage and related services (mortgage brokerage, mortgage banking, and special project brokering such as new subdivision sales). Real estate licensees may still be treated as independent contractors for both federal and state personal income tax purposes, depending upon the fact situation.

This issue has been addressed in part by the Federal Tax Equity and Fiscal Responsibility Act (TEFRA) and amendment of Section 650 and addition of Section 13004.1 to the California Unemployment Insurance Code. Under these laws, real estate licensees functioning on behalf of a supervising real estate broker, in certain fact situations, are and remain exempt from treatment as employees for income tax reporting and other labor-related purposes provided that certain conditions are met.

Section 13004.1 provides that an individual will not be considered an employee for *state income tax purposes* if all of the following conditions are met: (1) the individual is licensed by the Department of Real Estate and is performing brokerage services as a real estate licensee on a commission basis; (2) substantially all remuneration for such services is related directly to sales or other output rather than the number of hours worked; and (3) the real estate services are performed pursuant to a written agreement between the individual and the supervising broker which includes a provision that the individual will not be treated as an employee with respect to those services for state tax reporting purposes. Similar standards apply for establishing independent contractor status for federal income tax purposes.

Again, it is important to understand that the characterization of independent contractor status for state and federal income tax reporting purposes has no effect upon the supervising (individual or corporate) broker's civil or public liability for the conduct or misconduct of salespersons.

Commission and Deposit Disputes

The Real Estate Commissioner has no authority regarding commission disputes between licensees or between a licensee and his/her principal.

A commission dispute between (listing and selling) brokers is a civil matter.

A real estate salesperson (or broker acting in the capacity of a salesperson) involved in a commission dispute with his/her broker may contact the Labor Commissioner. In determining jurisdiction, the Labor Commissioner will consider the salesperson's status as either employee or

independent contractor. If the salesperson is an independent contractor, the dispute must be settled in a court of competent jurisdiction or through arbitration.

The Real Estate Commissioner has no authority to determine the proper disposition of a deposit in a failed real estate transaction. The Commissioner does not take the place of a court of law and does not give legal advice.

DISCRIMINATION

Federal and California laws prohibit discrimination in the sale, rental or use of real property, whether based on sex, race, color, religion, ancestry, national origin, disability or age. These laws apply to persons who sell or rent housing or other real property and to the real estate broker or salesperson involved in such transactions.

The Unruh Civil Rights Act (California Civil Code Section 51, et seq.) declares: "All persons within the jurisdiction of this State are free and equal, and no matter what their sex, race, color, religion, ancestry, national origin or disability are entitled to the full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever..."

It is the intent of the Unruh Act to give all persons full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever. This law applies to all aspects of real estate activities, including real estate brokerage. An owner/renter of real property cannot discriminate when offering a unit for rent.

Civil Code Section 52 provides monetary remedies to persons who have been discriminated against in violation of the Unruh Act, stating, "Whoever denies, aids, or incites denial, or makes any discrimination or distinction contrary to Section 51 or Section 51.5 [pertaining to business establishments] is liable for each and every such offense for the actual damages, and any amount that may be determined by a jury, or a court sitting without a jury, up to a maximum of three times the amount of actual damage but in no case less than one thousand dollars ($1,000), and any attorney's fees that may be determined by the court in addition thereto, suffered by any person denied the rights provided in Section 51 or 51.5."

Age Discrimination - Senior Citizen Housing

Various cases have held that the Unruh Civil Rights Act applies to age discrimination in apartment rental and condominium properties because they are considered to be businesses subject to this act. In 1984 the Legislature enacted Civil Code Section 51.2 to clarify the holdings in the California Supreme Court cases dealing with the scope of the applicability of the Unruh Civil Rights Act. In the same bill, it enacted Civil Code Section 51.3 to establish and preserve specially designed accessible housing for senior citizens. Additionally, these provisions have been subsequently amended to comply with provisions of the federal law as it pertains to senior citizen housing developments.

Section 51.2 states, in part, that: "Section 51 shall be construed to prohibit a business establishment from discriminating in the sale or rental of housing based upon age. Where accommodations are designed to meet the physical and social needs of senior citizens, a business establishment may establish and preserve such housing for senior citizens, pursuant to Section 51.3, except housing as to which Section 51.3 is preempted by the prohibitions in the

Federal Fair Housing Amendments Act of 1988 (P.L. 100-430) and implementing regulations against discrimination on the basis of familial status..."

Section 51.3 provides definitions and criteria to be applied for the express allowance for enforcement of legal documents that provide for age limitations for senior citizens housing. This law applies to condominium, stock cooperative, limited-equity housing cooperative, planned

development or multi-family residential rental property developed for and initially put into use as housing for senior citizens or substantially rehabilitated or renovated for, and immediately put into use as housing for senior citizens, as described in Section 51.3. The term "senior citizen" is defined as a person 62 years or older or one who is 55 years or older in a senior citizen housing development. A senior citizen housing development is a residential development built, substantially rehabilitated, or substantially renovated for senior citizens and which consists of:

- 70 or more dwelling units built prior to January 1, 1996 (or 150 or more dwelling units built on or after January 1, 1996) in a standard metropolitan statistical area (SMSA) of at least 1,000,000 total residents or 1,000 residents per square mile (1990 census);
- 100 or more dwelling units in an SMSA not exceeding either 399,000 total residents or 999 residents per square mile (1990 census);
- at least 35 dwelling units in any other area.

The law provides standards for the restrictions used for senior citizen housing developments. The restrictions cannot limit occupancy more strictly than to senior citizen residents and "a qualified permanent resident," i.e., a younger spouse or cohabitant or, as an alternative to a spouse, any person who provides primary physical or financial support to the senior citizen. In any such case, the lower age limit is 45 years. This "qualified permanent resident" must have an ownership interest in, or expectation of an ownership interest in, the dwelling unit within the housing development that otherwise limits occupancy based upon age. The qualified permanent resident can remain in residency after the death of the senior citizen or upon dissolution of a marriage with a senior citizen. The restrictions must allow for temporary residency of any non-qualifying person for not less than 60 days per calendar year.

Until January 1, 2000, unless this date is later changed by the legislature, housing developments which were constructed prior to February 8, 1982 can still discriminate by age for senior citizens as an exception to Section 51, if they meet the requirements for senior citizen housing, *except* the criteria that the housing be specifically designed for physical and social needs of senior citizens.

The Unruh Act does not apply to mobilehome developments.

Under the Unruh Act, as well as under case law, restrictions or prohibitions by covenant or condition in written instruments, such as CC&R's, on use, occupancy or transfer of title to real property limiting acquisition, use, occupation of real property because of any of the prohibited classifications are void. (Civil Code Section 51.3)

Housing Discrimination

The Fair Employment and Housing Act (Government Code Section 12900, et seq.) applies to owners of specified types of property, to real estate brokers and salespersons, to other agents and to financial institutions. Sections 12955 and 12980 – 12988 specifically cover housing discrimination. The law prohibits discrimination in supplying housing accommodations because of race, color, religion, sex, marital status, national origin, ancestry, age, familial status or disability. (The phrase "Housing accommodations" is defined as improved or unimproved real property used or intended to be used as a residence by the owner and which consists of not more than four dwelling units. The definition also includes four or fewer owner-occupied housing units that secure a home improvement loan.) The law forbids such discrimination in the sale, rental, lease or financing of practically all types of housing, and establishes methods of investigating, preventing and remedying violations. However, the provisions of Sections 51.2

and 51.3 of the Civil Code, as described above, which establish permissible age criteria for a senior citizen retirement community as an exception to the basic prohibition against age discrimination in housing, also apply to this Act.

Housing discrimination under the Fair Employment and Housing Act is handled by administrative procedures. Complaints are directed to the Department of Fair Employment and Housing and are investigated by its staff. If the Department decides that the law has been violated, and if the person accused of violating the law cannot be persuaded to correct the violation, the Department may file an accusation with the Fair Employment and Housing Commission or bring an action in the Superior Court for an injunction. If the Fair Employment and Housing Commission, after hearing, finds a violation of the law, it may order the sale or rental of the accommodation or like accommodations, if available. It may order financial assistance terms, conditions or privileges previously denied. In addition, it may order payment of punitive damages not to exceed $1,000, adjusted annually in accordance with the consumer price index, and the payment of actual damages. Substantial civil penalties can also be imposed by the Commission. The Department is required to do a compliance review to determine whether its order is being carried out.

The Fair Employment and Housing Act applies to all housing accommodations but does not apply to renting or leasing to a roomer or boarder in a single-family house, provided that no more than one roomer or boarder is to live within the household.

The term "discrimination" includes refusal to sell, rent, or lease housing accommodations, including inferior terms, misrepresentation as to availability, cancellations, etc. For sale or rent advertisements containing discriminatory information are prohibited. Also, discrimination includes failure to design or build a multi-family dwelling of four or more units in a manner that allows disabled persons access and use.

Other State Laws and Regulations

The Housing Financial Discrimination Act of 1977, also known as the Holden Act (Part 6 of Division 24 of the Health and Safety Code, Section 35800 et seq.), prohibits discriminatory loan practices on the part of financial institutions (banks, savings and loan associations, or other financial institutions, including mortgage loan brokers, mortgage bankers and public agencies which regularly make, arrange, or purchase loans for the purchase, construction, rehabilitation, improvement, or refinancing of housing accommodations). See Chapter 12 for further discussion.

No financial institution shall discriminate in their financial assistance wholly or partly on the basis of consideration of conditions, characteristics or trends in a neighborhood or geographic area unless the financial institution can demonstrate that such consideration in a particular case is necessary to avoid an unsafe and unsound business practice.

The Secretary of the Business, Transportation and Housing Agency has issued rules, regulations and guidelines for enforcement of this law and is empowered to investigate complaints regarding lending patterns and practices. Investigation of complaints has been delegated to the state agency which regulates the particular financial institution involved. If a violation is found, the Secretary can order that the loan be made on nondiscriminatory terms or impose a fine of up to $1,000.

Financial institutions are required to notify loan applicants of the existence of this law. Business and Professions Code Section 125.6 contains disciplinary provisions for discriminatory acts by any person licensed under the provisions of the Business and Professions Code.

Commissioner's Regulations 2725(f), 2780 and 2781 deal with discriminatory conduct and proper supervision of real estate licensees in that regard.

Business and Professions Code Section 10177(l) includes the practice of "block busting" as grounds for discipline of a real estate license.

Notice of Discriminatory Restrictions

Effective January, 2000, a county recorder, title insurance company, escrow company, or real estate licensee who provides a declaration, governing documents or deed to any person must provide a specified statement about the illegality of discriminatory restrictions and the right of homeowners to have such language removed. The statement must be contained in either a cover page placed over the document or a stamp on the first page of the document.

The Federal Rules

The Federal Fair Housing Act, Title VIII of the Civil Rights Act of 1968, provides an all-encompassing set of rules prohibiting discrimination on the part of owners of real property and their agents. This law applies to all sales or rentals of residences through the facilities of real estate licensees and to publication, posting, mailing or advertising in violation of this law. Direct refusal of an owner to sell a home because of race is, of course, a violation. This law applies to most rental of dwelling units, except it does not apply to the rental of rooms or units in dwellings of four or fewer living quarters if the owner actually occupies one of the living units as his residence.

Real estate licensees are in violation of this law if they commit any of the prohibited actions, even if there was no intent to discriminate, if the result is proscribed discrimination. The law applies to "blockbusting" and steering of home buyers to different areas on the basis of prohibited classifications.

Wherever federal law is applicable, it is paramount. Title VIII declares that its purpose is to provide "within constitutional limitations...for fair housing throughout the United States." In short, this law applies as thoroughly and as widely as is permissible under the broadest applicable provision of the Constitution and applies even to the most local transactions. This law is enforced by the Secretary of Housing and Urban Development or by civil actions by aggrieved parties or by an attorney general in federal or state court.

Another provision of Title VIII prohibits denial of membership or participation in a real estate board or multiple listing service to a person because of race, color, religion or national origin, or discrimination against a person in terms or conditions of membership. The federal law under Title VIII and relevant cases leads to the following general conclusion for real estate licensees: do not discriminate and, to that end, do not accept restrictive listings or make, print, or publish any notice, statement or advertisement with respect to a sale or rental of a dwelling which suggests discrimination because of race, color, religion, national origin or any other of the prohibited classifications.

The sum of the matter is that there are both a number of state laws and a federal law that apply to discrimination in real estate transactions. Every prohibition of the Unruh Act and the California Fair Employment and Housing Acts remains in effect, and what discrimination they do not prohibit, federal law does. Thus, no one may refuse to sell, lease or rent to another because of race or color, or on the basis of any other prohibited classifications, and no real estate licensee

may do so, regardless of the principal's direction. If a principal seeks to restrict a listing on the basis of any of the prohibited classifications, the licensee must refuse to accept the listing.

Discrimination and Panic Selling

Commissioner's Regulations 2780 and 2781

2780. Discriminatory Conduct as the Basis for Disciplinary Action.
Prohibited discriminatory conduct by a real estate licensee based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin includes, but is not limited to, the following:
(a) Refusing to negotiate for the sale, rental or financing of the purchase of real property or otherwise making unavailable or denying real property to any person because of such person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(b) Refusing or failing to show, rent, sell or finance the purchase of real property to any person or refusing or failing to provide or volunteer information to any person about real property, or channeling or steering any person away from real property, because of that person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the racial, religious, or ethnic composition of any occupants of the area in which the real property is located.

It shall not constitute discrimination under this subdivision for a real estate licensee to refuse or fail to show, rent, sell or finance the purchase of real property to any person having a physical handicap because of the presence of hazardous conditions or architectural barriers to the physically handicapped which conform to applicable state or local building codes and regulations.
(c) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the sale or purchase or negotiation or solicitation of the sale or purchase or the collection of payment or the performance of services in connection with contracts for the sale of real property or in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.

Prohibited discriminatory conduct by a real estate licensee under this subdivision does not include acts based on a person's marital status which are reasonably taken in recognition of the community property laws of this state as to the acquiring, financing, holding or transferring of real property.

(d) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the terms, conditions or privileges of sale, rental or financing of the purchase of real property.

This subdivision does not prohibit the sale price, rent or terms of a housing accommodation containing facilities for the physically handicapped to differ reasonably from a housing accommodation not containing such facilities.

(e) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in providing services or facilities in connection with the sale, rental or financing of the purchase of real property, including but not limited to:

processing applications differently, referring prospects to other licensees because of the prospects' race, color, sex, religion, ancestry, physical handicap, marital status or national origin, using with discriminatory intent or effect, codes or other means of identifying minority prospects, or assigning real estate licensees on the basis of a prospective client's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

Prohibited discriminatory conduct by a real estate licensee under this subdivision does not include acts based on a person's marital status which are reasonably taken in recognition of the community property laws of this state as to the acquiring, financing, holding or transferring of real property.

(f) Representing to any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin that real property is not available for inspection, sale or rental when such real property is in fact available.

(g) Processing an application more slowly or otherwise acting to delay, hinder or avoid the sale, rental or financing of the purchase of real property on account of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a potential owner or occupant.

(h) Making any effort to encourage discrimination against persons because of their race, color, sex, religion, ancestry, physical handicap, marital status or national origin in the showing, sale, lease or financing of the purchase of real property.

(i) Refusing or failing to cooperate with or refusing or failing to assist another real estate licensee in negotiating the sale, rental or financing of the purchase of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any prospective purchaser or tenant.

(j) Making any effort to obstruct, retard or discourage the purchase, lease or financing of the purchase of real property by persons whose race, color, sex, religion, ancestry, physical handicap, marital status or national origin differs from that of the majority of persons presently residing in a structural improvement to real property or in an area in which the real property is located.

(k) Performing any acts, making any notation, asking any questions or making or circulating any written or oral statement which when taken in context, expresses or implies a limitation, preference or discrimination based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin; provided, however, that nothing herein shall limit the administering of forms or the making of a notation required by a federal, state or local agency for data collection or civil rights enforcement purposes; or in the case of a physically handicapped person, making notation, asking questions or circulating any written or oral statement in order to serve the needs of such a person.

(l) Making any effort to coerce, intimidate, threaten or interfere with any person in the exercise or enjoyment of, or on account of such person's having exercised or enjoyed, or on account of such person's having aided or encouraged any other person in the exercise or enjoyment of any right granted or protected by a federal or state law, including but not limited to: assisting in any effort to coerce any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to move from, or to not move into, a particular area; punishing or penalizing real estate licensees for their refusal to discriminate in the sale or rental of housing because of the race, color, sex, religion, ancestry, physical handicap, marital status or

national origin of a prospective purchaser or lessee; or evicting or taking other retaliatory action against any person for having filed a fair housing complaint or for having undertaken other lawful efforts to promote fair housing.

(m) Soliciting of sales, rentals or listings of real estate from any person, but not from another person within the same area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(n) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in informing persons of the existence of waiting lists or other procedures with respect to the future availability of real property for purchase or lease.

(o) Making any effort to discourage or prevent the rental, sale or financing of the purchase of real property because of the presence or absence of occupants of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or on the basis of the future presence or absence of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, whether actual, alleged or implied.

(p) Making any effort to discourage or prevent any person from renting, purchasing or financing the purchase of real property through any representations of actual or alleged community opposition based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(q) Providing information or advice to any person concerning the desirability of particular real property or a particular residential area(s) which is different from information or advice given to any other person with respect to the same property or area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons. This subdivision does not limit the giving of information or advice to physically handicapped persons for the purpose of calling to the attention of such persons the existence or absence of housing accommodation services or housing accommodations for the physically handicapped.

(r) Refusing to accept a rental or sales listing or application for financing of the purchase of real property because of the owner's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any of the occupants in the area in which the real property is located.

(s) Entering into an agreement, or carrying out any instructions of another, explicit or understood, not to show, lease, sell or finance the purchase of real property because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(t) Making, printing or publishing, or causing to be made, printed or published, any notice, statement or advertisement concerning the sale, rental or financing of the purchase of real property that indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or any intention to make such preference, limitation or discrimination.

This subdivision does not prohibit advertising directed to physically handicapped persons for the purpose of calling to the attention of such persons the existence or absence of housing accommodation services or housing accommodations for the physically handicapped.

(u) Using any words, phrases, sentences, descriptions or visual aids in any notice, statement or advertisement describing real property or the area in which real property is located which indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

This subdivision does not prohibit advertising directed to physically handicapped persons for the purpose of calling to the attention of such persons the existence or absence of housing accommodation services or housing accommodations for the physically handicapped.

(v) Selectively using, placing or designing any notice, statement or advertisement having to do with the sale, rental or financing of the purchase of real property in such a manner as to cause or increase discrimination by restricting or enhancing the exposure or appeal to persons of a particular race, color, sex, ancestry, physical handicap, marital status or national origin.

This subdivision does not limit in any way the use of an affirmative marketing program designed to attract persons of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin who would not otherwise be attracted to the real property or to the area.

(w) Quoting or charging a price, rent or cleaning or security deposit for a particular real property to any person which is different from the price, rent or security deposit quoted or charged to any other person because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

This subdivision does not prohibit the quoting or charging of a price, rent or cleaning or security deposit for a housing accommodation containing facilities for the physically handicapped to differ reasonably from a housing accommodation not containing such facilities.

(x) Discriminating against any person because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in performing any acts in connection with the making of any determination of financial ability or in the processing of any application for the financing or refinancing of real property.

Nothing herein shall limit the administering of forms or the making of a notation required by a federal, state or local agency for data collection or civil rights enforcement purposes.

In any evaluation or determination as to whether, and under what terms and conditions, a particular lender or lenders would be likely to grant a loan, licensees shall proceed as though the lender or lenders are in compliance with Sections 35800 through 35833 of the California Health and Safety Code (The Housing Financial Discrimination Act of 1977).

Prohibited discriminatory conduct by a real estate licensee under this subdivision does not include acts based on a person's marital status which are reasonably taken in recognition of the community property laws of this state as to the acquiring, financing, holding or transferring of real property.

(y) Advising a person of the price or value of real property on the basis of factors related to the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of residents of an area or of residents or potential residents of the area in which the property is located.

(z) Discriminating in the treatment of, or services provided to, occupants of any real property in the course of providing management services for the real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of said occupants.

This subdivision does not prohibit differing treatment or services to a physically handicapped person because of the physical handicap in the course of providing management services for a housing accommodation.

(aa) Discriminating against the owners or occupants of real property because of the race, color, sex, religion, ancestry, physical, handicap, marital status or national origin of their guests, visitors or invitees.

(bb) Making any effort to instruct or encourage, expressly or impliedly, by either words or acts, licensees or their employees or other agents to engage in any discriminatory act in violation of a federal or state fair housing law.

(cc) Establishing or implementing rules that have the effect of limiting the opportunity for any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to secure real property through a multiple listing or other real estate service.

(dd) Assisting or aiding in any way, any person in the sale, rental or financing of the purchase of real property where there are reasonable grounds to believe that such person intends to discriminate because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

2781. Panic Selling as the Basis for Disciplinary Action.
Prohibited discriminatory conduct includes, but is not limited to, soliciting sales or rental listings, making written or oral statements creating fear or alarm, transmitting written or oral warnings or threats, or acting in any other manner so as to induce or attempt to induce the sale or lease of real property through any representation, express or implied, regarding the present or prospective entry of one or more persons of another race, color, sex, religion, ancestry, marital status or national origin into an area or neighborhood.

BASIC CONTRACT PROVISIONS AND DISCLOSURES IN A RESIDENTIAL REAL ESTATE TRANSACTION

A residential real estate sale transaction usually begins at the time a broker obtains an agency contract in the form of a listing from the property owner. If a buyer is found, the transaction proceeds through several closings:

Closing the sale. Buyer and seller agree as to terms. The deposit receipt form/contract is fully executed. This is the result of sales effort and negotiation.

Legal closing. Title insurance or title evidence has been furnished and escrow has the funds necessary to cash out the seller's equity, less expenses. All instruments necessary to transfer title are executed and recorded. Transfer of title and transfer of money are thought of as simultaneous acts.

Financial closing. Financial closing is closely related to legal closing but with more emphasis upon the settlement function or mechanics: i.e., the actual disbursement of funds by checks and a written accounting to all parties. In a complicated transaction involving new financing, there may be not only buyer and seller, but several old lenders and a new lender to be taken into consideration. To show that instructions of the escrow have been fully performed, the escrow holder will prepare settlement statements for the principals.

A BASIC TRANSACTION

An owner (the seller) of a single family residence (the property) in California wishes to sell the property.

The seller enters into an Exclusive Authorization And Right To Sell Agreement (the listing) with a California real estate broker (the listing broker).

Prior to entering into the listing, the broker gives the seller an agency disclosure form. This requirement is discussed later in this chapter and, more completely, in Chapter 10 in the Reference Book.

The listing provides that it will be placed into a multiple listing service and the listing broker can cooperate/share the commission if another broker (the selling broker) finds a buyer for the property.

The selling broker finds a buyer purportedly ready, willing and able to purchase the property. An offer (preceded by an agency disclosure form) is made, negotiated, and accepted so that a meeting of the minds is reflected in a real estate purchase contract and receipt for deposit (the contract). The contract includes confirmation of the agency relationships.

The transaction, grounded in the sale closing negotiated by the listing and selling brokers, proceeds to legal and financial closing.

This chapter examines the provisions of a listing agreement and a contract involved in such a transaction and the required disclosures.

A BASIC LISTING

The Exclusive Authorization and Right to Sell is a listing for sale of one or more specifically described parcels of real property. (This is one of several different types of listing agreements.) The phrase "right to sell" means "right to find a buyer." It does ***not*** authorize the broker to sign transaction documents for the seller. Prior to signing the listing agreement, the seller should be given the agency disclosure form.

Term

An exclusive listing must have a definite term. The term of the listing ends at midnight on a specified day. If the listing is intended to be for a certain number of weeks or months, the termination date should be determined with care to avoid misunderstanding.

Description of the Property

The description of the property should be as exact as possible to satisfy the statute of frauds. Accuracy of description avoids any doubt of enforcement of the listing on that ground.

Terms of Sale

The minimum requirement for setting forth the terms of sale, where cash is acceptable to the seller, is to express the price in cash.

Complications may arise when the seller demands assumption of the existing loan or loans, or indicates a willingness to pay part of the assumption fees or new set-up charges if the buyer assumes the existing loan or refinances with the existing lender. Such terms of sale should be spelled out in detail.

If the sale may be financed by a VA or FHA loan, the listing will include details of the seller's conditions with respect to the payment of points.

Where a first loan can be assumed and the seller is willing to carry secondary financing, the specific terms of the proposed secondary financing will be set forth.

The Broker's Authority

A listing authorizes the broker to:

- place a "for sale" sign on the property;
- place the property in a multiple listing service;
- cooperate with subagents or buyer's agents; and
- accept on the seller's behalf a prospective buyer's good faith deposit toward the purchase price.

The Broker's Duty

In return for the exclusive rights granted by the owner, the broker agrees to use due diligence in attempting to find a suitable buyer and negotiate a sale. Thus, the listing is a bilateral contract.

The listing states that the right of the broker is "irrevocable." Basically, this means that it cannot be revoked by either party without the other's consent. However, if there is a breach of contract (e.g., failure of the broker to use due diligence), the contract may be subject to rescission.

Broker's Compensation

The compensation clause in an exclusive right to sell listing will be specific and unequivocal. It will state simply that the broker is entitled to the compensation, expressed either as a percentage of the purchase price or a dollar amount, if the property is sold by the broker, by another broker, or by the seller during the term of the listing or any extension of it. It also obligates the seller to pay the compensation if, without the consent of the broker, the owner withdraws the property from sale or in some other way makes it unmarketable during the term of the listing or any extension thereof.

A listing's "safety clause" will designate a period of time after expiration of the listing during which the broker's compensation is protected if the owner personally sells to someone who physically entered and was shown the property or who wrote an offer on the property. For this clause to be effective, the broker must, either before or within the time specified in the agreement, notify the owner in writing of the names of the prospective buyers with whom the broker has negotiated during the listing term.

Negotiability of Commission

In the sale of residential property of not more than four units, including a mobilehome, Business and Professions Code Section 10147.5 requires that the listing (or whatever document initially establishes the broker's right to a commission, or increases the amount or rate of the commission) contain, in not less than 10-point boldface type, the following provision before the compensation clause:

> **Notice: The amount or rate of real estate commissions is not fixed by law. They are set by each broker individually and may be negotiable between the seller and broker.**

A broker cannot use a listing form in which the amount or rate of compensation is preprinted or otherwise inserted prior to negotiation with the seller.

Personal Property

The listing will specify the items of personal property included in the purchase price. For example:

> Sales price to include all screens, blinds, curtain rods, drapes, patio furniture, swimming pool equipment and supplies, outdoor potted plants, and outdoor statuary.

***Multiple Listing Service (MLLES))* and Internet**

A paragraph may provide that the listing will be submitted to a designated MLLES where information about the property will be disseminated to members, who may also solicit potential buyers for the property. The MLLES and broker often are also have a service to advertise the property on the internet.

Deposit

This clause authorizes the agent to accept a certain deposit to be applied toward the purchase price.

Other Provisions

Home protection plan. Informs seller of the availability of such coverage.

Keybox. Authorizes the agent to place a key repository on the listed property.

Sign. Authorizes placement of broker's "for sale" sign on the property.

Equal housing opportunity clause. This clause is *prima facie* evidence of nondiscriminatory intent. The proof of compliance is, of course, that the parties act in the spirit of the declaration.

Arbitration. This provision, if initialed by the broker individually, or by the broker's authorized associate licensee, and all sellers, constitutes an agreement to refer all disputes or claims "in law or equity" arising out of the listing or any resulting transaction to binding arbitration.

Attorney's fees. In the event of any legal action to resolve a dispute, this clause provides that the prevailing party will be paid reasonable attorney's fees.

Additional terms. Additional provisions could include: date for possession; rent if possession is delivered on a date other than closing day; repairs to be made by owner; and termite work. Also, if the seller has a prospect which the seller personally located, the seller may wish to exclude a sale to that person from seller's obligation to pay a commission.

Change of price or terms. A change of price or terms of a listing should never be made on the face of the original contract, but rather on a price change or extension form.

Owner's signature. All owners must sign the listing. If the property is owned by a partnership or a corporation, the proper officials must sign.

Agent's signature. When the listing is signed by an authorized licensee member of the broker's staff or by the broker himself, it becomes a (bilateral) contract. Broker (or broker's agent) must give the seller a copy of the agreement.

Single Agency

Single agency brokerage firms have become more common since the Agency Relationship Disclosure law was enacted. Special listing forms exist.

A Buyer-Broker agreement such as the "Buyer Representation Agreement" or the "Exclusive Authorization to Locate Property" will contain many clauses similar to those in a seller-broker exclusive listing. Cooperation between brokers representing sellers only and buyers only should be conducted with full disclosure of the nature and terms of the cooperation and understanding of the compensation split, if any. In order to avoid disputes with the buyer, the broker should be particularly careful in describing the property the broker is engaged to locate and when the commission will be deemed earned. Changes in the buyer's specifications should be made in writing and a complete "paper trail" maintained throughout the transaction.

PURCHASE CONTRACT AND RECEIPT FOR DEPOSIT

This section discusses provisions which comprise a comprehensive Residential Real Estate Purchase Contract and Receipt for Deposit. When completed with the terms and other information relative to the buyer's attempt to purchase the property, it is an offer. When the seller [or seller or buyer after counter offer(s)] communicates unqualified acceptance, it is a contract. In this discussion, we refer to the document as the deposit receipt, offer, or contract.

Date and Place of Buyer's Offer

This is the date and place the deposit receipt is signed by the (prospective) buyer. This is *not* the date used to measure temporal compliance with any of the performance provisions of the

contract. Those time constraints flow from the date a contract is formed by receipt of communication of acceptance.

The Full and Correct Name of the Buyer

This will include the buyer's marital status (single person, husband and wife, unmarried, widow or widower). If the buyer is a corporation, include the state where the corporation is chartered. If buyer is a general partnership, include the names of the partners. If buyer is a limited partnership, include the name of the general partner. If the buyer is a real estate licensee, disclose that fact. It is not necessary to include the manner in which buyer will take title. That will be taken care of in escrow.

Description of the Property

The property description must be adequate for a court to identify it: street address, map book, page and parcel, or other legal description.

Purchase Price and Terms

The offer must state unmistakably the total purchase price offered and the terms to which the buyer is willing to commit (e.g., all cash, new loan, or loan assumption). The total purchase price will *not* include the buyer's closing costs and any costs associated with obtaining financing.

Financing

The contract will contain a financing contingency unless the buyer is paying all cash or specified there is no loan contingency. That is, the loan(s) necessary for closing will be described and buyer will agree to act diligently to obtain the financing. There will be a time limitation for this to occur. If, in spite of buyer's diligent attempt, the stated financing is not obtained within the allotted time, the buyer must either cancel the contract or remove the financing contingency and proceed with the transaction.

Deposit

The offer will detail the form (cash, personal or cashier's check, promissory note, or money order), amount and disposition of buyer's deposit. Disposition means deposit of the funds into escrow or into the broker's trust account in a bank or other recognized depository in this state not later than three business days after receipt of the funds by the broker or by the broker's salesperson. If a check is used, the offer may require that the check be held after acceptance of the offer.

Time Constraints

The offer will require delivery of acceptance by a date certain. If this does not occur, the offer is revoked and the deposit must be returned.

The contract will require that buyer and seller deliver instructions to the escrow holder within a certain number of days after acceptance of the offer.

The contract will require that escrow close within a certain number of days after acceptance of the offer.

The contract will state that time is of the essence of the agreement and the time for performance can be extended or otherwise modified only by a writing signed by both buyer and seller.

The contract will state that title will vest as directed by the buyer in instructions to the escrow holder. As there can be significant legal and tax implications, a real estate licensee should urge a buyer to seek competent advice regarding the manner of taking title.

The contract will typically require transfer by grant deed, with mineral, oil and water rights if currently owned by the seller.

The contract will state that title must be free of financing liens except as provided in the contract and will be subject to all other encumbrances, easements, covenants, conditions, and restrictions, etc. shown in the preliminary title report. Title will also be subject to any other exceptions disclosed to, or discovered by, the buyer prior to closing unless the buyer disapproves in writing of a particular exception.

The contract will designate which party must pay for a preliminary title report and a policy of title insurance. Prorations

Typically, the contract will require that certain expenses of ownership be paid current as of the date of close of escrow, to become the buyer's responsibility thereafter. These include:

- real property taxes (including supplemental taxes) and assessments;
- if applicable, homeowners' association assessments;
- premiums on insurance assumed by buyer; and
- payments on bonds assumed by buyer.

If the property is a rental, the rent will be prorated so that any prepaid rent for time on and after the date of close of escrow will be credited to the buyer.

Transfer Taxes/Fees
The contract will fix responsibility for the county transfer tax, the city transfer tax (if any) and any homeowners' association transfer fee.

Occupancy and Possession
The contract will include a paragraph in which the buyer designates whether he/she will occupy the property as a principal residence. The contract will further require delivery of possession (keys, etc.) on a date certain, usually the date escrow closes. If the seller is to remain in possession after close of escrow or if the buyer is to take possession prior to close of escrow, such possession should be by appropriate written agreement.

Buyer's Inspection of the Property
Acceptance of the property's condition is a contract provision, subject to inspections to be conducted at buyer's expense. The buyer must communicate approval of the property's condition or request the seller make repairs or take other actions The buyer and seller then have a certain period of time to negotiate buyer's requests. If the seller is willing to correct the items, the transaction proceeds. If the seller is unable or unwilling to correct the items, the buyer must either proceed with the transaction or cancel the contract.

Condition of the Property
The Property is usually sold in its condition on the date of acceptance of the contract. The buyer still has the right to inspect the property and request that the seller make repairs. The seller remains obligated to disclose known material defects, however.

Smoke Detector(s)
The contract may reiterate state laws that require that dwelling units be equipped with smoke detectors approved by the State Fire Marshall. In an existing dwelling, there must be a battery operated smoke detector outside each sleeping area. As of August 14, 1992, new construction (or an addition, alteration or repair that exceeds $1,000 and requires a permit or includes addition of a sleeping room) must include smoke detectors in each bedroom and at a point centrally located *outside* the bedroom(s). In new construction, the smoke detector(s) must be hard-wired, with battery back-up. The seller must give the buyer written certification of smoke detector compliance, as required by Health and Safety Code Section 13113.8. This may be done in the contract or in a separate writing. Certain transactions are exempt from this requirement, as set forth in Health and Safety Code Section 13113.8(d). These exemptions are nearly identical to those set forth below relative to the provision of a Transfer Disclosure Statement.

Water Heater Bracing
The contract may set forth the seller's duty to see that each water heater is braced, anchored or strapped, in accordance with the California Plumbing Code, to resist falling or horizontal displacement during an earthquake. As indicated in Health and Safety Code Section 19211, the seller must give the buyer written certification of compliance in the contract, the Homeowner's Guide to Earthquake Safety (discussed below), in the Transfer Disclosure Statement, or in some other transaction document.

Retrofit
The contract should assign responsibility for any retrofitting required, upon sale, by the local government. This could include installation of low flow shower heads and gallon restricted flush toilets.

Governmental Compliance
The contract may include the seller's representation that he/she has no knowledge of any notice of violation of any building, zoning, fire, or health laws, regulations or ordinances. If the seller has such knowledge, disclosure must be made. Further, the contract may include the seller's covenant to notify the buyer if the seller receives a notice of violation.

Fixtures
Subject to specific exclusions made part of the contract, the buyer is entitled to all fixtures. Fixtures are items attached permanently (e.g., by cement, plaster, bolts, screws, or nails) to what is permanent (walls, etc.). Examples are electrical, lighting, plumbing and heating fixtures, fireplace inserts, solar systems, built-in appliances, window coverings, TV antennas, air conditioners, and in-ground landscaping.

Personal Property
The buyer is entitled to only that personal property listed in the contract. This could include any large outside potted plants, as these are ordinarily not fixtures.

Home Warranty Plans
The contract may remind seller and buyer of the availability of home warranty plans. If a plan is to be purchased, the contract will detail the duration, maximum cost, provider, and responsibility for payment.

Septic/Sewer/Well Systems
As applicable, the contract should specify responsibility for inspection and any needed repair of the septic system and testing of the well for potability and production. If local law requires connection to a sewer system, the contract must assign this responsibility. Of course, these items must be completed prior to close of escrow.

Pest Control
The contract will specify whether or not a pest control inspection is to be performed and, if so, at whose expense and may specify who must pay for any work required so that a registered structural pest control company can issue a written certification that the property is free of evidence of active infestation in the accessible areas. Lenders may require issuance of a certification prior to funding. If the contract provides that some of the required work will be completed at seller's expense after close of escrow, that provision may also require that the seller deposit funds into escrow, to be disbursed when the buyer has received a written certification.

A copy of the structural pest control inspection report (and other pest control documents required by Civil Code Section 1099) must be delivered to the buyer as soon as practical before transfer of title, provided the report is a condition affecting the transfer or financing of the property. If more than one licensee is acting as an agent in the transaction, the selling agent must deliver the documents, unless the seller has given written instructions to another licensee acting as agent in the transaction to make the delivery. The responsible broker shall maintain a record of action taken to effect compliance. (Commissioner's Regulation 2905)

Rental Property
If applicable, an addendum to the contract should state that the buyer takes the property subject to the rights of existing tenants. The contract can help ensure that the rental situation undergoes a smooth transition by requiring that:

- the seller, within a stated period of time, give the buyer copies of the rental agreement/lease, the current income and expense statement, and any notices sent to the tenants;
- the seller cannot make any changes to the rental agreement/lease without the buyer's consent;
- the seller must give the buyer written statements from the tenants confirming the salient aspects of the tenancy and that no defaults exist; and
- the seller must transfer to the buyer, through escrow, any unused tenant deposits.

Repairs and Final Inspection
The contract may provide that all required repairs will be performed in a skillful manner with materials of comparable quality to the original and, unless otherwise agreed in writing, be completed prior to close of escrow. The buyer can be given the right to inspect the property prior to close of escrow to confirm both the repairs and that the property is otherwise in the same condition as when the contract was formed.

Sale of Buyer's Property
If applicable, the contract will provide that buyer is not obligated to complete the transaction unless buyer closes escrow on the sale of his/her property, as described. The contract may then afford the seller two options:

- to continue to offer the property for sale and to accept another offer. If this happens, the contract will provide that the buyer must, in writing and within a stated period of time,

remove this contingency and the loan contingency of there is one. If the buyer does not do this, the transaction is terminated.

- to continue to market the property for back-up offers only.

Property Destruction or Damage
The contract may assign the risk of loss due to destruction or damage to the property which is not the fault of either buyer or seller. If the contract does not, then damage or destruction prior to close of escrow is the seller's problem. An exception to this would be damage or destruction occurring after buyer takes possession but before escrow closes (i.e., buyer moved in as a tenant).

Multiple Listing Service
The contract may give the brokers authorization to report the terms of the transaction to any MLS, to be published and distributed to other parties on terms approved by the MLS.

Equal Housing Opportunity
The contract may inform the parties that the property is sold in compliance with federal, state and local anti-discrimination laws. It is illegal to discriminate on the basis of race, color, religion, sex, handicap, familial status, or national origin.

Mediation/Arbitration of Disputes
The parties may agree to mediate all disputes and claims before resorting to arbitration or court action. A mediator is impartial and may facilitate resolution of a dispute but cannot impose a settlement. However, mediation can result in a binding settlement document signed by seller and buyer. For mediation which is not successful, the contract may afford the option of proceeding to arbitration. An arbitration, conducted in accordance with the rules of either the American Arbitration Association (AAA) or Judicial Arbitration and Mediation Services, Inc. (JAMS), results in a binding decision.

Liquidated Damages
If separately signed or initialed by both seller and buyer, the liquidated damages paragraph is activated and provides that if the seller proves that the buyer breached the contract:

1. The seller is released from the obligation to sell the property to the buyer.
2. The amount of the liquidated damages is limited to the buyer's deposit, to a maximum of 3% of the purchase price.

The liquidated damages provision must be printed in at least 10-point bold type or in contrasting red print in at least 8-point bold type.

If the deposit was increased after the initial offer/acceptance, the buyer and seller must, if the amount of the increase is to be subject to liquidated damages, sign a separate liquidated damages agreement covering the increased deposit.

Attorney's Fees
The contract may provide that the prevailing party in any action, proceeding or arbitration between buyer and seller is entitled to reasonable attorney's fees and costs. This provision may include an exclusion if the prevailing party commenced the action, proceeding or arbitration without first attempting mediation.

Offer and Acceptance - Contract
In order to form a binding contract, the seller must accept the buyer's offer, without modification, and communicate that acceptance to the buyer before a specified expiration date.

If the seller finds unacceptable some element(s) of the offer, the seller may make a counteroffer, giving the buyer a certain time to accept. These negotiations will culminate in either a stalemate or a contract. If a contract is reached, the result will be either breach or transfer of the property.

The acceptance clause may include the seller's agreement to compensate the listing and selling broker's:

- on recordation of the deed;
- upon seller's default; or
- upon buyer's default (a stated portion of any damages seller recovers from buyer, after first deducting title and escrow expenses and any costs of collection).

DISCLOSURES

The following are important disclosure requirements which attach primarily to the sale of residential real property of one-to-four units.

Real Estate Transfer Disclosure Statement

Many facts about a residential property affect its value and desirability. These include:

- age, condition, and any defects or malfunctions of the structural components and/or plumbing, electrical, heating, or other mechanical systems;
- easements, common driveways, or fences;
- room additions, structural alterations, repairs, replacements, or other changes, especially those made without required building permits;
- flood, drainage, settling or soil problems on or near the property;
- zoning violations, such as nonconforming uses or insufficient setbacks;
- homeowners' association obligations and deed restrictions or "common area" problems;
- citations against the property or lawsuits against the owner or affecting the property;
- neighborhood noise or nuisance problems; and
- location of the property within a known earthquake zone.

California Civil Code Section 1102.3 requires that a seller of real property consisting of one-to-four residential dwelling units deliver to prospective buyers a specified written disclosure statement concerning the condition of the property. The disclosure covers matters within the personal knowledge of the seller and the agent, and matters based on a reasonably diligent inspection of the property. This requirement extends to any transfer by sale, exchange, installment land sale contract, lease with an option to purchase, any other option to purchase, or ground lease coupled with improvements. The following transfers are exempt:

- transfers required to be preceded by delivery to the prospective transferee of a subdivision public report or where a public report is not required because the offering of subdivided land satisfies all the criteria in Business and Professions Code Section 11010.4;
- transfer pursuant to a court order;

- transfer to a mortgagee by a mortgagor who is in default; transfer by a foreclosure sale, or pursuant to a power of sale, after such default;
- transfer by a fiduciary in the administration of a decedent's estate, guardianship, conservatorship or certain transfers from a trust;
- transfer from one co-owner to another;
- transfer to a spouse or to a person or persons in the lineal line of consanguinity;
- transfer between spouses resulting from a judgment of dissolution of marriage or of legal separation or from a property settlement agreement incidental to such a judgment;
- transfer by the State Controller of unclaimed property;
- transfer resulting from failure to pay taxes; and
- transfer to or from any governmental entity.

The required disclosure must be delivered to the prospective buyer as soon as practicable before transfer of title, or before the execution of the contract in the case of a lease option, sales contract, or ground lease coupled with improvements. If any disclosure or amended disclosure is delivered after execution of the offer by the buyer, the buyer has three days after delivery in person or five days after delivery by deposit in the United States mail to terminate the offer or agreement to purchase by delivering a written notice of termination to the seller or to the seller's agent.

The obligation to prepare and deliver disclosures is imposed upon the seller and the seller's agent and any agent acting in cooperation with such agent. If more than one real estate agent is involved in the transaction, (unless otherwise instructed by the seller) the agent obtaining the offer is required to deliver the disclosures to the prospective buyer. If the disclosure is based on a report or opinion of an expert, such as a contractor or structural pest control operator, the seller and the agent may be protected from liability for any error as to the item covered by the report or opinion.

The required disclosures are set forth in Civil Code Section 1102.6.

Local Option Disclosure Statement

Civil Code Section 1102.6a permits any city or county to require an additional disclosure statement focusing on some local condition which may materially affect a buyer's use and enjoyment of residential property. The statute uses the example of adjacent land zoned for timber production and perhaps subject to harvest.

Mello-Roos Disclosure

The Mello-Roos Community Facilities Act of 1982 authorizes the formation of community facilities districts, the issuance of bonds, and the levying of special taxes thereunder to finance designated public facilities and services. Civil Code Section 1102.6b requires that a seller of a property consisting of one-to-four dwelling units subject to the lien of a Mello-Roos community facilities district make a good faith effort to obtain from the district a disclosure notice concerning the special tax and give the notice to a prospective buyer. The same exemptions apply as for delivery of a Real Property Transfer Disclosure Statement.

Disclosure Regarding Lead-Based Paint Hazards

Many housing units in California still contain lead-based paint, which was banned for residential use in 1978. Lead-based paint can peel, chip, and deteriorate into contaminated dust, thus becoming a lead-based paint hazard. A child's ingestion of the lead-laced chips or dust may result in learning disabilities, delayed development or behavior disorders.

The federal Real Estate Disclosure and Notification Rule (the Rule) requires that owners of "residential dwellings" built before 1978 disclose to their agents and to prospective buyers or lessees/renters the presence of lead-based paint and/or lead-based paint hazards and any known information and reports about lead-based paint and lead-based paint hazards (location and condition of the painted surfaces, etc.). The Rule defines a residential dwelling as a single-family dwelling or a single-family dwelling unit in a structure that contains more than one separate residential dwelling unit, and in which each such unit is used or occupied, or intended to be used or occupied, in whole or in part, as the residence of one or more persons.

Properties affected by the Rule are termed target housing. Target housing does *not* include pre-1978 housing which is:

- sold at a foreclosure sale (but a subsequent sale of such a property *is* covered);
- a "0-bedroom dwelling" (e.g., a loft, efficiency unit or studio);
- a dwelling unit leased for 100 or fewer days (e.g., a vacation home or short-term rental), provided the lease cannot be renewed or extended;
- housing designated for the elderly or handicapped, unless children reside there or are expected to reside there;
- leased housing for which the requirements of the Rule have been satisfied, no pertinent new information is available, and the lease is renewed or renegotiated;
- rental housing that has been inspected by a certified inspector and found to be free of lead-based paint. (The Rule allows use of state certified inspectors only until a federal certification program or a federally accredited state certification program is in place.)

Sellers (and lessors) of units in pre-1978 multifamily structures will have to provide a buyer (or lessee) with any available records or reports pertaining to lead-based paint and/or lead-based paint hazards in areas used by all the residents (stairwells, lobbies, recreation rooms, laundry rooms, etc.). If there has been an evaluation or reduction of lead-based paint and/or lead-based paint hazards in the entire structure, the disclosure requirement extends to any available records or reports regarding the other dwelling units.

The federal Environmental Protection Agency (EPA) publishes a pamphlet titled *"Protect Your Family From Lead In Your Home."* This pamphlet describes ways to recognize and reduce lead hazards. The Rule requires that a seller (or lessor) of target housing deliver this pamphlet to a prospective buyer (or tenant) before a contract is formed. If this is done after that time the buyer has the right to cancel the contract.

The Rule requires that a seller of target housing offer a prospective buyer ten days to inspect for lead-based paint and lead-based paint hazards. This 10-day inspection period can be increased, decreased, or waived by written agreement between buyer and seller. The Rule does not require a seller to pay for an inspection or to remove any lead-based paint/hazards, but merely gives a buyer the opportunity to have the property inspected. A list of State-certified lead inspectors and

contractors is available by calling the California Department of Health Services. The Rule further requires that the seller's (or lessor's) lead-based paint/lead-based paint hazards disclosures, a Lead Warning Statement, and the buyer's (or lessee's) acknowledgment of receipt of the information, offer of inspection period (or waiver of same) and the EPA pamphlet be included in an attachment to the contract. Seller (or lessor), buyer (or tenant) and agent must sign and date the attachment. The retention period, for sellers (or lessors) and agents, of this document is three years from completion of the sale (or from commencement of the lease/rental).

A real estate agent must ensure that:

- his or her principal (seller or lessor) is aware of the disclosure requirements;
- the transaction documentation includes the required notifications and disclosures;
- the buyer or lessee/renter receives the EPA pamphlet; and,
- in the case of a sale, the buyer is offered an opportunity to have the property inspected for lead-based paint and lead-based paint hazards. In the case of a sale, "agent" does not include one who represents only the buyer and receives compensation only from the buyer.

Violation of the Rule may result in civil and/or criminal penalties.

To obtain the essential compliance information, a person may call the Environmental Protection Agency.

California's environmental hazards pamphlet. As discussed above, in California a seller (with a few exceptions) of residential real property comprising one-to-four dwelling units must give the buyer a Real Estate Transfer Disclosure Statement. The statement must include environmental hazards of which the seller is aware. The listing and selling agents must inspect the property and disclose to the buyer material facts, including environmental hazards (e.g., lead-based paint), which may affect the value or desirability of the property. Further, the seller or the seller's agent can give the buyer (of any real property) a pamphlet titled *"Environmental Hazards: A Guide for Homeowners, Buyers, Landlords, and Tenants."* If the buyer receives the pamphlet, neither the seller nor agent is required to say more about environmental hazards (again, assuming no awareness of such a problem).

Disclosures Regarding State Responsibility Areas

The Department of Forestry and Fire Protection (the Department) has produced maps identifying rural lands classified as state responsibility areas. In a state responsibility area, the state (as opposed to a local or federal agency) has the primary financial responsibility for the prevention and extinguishing of fires. Maps of these state responsibility areas and any changes (including new maps to be produced every five years) are to be provided to assessors in the affected counties.

If a seller knows that the property is located in a state responsibility area <u>or</u> the property is included on a map given by the Department to the county assessor, the seller must disclose the possibility of substantial fire risk and that the land is subject to certain preventative requirements. (Public Resources Code Section 4291 lists the requirements.) Notices of the location of the maps will be posted at the offices of the county recorder, county assessor, and the county planning commission.

With the agreement of the Director of Forestry and Fire Protection, a county may, by ordinance, assume responsibility for *all* fires, including those occurring in state responsibility areas. Absent such an ordinance, the seller of property located in a state responsibility area must disclose to the

buyer that the state is *not* obligated to provide fire protection services for any building or structure unless such protection is required by a cooperative agreement with a county, city, or district.

These disclosures must be made on the Natural Hazard Zone Disclosure Statement.

Disclosure of Ordnance Location

Federal and state agencies have identified certain areas once used for military training which may contain live ammunition. A seller of residential property located within one mile of such a hazard must, pursuant to Civil Code Section 1102.15, give the buyer written notice as soon as practicable before transfer of title. This obligation depends upon the seller having actual knowledge of the hazard. The exemptions which pertain to delivery of the Real Property Transfer Disclosure Statement apply also to this requirement.

Disclosure of Geological Hazards and Earthquake Fault Zones

Pursuant to the Alquist-Priolo Earthquake Fault Zoning Act, the State Geologist is in the process of identifying areas of the state susceptible to "fault creep" and delineating these areas on maps prepared by the State Division of Mines and Geology.

A seller of real property situated in an earthquake fault zone, or the agent of the seller and any agent acting in cooperation with such agent, must disclose to the buyer that the property is or may be situated in an earthquake fault zone. This disclosure must be made on the Natural Hazard Zone Disclosure Statement,

In addition, the Seismic Safety Commission has developed a Homeowner's Guide to Earthquake Safety for distribution to real estate licensees and the general public. The guide includes information on geologic and seismic hazards for all areas, explanations of related structural and nonstructural hazards, recommendations for mitigating the hazards of an earthquake, and a statement that safety or damage prevention cannot be guaranteed with respect to a major earthquake and that only precautions such as retrofitting can be undertaken to reduce the risk. The Seismic Safety Commission has also developed a Commercial Property Owner's Guide to Earthquake Safety.

If a buyer receives a copy of the Homeowner's Guide (or, if applicable, the Commercial Property Owner's Guide), neither the seller nor the broker are required to provide additional information regarding geologic and seismic hazards. Sellers and real estate licensees must, however, disclose that the property is in an earthquake fault zone and the existence of known hazards affecting the real property being transferred.

Delivery of a booklet is required in the following transactions:

1. Transfer of any real property improved with a residential dwelling built prior to January 1, 1960 and consisting of one-to-four units any of which are of conventional light-frame construction (Homeowner's Guide); and,
2. Transfer of any masonry building with wood-frame floors or roofs built before January 1, 1975 (if residential, both guides; if commercial property, only the Commercial Guide).

In a transfer subject to item 1 above, the following aspects of the structure and any corrective measures taken, which are within the seller's actual knowledge, must be disclosed to a prospective buyer:

- absence of foundation anchor bolts;

- unbraced or inappropriately braced perimeter cripple walls;
- unbraced or inappropriately braced first-story wall or walls;
- unreinforced masonry perimeter foundation;
- unreinforced masonry dwelling walls;
- habitable room or rooms above a garage; and
- water heater not anchored, strapped, or braced.

Certain exemptions apply to the obligation to deliver the booklet when transferring either a dwelling of one-to-four units or a *reinforced* masonry building. These exemptions are essentially the same as those that apply to delivery of the Real Estate Transfer Disclosure Statement.

Environmental Hazard Disclosures

The Real Estate Transfer Disclosure Statement includes disclosure of hazardous substances, materials, or products including, but not limited to, asbestos, formaldehyde, radon gas, lead-based paint, fuel or chemical storage tanks, and contaminated soil or water.

(Lessees or renters of real property who know or suspect that a release of a hazardous substance has occurred or may occur on or beneath the property are required to provide written notice of that condition to the property owner or lessor. Failure of the lessee or renter to provide written notice to the property owner or lessor may subject the lessee or renter to actual damages and/or civil penalties.)

The Department of Real Estate, the Department of Toxic Substances Control, and the Office of Environmental Health Hazard Assessment have developed a booklet to be used for the purpose of educating and informing consumers on environmental hazards which may be located on and affect real property. The booklet, titled *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords, and Tenants* identifies common environmental hazards, describes the risks involved with each, discusses mitigation techniques, and provides lists of publications and sources from which consumers can obtain more detailed information. Hazards discussed in the booklet are asbestos, radon, lead, and formaldehyde. The booklet also provides general information on hazardous wastes and the use and disposal of hazardous household products.

If the booklet is provided to a prospective buyer of real property, neither the seller nor a real estate agent involved in the sale has a duty to provide further information concerning such hazards, other than lead, unless the seller or licensee has actual knowledge of the existence of environmental hazards on or affecting the subject property.

Energy Conservation Retrofit and Thermal Insulation Disclosure

State law prescribes a minimum energy conservation standard for all new construction without which a building permit may not be issued. Local governments also have ordinances that impose additional energy conservation measures on new and/or existing homes. Some local ordinances impose energy retrofitting as a condition of the sale of an existing home. The requirements of the various ordinances, as well as who is responsible for compliance, may vary among local jurisdictions. The existence and basic requirements of local energy ordinances should be disclosed to a prospective buyer by the seller and/or the seller's agent and any cooperating agent.

Federal law requires a "new home" seller to disclose in every sales contract the type, thickness, and R-value of the insulation which has been or will be installed in the house.

Special Flood Hazard Area Disclosure and Responsibilities of FEMA

Flood Hazard Boundary Maps identify the general flood hazards within a community. They are also used in flood plain management and for flood insurance purposes. Flood Hazard Boundary Maps developed by the Federal Emergency Management Agency (FEMA) in conjunction with communities participating in the National Flood Insurance Program (NFIP) delineate areas within the 100-year flood boundary termed "special flood zone areas." Also identified are areas between 100 and 500-year levels termed "areas of moderate flood hazards" and the remaining areas above the 500-year level termed "areas of minimal risk."

A seller of property located in a special flood hazard area, or the seller's agent and any cooperating agent, must disclose that fact to the buyer and that federal law requires flood insurance as a condition of obtaining financing on most structures located in a special flood hazard area. Since the cost and extent of flood insurance coverage may vary, the buyer should contact an insurance carrier or the intended lender for further information.The disclosure must be made on the Natural Hazard Zone Disclosure Statement.

Local Requirements Resulting from City and County Ordinances

Residential properties located in cities and counties throughout California are typically subject to specific local ordinances relating to occupancy, zoning and use, building code compliance, and fire, health and safety code regulations. Whether such matters must be investigated when they are not within the personal knowledge of the seller or the agent may depend on the circumstances. Civil Code Section 2079.3 provides that the listing and selling agents' duty to inspect does not include areas off the site of the property or public records or permits concerning the title or use of the property in the absence of special circumstances.

Foreign Investment in Real Property Tax Act

Federal law requires that a buyer of real property must withhold and send to the Internal Revenue Service (IRS) 10% of the gross sales price if the seller of the real property is a "foreign person." The primary grounds for exemption from this requirement are: the seller's nonforeign affidavit and U.S. taxpayer I.D. number; a qualifying statement obtained through the IRS attesting to other arrangements resulting in collection of, or exemption from, the tax; or the sales price does not exceed $300,000 and the buyer intends to reside in the property.

Because of the number of exemptions and other requirements relating to this law, it is recommended that the IRS be consulted for more detailed information. Sellers and buyers and the real estate agents involved who desire further advice should also consult an attorney, CPA, or other qualified tax advisor.

Notice and Disclosure to Buyer of State Tax Withholding on Disposition of California Real Property

In certain California real estate sale transactions, the buyer must withhold 3 1/3% of the total sale price as state income tax and deliver the sum withheld to the State Franchise Tax Board. The escrow holder, in applicable transactions, is required by law to notify the buyer of this responsibility.

A buyer's failure to withhold and deliver the required sum may result in the buyer being subject to penalties. Should the escrow holder fail to notify the buyer, penalties may be levied against the escrow holder.

Transactions to which the law applies are those in which:

- The seller shows an out of state address, or sale proceeds are to be disbursed to a financial intermediary of the seller;
- The sales price exceeds $100,000; and,
- The seller does not certify that he/she is a resident of California or that the property being conveyed is his/her personal residence, as defined in Section 1034 of the Internal Revenue Code. (Note: If the seller is a corporation, the certification would be that the corporation has a permanent place of business in California.)

For further information, contact the Franchise Tax Board.

Furnishing Controlling Documents and a Financial Statement

The owner (other than a subdivider) of a separate interest in a common interest development (community apartment project, condominium project, planned development, or stock cooperative) must provide a prospective buyer with the following:

- a copy of the governing documents of the development;
- should there be an age restriction not consistent with Civil Code Section 51.3, a statement that the age restriction is only enforceable to the extent permitted by law and specifying the applicable provisions of law;
- a copy of the most recent documents of the homeowners' association, including financial statements, budgets and insurance information required under Civil Code Section 1365;
- a written statement from the association specifying the amount of the current regular and special assessments as well as any unpaid assessment, late charges, interest, and costs of collection which are or may become a lien against the property; and,
- information regarding any approved change in the assessments or fees which is not yet due and payable as of the disclosure date.

Notice Regarding the Advisability of Title Insurance

In an escrow for a sale (or exchange) of real property where no title insurance is to be issued, the buyer (or both parties to an exchange) must receive and sign the following notice as a separate document in the escrow:

"IMPORTANT: IN A PURCHASE OR EXCHANGE OF REAL PROPERTY, IT MAY BE ADVISABLE TO OBTAIN TITLE INSURANCE IN CONNECTION WITH THE CLOSE OF ESCROW SINCE THERE MAY BE PRIOR RECORDED LIENS AND ENCUMBRANCES WHICH AFFECT YOUR INTEREST IN THE PROPERTY BEING ACQUIRED. A NEW POLICY OF TITLE INSURANCE SHOULD BE OBTAINED IN ORDER TO ENSURE YOUR INTEREST IN THE PROPERTY THAT YOU ARE ACQUIRING."

This requirement is also of interest to a real estate broker conducting an escrow pursuant to the exemption set forth in Financial Code Section 17006(a)(4).

Visual Inspection

The real estate agent representing a seller of residential property consisting of one to four dwelling units (or a manufactured home) and any cooperating agent each have the duty to conduct a reasonably competent and diligent visual inspection of the property and to disclose to a prospective buyer all material facts affecting value, desirability, and implicitly intended use.

The required inspection does not include areas not reasonably accessible. If the real property is a dwelling unit in a condominium, planned development, or a stock cooperative, the visual inspection need only include the unit involved and not the common area. It also does not include investigation of areas off the site of the property or public records and permits in the absence of special circumstances.

Nothing in the law relieves a buyer of the duty to exercise reasonable care to protect himself/herself, including the facts that are known to or within the reasonably diligent attention and observation of the buyer.

An agent's certification of performing the required visual inspection is contained in the Real Estate Transfer Disclosure Statement. This requirement does not apply if the sale is made pursuant to a subdivision public report or the sale is exempt from the public report requirement pursuant to Business and Professions Code Section 11010.4, *provided* that the property has not been previously occupied.

Agency Relationship Disclosure

To clarify relationships between buyers and sellers and real estate brokers, the law requires persons acting as agents in certain residential real estate transactions to make statutorily prescribed written disclosures concerning the agency roles intended. This requirement applies to transactions involving the sale or exchange of certain estates (including leases of more than one year) in residential real property of from one-to-four dwelling units, as well as the sale or exchange of mobilehomes occurring through a real estate agent. The seller should receive the agency disclosure before signing the listing agreement.

Principals and agents may modify and change the agency relationship(s) between the parties by written consent of all of the parties to the transaction. The required agency disclosure form is set forth in Civil Code Section 2079.16.

No Disclosure Required for Manner/Occurrence of Death; Affliction of Occupant with AIDS
No cause of action arises against an owner or the owner's agent (or any cooperating agent) when selling, leasing, or renting real property and failing to disclose to the buyer, lessee, or renter the following:

- the manner or occurrence of an occupant's death upon the real property if the death occurred more than 3 years prior to the transferee's offer to purchase, lease, or rent the property; or
- that an occupant of the property was afflicted with, or died from, Acquired Immune Deficiency Syndrome (AIDS).

Note that the controlling statute does not change the law relating to disclosure of any other physical or mental condition or disease of an occupant or the physical condition of the property. Further, the statute will not protect the owner or agent(s) from misrepresentation if the buyer asks a direct question concerning deaths occurring on the real property.

Disclosure of Sale Price Information
Within one month after the close of escrow for the transfer of title to real property (or the sale of a business opportunity) through a real estate agent(s), the agent(s) must inform the buyer and seller in writing of the selling price. In the case of an exchange, the information on the selling price is required to include a description of the property and the amount of added money consideration, if any.

If a transaction is closed through an authorized third party escrow holder, a closing statement from said escrow holder will be regarded as compliance with the requirements of this law.

Seller Financing Disclosure Statement

Some sellers of residential properties participate in financing the sale of their homes by extending credit to the buyer in the form of a seller "carry-back." This is usually in the form of a promissory note secured by a deed of trust. To ensure adequate disclosure and to prevent abuses involving some of these seller-assisted financing plans, the state legislature enacted a disclosure law which applies to real estate transactions involving residential dwellings of not more than four units if the seller extends credit to the buyer through a written agreement which provides for either a finance charge or more than four payments of principal and interest (or interest only), not including the down payment.

Written disclosures required by this law are the responsibility of the *arranger of credit*. An *arranger of credit* is defined as a person who is not a party to the transaction (except as noted below), but is involved in negotiation of the credit terms and completion of the credit documents, and who is compensated for arranging the credit or for facilitating the transaction. A real estate broker may be deemed an arranger of credit. The duty to provide the disclosures also applies to an attorney or a real estate licensee who is a principal in the transaction.

Disclosures pursuant to this law are *not* required to be given to a buyer or seller who is entitled to receive (in connection with the credit being extended) a disclosure under any of the following :

- Federal Truth-in-Lending Act;
- Real Estate Settlement Procedures Act (RESPA);
- A mortgage loan disclosure statement (Business and Professions Code Section 10240) or a lender/purchaser disclosure statement (Business and Professions Code Section 10232.4); or
- Section 25110 of the Corporations Code or exemption therefrom relating to the sale of qualified securities under permit or exempt securities or transaction.

The disclosure statement required by this law must be delivered as soon as possible before the execution of any note or security document. The statement must be signed by the arranger of credit and the buyer and seller, who are each to receive a copy. Should there be more than one arranger of credit, the arranger obtaining the offer from the buyer is responsible for making the disclosure unless another person is designated in writing by the parties to the transaction.

The disclosure statement will include comprehensive information about the financing, cautions applicable to certain types of financing, and suggestions of procedures which will protect the parties during the term of the financing. The disclosures include:

- identification of the note, or credit, or security document and the property which is or will become the security;
- a copy of the note, or credit, or security document, or a description of the terms of these documents;
- the terms and conditions of each encumbrance recorded against the property which shall remain as a lien or is an anticipated lien which will be senior to the financing being arranged;

- a warning about the hazards and potential difficulty of refinancing and, should the existing financing or the financing being arranged involve a balloon payment, the amount and due date of any balloon payment and a warning that new financing may not be available;
- an explanation of the possible effects of an *increase* in the amount owed due to negative amortization as a result of any variable or adjustable-rate financing being arranged;
- if the financing being arranged involves an all-inclusive trust deed (AITD), a statement of the possible penalties, discounts, responsibilities, and rights of parties to the transaction with respect to acceleration and/or prepayment of a prior encumbrance as the result of the creation and/or refinancing of the AITD;
- if the financing involves an AITD or a real property sales contract, a statement identifying the party to whom payments will be made and to whom such payments will be forwarded, and if the party receiving and forwarding the payments is not a neutral third party, a warning that the principals may wish to designate a neutral third party;
- a complete disclosure about the prospective buyer, including credit and employment information along with a statement that the disclosure is not a representation of the credit worthiness of the prospective buyer; or, a statement that no representation regarding the credit worthiness of the prospective buyer is being made;
- a warning regarding possible limitations on the seller's ability, in the event of foreclosure, to recover proceeds of the sale financed;
- a statement recommending loss payee clauses be added to the property insurance policy to protect the seller's interest and advising of the existence or the availability of services which will notify the seller if the property taxes are not paid;
- a statement suggesting or acknowledging that the seller should file or has filed a request for notice of delinquency and a request for notice of default in case the buyer fails to pay liens senior to the financing being arranged;
- a statement that a title insurance policy has been or will be obtained and furnished to the buyer and seller insuring their respective interests, or that the buyer and seller should each obtain title insurance coverage;
- a disclosure whether the security documents for the financing being arranged have been or will be recorded, and what might occur if the documents are not recorded; and,
- information as to whether the buyer is to receive any "*cash back*" from the sale, including the amount, source, and purpose of the cash refund.

The requirement of a seller financing disclosure statement also applies to transactions by real property sales contracts (as defined in Civil Code Section 2985) and to leases with option-to-purchase provisions where the facts demonstrate intent to transfer equitable title. If the extension of credit is subject to a balloon payment, a balloon payment notice is to be included on the face of the promissory note or other evidence of debt.

An arranger of credit must inform the seller that a buyer who intends to occupy the real property involved may have the right to homeownership counseling in the event of a default in the mortgage payments. The collector of the payments, whether the seller or a loan servicing agent, has the duty to inform the defaulting homeowner of the availability of such counseling. Loss of

or reduced ability to make payments on a residence may entitle the homeowner to the aforementioned counseling. The duty to inform a defaulting homeowner of the availability of counseling is operative regardless of the nature of the credit transaction or the presence of an arranger of credit.

TRUST FUNDS

Real estate brokers and salespersons receive trust funds in the normal course of doing business. They receive these funds on behalf of others, thereby creating a fiduciary responsibility to the funds' owners. Brokers and salespersons must handle, control and account for these trust funds according to established legal standards. While compliance with these standards may not necessarily have a direct bearing on the financial success of a real estate business, non-compliance can result in unfavorable business consequences. Improper handling of trust funds is cause for revocation or suspension of a real estate license, not to mention the possibility of being held financially liable for damages incurred by clients.

This chapter discusses the legal requirements for receiving and handling trust funds in real estate transactions as set forth in the Real Estate Law and the Regulations of the Real Estate Commissioner. It describes the requisites for maintaining a trust fund bank account and the precautions a licensee should take to ensure the integrity of the account. It explains and illustrates the trust fund record keeping requirements under the Business and Professions Code and the Commissioner's Regulations.

The discussions and examples in this chapter involve real property sales and property management trust account transactions. Other types of real estate activities involving trust funds, although subject to the same laws and regulations, may also have to comply with additional legal and regulatory requirements. While these other types of transactions may require records significantly different from those illustrated, the record keeping fundamentals still apply.

GENERAL INFORMATION

Trust Funds and Non-Trust Funds

Since trust funds must be handled in a special manner, a licensee must be able to distinguish trust funds from non-trust funds. Trust funds are money or other things of value that are received by a broker or salesperson on behalf of a principal or any other person, and which are held for the benefit of others in the performance of any acts for which a real estate license is required. Trust funds may be cash or non-cash items. Some examples are; cash; a check used as a purchase deposit (whether made payable to the broker or to an escrow or title company); a personal note made payable to the seller; or even an automobile's "pink slip" given as a deposit.

The discussions in this chapter pertain to real estate trust funds received by licensees, and not to non-trust funds such as real estate commissions, general operating funds, and rents and deposits from broker-owned real estate. These other types of funds, as long as not commingled with trust funds, are not subject to the Real Estate Law and Commissioner's Regulations. It should be noted, however, that under certain circumstances the Department of Real Estate does have the jurisdiction to look into transactions involving non-trust funds.

Why a Trust Account?

A trust account is set up as a means to separate trust funds from non-trust funds. Although it can certainly be argued that keeping trust funds in a trust account will not prevent a dishonest broker from misusing the funds, separating client's funds from the broker's own funds provides a better physical and accounting control over the trust funds.

An important reason for designating a trust fund depository as a trust account is the protection afforded principals' funds in situations where legal action is taken against the broker or if the broker becomes incapacitated or dies. Trust funds held in a true trust account cannot be "frozen" pending litigation against the broker or during probate.

Trust funds also have better insurance protection if deposited into a trust account. The general counsel of the FDIC, in an opinion in 1965, held that funds of various owners which are placed in a custodial deposit (trust account) in an insured bank will be recognized for insurance purposes to the same extent as if the owners' names and interests in the account are individually disclosed on the records of the bank, provided the trust account is specifically designated as custodial and the name and interest of each owner of funds in the account are disclosed on the depositor's records. Each client with funds deposited in a trust account maintained with a federally insured bank is insured by the FDIC up to $100,000, as opposed to just $100,000 for the entire account, as long as the regulatory requirements are met.

Trust Fund Handling Requirements

A typical trust fund transaction begins with the broker or salesperson receiving trust funds from a principal in connection with the purchase or lease of real property. According to Business and Professions Code Section 10145, trust funds received must be placed into the hands of the owner(s) of the funds, into a neutral escrow depository, or into a trust account maintained pursuant to Commissioner's Regulation 2832 not later than three business days following receipt of the funds by the broker or by the broker's salesperson.

An exception to this rule is ***when*** a check is received from an offeror in connection with an offer to purchase or lease real property. As provided under Commissioner's Regulation 2832, a deposit check may be held uncashed by the broker until acceptance of the offer if the following conditions are met:

1. the check by its terms is not negotiable by the broker, or the offeror has given written instructions that the check shall not be deposited or cashed until acceptance of the offer; and
2. the offeree is informed, before or at the time the offer is presented for acceptance, that the check is being held.

If the offer is later accepted, the broker may continue to hold the check undeposited only if the broker receives written authorization from the offeree to do so. Otherwise, the check must be placed, not later than three business days after acceptance, into a neutral escrow depository or into the trust fund bank account or into the hands of the offeree if both the offeror and offeree expressly so provide in writing.

According to Business and Professions Code Section 10145, a real estate salesperson who accepts trust funds on behalf of the broker under whom he or she is licensed must immediately deliver the funds to the broker or, if directed ***to do so*** by the broker, place the funds into the hands of the broker's principal or into a neutral escrow depository or deposit the funds into the broker's trust fund bank account.

A *neutral escrow depository,* as used in Business and Professions Code Section 10145, means an escrow business conducted by a person licensed under Division 6 (commencing with Section 17000) of the Financial Code or by any person described in subdivisions (a)(1) and (a)(3) of Section 17006 of the Financial Code.

Identifying the Owner(s) of Trust Funds
A broker must be able to identify who owns the trust funds and who is entitled to receive them, since these funds can be disposed of only upon the authorization of that person. The person entitled to the funds may or may not be the person who originally gave the funds to the broker or the salesperson. In some instances the party entitled to the funds will change upon the occurrence of certain events in the transaction. For example, in a transaction involving an offer to buy or lease real property or a business opportunity, the party entitled to the funds received from the offeror (prospective buyer or lessor) will depend upon whether or not the offer has been accepted by the offeree (seller or landlord).

Prior to the acceptance of the offer, the funds received from the offeror belong to that person and must be handled according to his/her instructions. If the funds are deposited in a trust fund bank account, they must be maintained there for the benefit of the offeror until acceptance of the offer. Or, as discussed in the previous section, if the offeror wishes, his/her check may be held uncashed by the broker as long as he/she gives written instructions to the broker to do so and the offeree is informed before or at the time the offer is presented for acceptance that the check is being so held.

After acceptance of the offer, the funds shall be handled according to instructions from the offeror and the offeree as follows:

- An offeror's check held uncashed by the broker before acceptance of the offer may continue to be held uncashed after acceptance of the offer, only upon written authorization from the offeree. [Commissioner's Regulation 2832(d)]
- The offeror's check may be given to the offeree only if the offeror and offeree expressly so provide in writing. [Commissioner's Regulation 2832(d)]
- All or part of an offeror's purchase money deposit in a real estate sales transaction shall not be refunded by an agent or subagent of the seller without the *express written permission* of the offeree to make the refund.

TRUST FUND BANK ACCOUNTS

General Requirements
Trust funds, such as a purchase money deposit check, received by a licensee that are not forwarded directly to the broker's principal or to a neutral escrow depository or for which the broker does not have authorization to hold uncashed must be deposited to the broker's trust fund bank account. (Business and Professions Code Section 10145)

Business and Professions Code Section 10145 and Commissioner's Regulation 2832 require that a trust account meet the following criteria:

1. designated as a trust account in the name of the broker as trustee;
2. maintained with a bank or recognized depository located in California; and
3. not an interest-bearing account for which prior written notice can, by law or regulation, be required by the financial institution as a condition to withdrawal (except as noted in the discussion below of "Interest-Bearing Accounts").

A broker may have an out-of-state trust account if the account is insured by the Federal Deposit Insurance Corporation (FDIC) and is used to service first loans for the types of note owners/investors specified in Section 10145(a)(2) of the Business and Professions Code.

Trust Account Withdrawals

According to Commissioner's Regulation 2834, withdrawals from the trust account may be made only upon the signature of one or more of the following:

1. the broker in whose name the account is maintained;
2. the designated broker-officer if the account is in the name of a corporate broker;
3. if specifically authorized in writing by the broker, a salesperson licensed to the broker; or
4. if specifically authorized in writing by the broker who is a signatory of the trust account, an unlicensed employee of the broker covered by a fidelity bond at least equal to the maximum amount of trust funds to which the employee has access at any time.

No arrangement under which a person named in items 3 or 4 is authorized to make withdrawals from a broker's trust fund relieves an individual broker or the broker-officer of a corporate broker licensee from responsibility or liability as provided by law in handling trust funds in the broker's custody.

Interest-Bearing Accounts

A trust fund bank account normally may not be interest-bearing. A broker may, however, at the request of the owner of trust funds, or of the principals to a transaction or series of transactions from whom the broker has received trust funds, deposit the funds into an interest-bearing account in a bank or savings and loan association if all of the following requirements of Business and Professions Code Section 10145(d) are met:

1. The account is in the name of the broker as trustee for a specified beneficiary or specified principal of a transaction or series of transactions.
2. All of the funds in the account are covered by insurance provided by an agency of the federal government.
3. The funds in the account are kept separate, distinct, and apart from funds belonging to the broker or to any other person for whom the broker holds funds in trust.
4. The broker discloses the following information to the person from whom the trust funds are received and to any beneficiary whose identity is known to the broker at the time of establishing the account:
   - the nature of the account;
   - how the interest will be calculated and paid under various circumstances;
   - whether service charges will be paid to the depository and by whom; and
   - possible notice requirements or penalties for withdrawal of funds from the account.
5. No interest earned on funds in the account shall inure directly or indirectly to the benefit of the broker or to any person licensed to the broker, even if the funds' owners would permit such an arrangement.

6. In an executory sale, lease, or loan transaction in which the broker accepts funds in trust to be applied to the purchase, lease, or loan, the parties to the contract shall have specified in the contract or by collateral written agreement the person to whom interest earned on the funds is to be paid or credited.

The only other situation where a real estate broker is allowed to deposit trust funds into an interest-bearing account occurs when the broker is acting as an agent for a financial institution which is the beneficiary of a loan. In this case the broker may, pursuant to Commissioner's Regulation 2830.1, deposit and maintain funds received from or for the account of an obligor (borrower) into an interest-bearing trust account in a bank or savings and loan association in order to pay interest on an impound account to the obligor in accordance with Section 2954.8 of the Civil Code, as long as the following requirements are met:

1. The funds received from or for the account of the obligor are for the future payment of property taxes, assessments or insurance relating only to a property containing a one-to-four family residence.
2. The account is in the name of the broker as trustee.
3. All of the funds in the account are covered by insurance provided by an agency of the federal government.
4. All of the funds in the account are funds held in trust by the broker for others.
5. The broker discloses to the obligor how interest will be calculated and paid.
6. No interest earned on the trust funds shall inure directly or indirectly to the benefit of the broker or to any person licensed to the broker.

Commingling Prohibited

Funds belonging to a licensee may not be commingled with trust funds. Commingling is strictly prohibited by the Real Estate Law. It is grounds for the revocation or suspension of a real estate license pursuant to Business and Professions Code Section 10176(e).

Commingling occurs when:

1. Personal or company funds are deposited into the trust fund bank account. ***Except for what is provided in Section 2835 of the Commissioner's Regulations as noted below, this is a violation of the law even if separate records are kept.***
2. Trust funds are deposited into the licensee's general or personal bank account rather than into the trust fund account. In this case the violation is not only commingling, but also handling trust funds contrary to Business and Professions Code Section 10145. It is also grounds for suspension or revocation of a license under Business and Professions Code Section 10177(d).
3. Commissions, fees, or other income earned by the broker and collectible from the trust account are left in the trust account for more than 25 days from the date they were earned.

A common example of commingling is depositing rents and security deposits on broker-owned properties into the trust account. As these funds relate to the broker's properties, they are not trust funds and, therefore, may not be deposited into the trust fund bank account. Likewise, the broker may not make mortgage payments and other payments on broker-owned properties from the trust account even if the broker reimburses the account for such payments. Conducting

personal business through the trust account is strictly prohibited and is a violation of the Real Estate Law.

Commissioner's Regulation 2835 provides that the following situations do not constitute "commingling" for purposes of Business and Professions Code Section 10176(e):

(a) The deposit into a trust account of reasonably sufficient funds, not to exceed $200, to pay service charges or fees levied or assessed against the account by the bank or financial institution where the account is maintained.

(b) The deposit into a trust account maintained in compliance with item (d) below of funds belonging in part to the broker's principal and in part to the broker when it is not reasonably practicable to separate such funds, provided the part of the funds belonging to the broker is disbursed not later than 25 days after the deposit and there is no dispute between the broker and the broker's principal as to the broker's portion of the funds. When the right of a broker to receive a portion of trust funds is disputed by the broker's principal, the disputed portion shall not be withdrawn until the dispute is settled.

(c) The deposit into a trust account of broker-owned funds in connection with mortgage loan activities as defined in subdivision (d) or (e) of Section 10131 of the Business and Professions Code or when making, collecting payments on, or servicing a loan which is subject to the provisions of Section 10240 of the Business and Professions Code provided:

(1) The broker meets the criteria of Section 10232 of the Business and Professions Code.

(2) All funds in the account which are owned by the broker are identified at all times in a separate record which is distinct from any separate record maintained for a beneficiary.

(3) All broker-owned funds deposited into the account are disbursed from the account not later than 25 days after their deposit.

(4) The funds are deposited and maintained in compliance with item (d) below.

(5) For this purpose, a broker shall be deemed to be subject to the provisions of Section 10240 of the Business and Professions Code if the broker delivers the statement to the borrower required by Section 10240.

(d) The trust fund account into which the funds are deposited is maintained in accordance with the provisions of Section 10145 of the Business and Professions Code, the Commissioner's Regulations, and the provisions of Title 10, California Code of Regulations, Section 260.105.30.

To summarize, a real estate broker's personal funds may be in the trust account in the following two specific instances:

1. Up to $200 to cover checking account service fees and other bank charges such as check printing charges and service fees on returned checks. Trust funds may not be used to pay for these expenses. (The preferred practice, however, is for the broker to have the bank debit his/her own *personal* account for any trust account fees and charges.)
2. Commissions, fees, and other income earned by a broker and collectible from trust funds may remain in the trust account for a period not to exceed 25 days. Regulation 2835 recognizes that it may not always be practical to disburse the earned income immediately upon receipt. For instance, a property management company may find it too burdensome to collect its

management fee every time a rent check is received and deposited to the trust account. Therefore, as long as the broker disburses the fee from the trust account within 25 days after deposit there is no commingling violation. Note, however, that income earned *shall not* be taken from trust funds received *before* depositing such funds into the trust bank account. Also, under no circumstances may the broker pay personal obligations from the trust fund bank account even if such payments are a draw against commissions or other income. The broker must issue a trust account check to himself/herself for the total amount of the income earned, adequately documenting such payment, and then pay personal obligations from the proceeds of that check.

Trust Fund Liability

Trust fund liability arises when funds are received from or for the benefit of a principal. The aggregate trust fund liability at any one time for a trust account with multiple beneficiaries is equal to the total *positive* balances due to all beneficiaries of the account at the time. Note that beneficiary accounts with negative balances are not deducted from other accounts when calculating the aggregate trust fund liability.

Funds on deposit in the trust account must always equal the broker's aggregate trust fund liability. If the trust account balance is *less* than the total liability a *trust fund shortage* results. Such a shortage is in violation of Commissioner's Regulation 2832.1, which states that the written consent of every principal who is an owner of the funds in the account shall be obtained by a real estate broker prior to each disbursement if such a disbursement will reduce the balance of the funds in the account to an amount less than the existing aggregate trust fund liability of the broker to all owners of the funds. Conversely, if the trust account balance is *greater* than the total liability, there is a *trust fund overage* and the broker may be in violation of Business and Professions Code Section 10176(e) for commingling.

A trust fund discrepancy of any kind is a serious violation of the Real Estate Law. Many real estate licenses have been revoked after a DRE audit disclosed a trust account shortage. To ensure that the balance of the trust account always equals the trust fund liabilities, a broker should implement the following procedures:

1. Deposit intact and in a timely manner to the trust account all funds that are not forwarded to escrow or to the funds' owner(s) or which are not held uncashed as authorized. This practice, required under Commissioner's Regulation 2832, lessens the risk of the funds being lost, misplaced, or otherwise not deposited to the trust account. A licensee is accountable for all trust funds received whether or not they are deposited. DRE auditors have seen numerous cases where trust funds received were properly recorded on the books but were never deposited to the trust account.

2. Maintain adequate supporting papers for any disbursement from the trust account. Record the disbursement accurately in both the Bank Account Record and the Separate Beneficiary Record. The broker must be able to account for all disbursements of trust funds. Any unidentified disbursement will cause a shortage.

3. Disburse funds from a beneficiary's account only when the disbursement will not result in a negative or deficit balance (negative accountability) in the account. Many trust fund shortages are caused by disbursements to a beneficiary in excess of funds received from or for account of that beneficiary. The excess disbursements are, in effect, paid out of funds belonging to other beneficiaries. A shortage occurs because the balance of the trust fund bank

account, even if it is a positive balance, is less than the broker's liability to the other beneficiaries.

4. Ensure that a check deposited to the trust fund account has cleared before disbursing funds against that check. This applies, for example, when a broker who has deposited an earnest money check for a purchase transaction has to return the funds to the buyer because the offer is rejected by the seller. A trust fund shortage will result if the broker issues the buyer a trust account check and the buyer's deposit check bounces or for some reason fails to clear the bank.
5. Keep accurate, current and complete records of the trust account and the separate record for each beneficiary. These records are essential to ensure that disbursements are correct.
6. On a monthly basis, reconcile the cash record with the bank statement and with the separate record for each beneficiary or transaction.

Summary - Maintaining Trust Account Integrity

In summary, to maintain the integrity of the trust fund bank account, a broker must ensure that:

1. his/her personal or general operating funds are not commingled with trust funds;
2. the balance of the trust fund account is equal to the broker's trust fund liability to all owners of the funds; and
3. the trust fund records are in an acceptable form and are current, complete and accurate.

ACCOUNTING RECORDS

General Requirements

An important aspect of the broker's fiduciary responsibility to the client is the maintenance of adequate records to account for trust funds received and disbursed. This is true whether the funds are deposited to the trust fund bank account, sent to escrow, held uncashed as authorized under Commissioner's Regulation 2832, or released to the owner(s) of the funds. These records:

1. provide a basis upon which the broker can prepare an accurate accounting for clients.
2. state the amount of money the broker owes the account beneficiaries at any one time. (This is especially important when there are a large number of transactions.)
3. prove whether or not there is an imbalance in the trust account. Some brokers audited by DRE have disagreed that their trust accounts had a shortage or an overage in the amount disclosed by the audit, but could not provide documentation to support their position.
4. guarantee that beneficiary funds deposited in the trust account will be insured up to the maximum FDIC insurance coverage.

There are two types of accounting records that may be used for trust funds: columnar records in the formats prescribed by Commissioner's Regulations 2831 and 2831.1; and records other than columnar that are in accordance with generally accepted accounting practices *which include details specified in subdivision (a) of the Regulations and are in a format that will readily enable tracing and reconciliation in accordance with Section 2831.2.* Regardless of the type of records used, they must include the following information:

1. all trust fund receipts and disbursements, with pertinent details, presented in chronological sequence;

2. the balance of the trust fund account, based on recorded transactions;
3. all receipts and disbursements affecting each beneficiary's balance, presented in chronological sequence; and
4. the balance owing to each beneficiary or for each transaction.

Either manually produced or computerized accounting records are acceptable. The type and form of records appropriate to a particular real estate operation as well as the means of processing transactions will depend on factors such as the nature of the business, the number of clients, the volume of transactions, and the types of reports needed. For example, manual recording on columnar records might be satisfactory for a broker handling a small number of transactions, while a computerized system might be more appropriate and practical for a large property management operation.

Columnar Records

A broker may decide to use the columnar records prescribed by Commissioner's Regulations 2831 and 2831.1. The records required will depend on whether the trust funds received are deposited to the trust account or are forwarded to an escrow depository or to the owner of the funds. These records are:

1. Columnar Record of All Trust Funds Received and Paid Out - Trust Fund Bank Account (DRE form RE 4522);
2. Separate Record for Each Beneficiary or Transaction (DRE form RE 4523); and
3. Record of All Trust Funds Received - Not Placed in Broker's Trust Account (DRE form RE 4524).

The first two records are required when trust funds are received and deposited to the trust fund bank account.

The third record is required when trust funds received are not deposited to the trust account, but are instead forwarded to the authorized person(s).

If the trust fund account involves clients' funds from rental properties managed by the broker, the Separate Record for Each Property Managed (DRE form RE 4525) may be used in lieu of the Separate Record for Each Beneficiary or Transaction.

A broker who has an escrow division pursuant to Financial Code Section 17006(a)(4) must keep the above mentioned records for escrow funds. (Commissioner's Regulation 2951)

Record of All Trust Funds Received and Paid Out - Trust Fund Bank Account

This record is used to journalize all trust funds deposited to and disbursed from the trust fund bank account. At a minimum, it must show the following information in columnar form: date funds were received; name of payee or payor; amount received; date of deposit; amount paid out; check number and date; and the daily balance of the trust account.

All transactions affecting the trust account are entered in chronological order on this record regardless of payee, payor or beneficiary. If there is more than one trust fund bank account, a different columnar record must be maintained for each account, pursuant to Commissioner's Regulation 2831.

Separate Record for Each Beneficiary or Transaction
This record is maintained to account for funds received from or for the account of each beneficiary, or for each transaction, and deposited to the trust account. With this record, the broker can ascertain the funds owed to each beneficiary or for each transaction. The record must show the following in chronological order: date of deposit; amount of deposit; name of payee or payor; check number; date and amount; and balance of the individual account after posting transactions on any date.

A separate record must be maintained for each beneficiary or transaction from whom the broker received funds that were deposited to the trust fund bank account. If the broker has more than one trust account, each account must have its own set of beneficiary records so that they can be reconciled with the individual trust fund bank account record required by Commissioner's Regulation 2831.2.

Record of All Trust Funds Received - Not Placed in Broker's Trust Account
This record is used to keep track of funds received and not deposited to a trust fund bank account. In this situation, the broker is handling the funds and must keep records of same. Examples are:

1. earnest money deposits forwarded to escrow;
2. rents forwarded to landlords; and
3. borrowers' payments forwarded to lenders.

This record must show the date funds were received, the form of payment (check, note, etc.), amount received, description of property, identity of the person to whom funds were forwarded, and date of disposition. Trust fund receipts are recorded in chronological sequence, while their disposition is recorded in the same line where the corresponding receipt is recorded.

Transaction folders usually maintained by a broker for each real estate sales transaction showing the receipt and disposition of undeposited checks are not acceptable alternatives to the Record of Trust Funds Received But Not Deposited to the Trust Fund Bank Account.

An exception to this record keeping requirement is provided in Commissioner's Regulation 2831(e), which states that a broker is not required to keep records of checks made payable to service providers, including but not limited to escrow, credit and appraisal services, when the total amount of such checks for any transaction does not exceed $1,000. However, a broker shall retain for three years copies of receipts issued or obtained in connection with the receipt and distribution of such checks and, upon request of the Department or the maker of the checks, a broker must account for the receipt and distribution of the checks.

Separate Record for Each Property Managed
This record is similar to, and serves the same purpose as, the Separate Record for Each Beneficiary or Transaction. It does not have to be maintained if a separate record is already used for a property owner's account. The Separate Record for Each Property Managed is useful when the broker wants to show some detailed information about a specific property being managed.

OTHER ACCOUNTING SYSTEMS AND RECORDS

A broker may use trust fund records not in the columnar form as prescribed by Commissioner's Regulations 2831 and 2831.1. Such records must be in accordance with generally accepted

accounting principles *and must include detail specified in subdivision (a) of these Regulations and be in a format that will readily enable tracing and reconciliation in accordance with Section 2831.2.* Whether prepared manually or by computer, they must include at least the following:

1. A *journal* to record in chronological sequence the details of all trust fund transactions.
2. A *cash ledger* to show the bank balance as affected by the transactions recorded in the journal. The ledger is posted in the form of debits and credits. (In some cases the cash ledger may be combined with the journal.)
3. A *beneficiary ledger* for each of the beneficiary accounts to show in chronological sequence the transactions affecting each beneficiary's account, as well as the balance of the account.

To comply with generally accepted accounting principles, there must be one set of journal, cash ledger, and beneficiary ledger for each trust fund bank account.

Journal

A journal is a daily chronological record of trust fund receipts and disbursements. A single journal may be used to record both the receipts and the disbursements, or a separate journal may be used for each. To meet minimum record keeping requirements, a journal must:

1. Record all trust fund transactions in chronological sequence.
2. Contain sufficient information to identify the transaction such as the date, amount received or disbursed, name of or reference to payee or payor, check number or reference to another source document of the transaction, and identification of the beneficiary account affected by the transaction.
3. Correlate with the ledgers. For example, it should show the same figures that are posted, individually or in total, in the cash ledger and in the beneficiary ledgers. The details in the journal must be the basis for posting transactions on the ledgers and arriving at the account balances.
4. Show the total receipts and total disbursements regularly, at least once a month.

Cash Ledger

The cash ledger shows, usually in summary form, the periodic increases and decreases (debits and credits) in the trust fund bank account and the resulting account balance. It can be incorporated into the journal or it can be a separate record, for example a general ledger account. If a separate record is used, the postings must be based on the transactions recorded in the journal. The amounts posted on the ledger must be those shown in the journal.

Beneficiary Ledger

A separate beneficiary ledger must be maintained for each beneficiary or transaction or series of transactions. This ledger shows in chronological sequence the details of all receipts and disbursements related to the beneficiary's account, and the resulting account balance. It reflects the broker's liability to a particular beneficiary. Entries in all these ledgers must be based on entries recorded in the journal.

RECORDING PROCESS

Keeping complete and accurate trust fund records is easier when specific procedures are regularly followed. The following procedures may be useful in developing a record keeping routine:

1. Record transactions daily in the trust fund bank account and in the separate beneficiary records.
2. Use consistently the same specific source documents as a basis for recording trust fund receipts and disbursements. (For example, receipts pertaining to real estate resales will be recorded based on the Real Estate Contract and Receipt for Deposit form, and disbursements will always be recorded based on the checks issued from the trust account or debit notices from the bank.)
3. Calculate the account balances on all applicable records at the time entries are made.
4. Reconcile the records monthly to ascertain that transactions are properly recorded on both the bank account record and the applicable subsidiary records.
5. *Reconcile the trust records to the trust account bank statement on a monthly basis to ascertain that amounts per the bank are in agreement with amounts per the trust fund records.*
6. If more than one trust fund bank account is maintained, keep a different set of properly labeled columnar records (cash record and beneficiary record) for each account.

RECONCILIATION OF ACCOUNTING RECORDS

Purpose

The trust fund bank account record, the separate beneficiary or transaction record, and the bank statement are all interrelated. Any entry made on the bank account record must have a corresponding entry on a separate beneficiary record. By the same token, any entry or transaction shown on the bank statement must be reflected on the bank account record. This applies to columnar as well as to other types of records.

The accuracy of the records is verified by reconciling them at least once a month. Reconciliation is the process of comparing two or more sets of records to determine whether their balances agree. It will disclose whether the records are completed accurately.

For trust fund record keeping purposes, two reconciliations must be made at the end of each month:

1. reconciliation of the bank account record (RE 4522) with the bank statement; and,
2. reconciliation of the bank account record (RE 4522) with the separate beneficiary or transaction records (RE 4523).

Reconciling the Bank Account Record With the Bank Statement

The reconciliation of the bank account record with the bank statement will disclose any recording errors by the broker or by the bank. If the balance on the bank account record agrees with the bank statement balance as adjusted for outstanding checks, deposits in transit, and other transactions not yet included in the bank statement, there is more assurance that the balance on the bank account record is correct. Although this reconciliation is not required by the Real Estate Law or the Commissioner's Regulations, it is an essential part of any good accounting system.

Reconciling the Bank Account Record With the Separate Beneficiary or Transaction Records
This reconciliation, which is required by Commissioner's Regulation 2831.2, will substantiate that all transactions entered on the bank account record were posted on the separate beneficiary or transaction records. The balance on the bank account record should equal the total of all beneficiary record balances. Any difference should be located and the records corrected to reflect the correct bank and liabilities balances. Commissioner's Regulation 2831.2 requires that this reconciliation process be performed monthly except in those months when there is no activity in the trust fund bank account, and that a record of each reconciliation be maintained. This record should identify the bank account name and number, the date of the reconciliation, the account number or name of the principals or beneficiaries or transactions, and the trust fund liabilities of the broker to each of the principals, beneficiaries or transactions.

Unexplained Trust Account Overages
When a broker performs a reconciliation pursuant to Commissioner's Regulation 2831.2, the broker may find an unexplained overage. An unexplained overage is defined as funds in a real estate broker's trust account which exceed the aggregate trust fund liability of such account where the broker is unable to determine the ownership of such excess funds.

Unexplained trust account overages are trust funds and unless the broker can establish the ownership of such funds, the funds must be maintained in the broker's trust fund account or in a separate trust fund account established to hold such funds.

Unexplained trust account overages may not be used to offset or cover shortages that may exist otherwise in the broker's trust account.

A broker must keep a separate record of unexplained trust account overages including a separate subsidiary ledger to record the potential trust fund liability. Such records must include the date of recording and the date on which such funds became an unexplained trust account overage. A broker holding unexplained trust account overages must perform a monthly reconciliation of such funds in accordance with Commissioner's Regulation 2831.2.

Suggestions for Reconciling Records
The following is a general discussion on how to perform the trust account reconciliations.

1. Before performing the reconciliations, record all transactions up to the cut-off date in both the bank account record and the separate beneficiary or transaction records.
2. Use balances as of the same cut-off date for the two records and the bank statement.
3. For the bank account reconciliation, calculate the adjusted bank balance from the bank statement and from the bank account record. (Brokers commonly err by calculating the adjusted bank balance based solely on the bank statement, ignoring the bank account record. While they may know the correct account balances, they may not realize their records are incomplete or erroneous.)
4. Keep a record of the two reconciliations performed at the end of each month, along with the supporting schedules.
5. Locate any difference between the three sets of accounting records. A difference can be caused by:
   - not recording a transaction
   - recording an incorrect figure
   - erroneous calculations of entries used to arrive at account balances

- missing beneficiary records
- bank errors.

DOCUMENTATION REQUIREMENTS

Activities and Related Documents

In addition to accounting records, the Department of Real Estate requires that the broker maintain all documents prepared or obtained in connection with any real estate transaction handled. Here is a list of typical activities and the corresponding documentation.

Activity	*Documentation*
1. Receiving trust funds in the form of:	
Purchase deposits from buyers	• Real estate purchase contract and receipt for deposit, signed by the buyer
Rents and security deposits from tenants	• Collection receipts
Other receipts	• Collection receipts
2. Depositing trust funds	• Bank deposit slips
3. Forwarding buyers' checks to escrow	• Receipt from title/escrow company and copy of check
4. Returning buyers' checks	• Copy of buyer's check signed and dated by buyer, signifying buyer's receipt of check
5. Disbursing trust funds	• Checks issued • Supporting papers for the checks, such as invoices, escrow statements, billings, receipts, etc.
6. Receiving offers and counteroffers from buyers and sellers	• Real estate purchase contract and receipt for deposit, signed by respective parties • Agency disclosure statement • Transfer disclosure statement

7. Collecting management fees from the trust fund bank account	• Property management agreements between broker and property owners. (Note: If only one trust fund check is issued for management fees charged to various property owners, there should be a schedule or listing on file showing each property and amount charged, and the total amount, which should agree with the check amount.) • Cancelled checks
8. Reconciling bank account record with separate beneficiary records	• Record of reconciliation

ADDITIONAL REQUIREMENTS - DOCUMENTS

The following is an additional requirement of the Real Estate Law and the Commissioner's Regulations relating to the preparation and management of real estate transaction documents.

Person Signing Contract to be Given Copy
Under Business and Professions Code Section 10142, any time a licensee prepares or has prepared an agreement authorizing or employing that licensee to perform any acts for which a real estate license is required or when the licensee obtains the signature of any person to any contract pertaining to such services or transaction, the licensee must deliver a copy of the agreement to the person signing it at the time the signature is obtained. Examples of such documents are listing agreements, real estate purchase contract and receipt for deposit forms, addenda to contracts, and property management agreements.

AUDITS AND EXAMINATIONS

Because of the importance of trust fund handling, the Commissioner has an ongoing program of examining brokers' records. As necessary, audited licensees are made aware of deficiencies in trust fund handling and record keeping. If an audit discloses actual trust fund imbalances or money handling procedures which may cause monetary loss, appropriate disciplinary proceedings are initiated.

Section 10148 of the Business and Professions Code provides that a real estate broker shall retain for three years copies of all listings, deposit receipts, canceled checks, trust records, and other documents executed by or obtained by the broker in connection with any transaction for which a real estate broker license is required. The retention period shall run from the date of the closing of the transaction or from the date of the listing if the transaction is not consummated. After notice, such books, accounts and records shall be made available for examination, inspection and copying by the Commissioner or a designated representative during regular business hours, and

shall, upon the appearance of sufficient cause, be subject to audit without further notice, except that such audit shall not be harassing in nature.

SAMPLE TRANSACTIONS

To demonstrate the record keeping requirements discussed in this chapter, we have simulated trust account records for typical real estate transactions occurring over a thirty-day period. To set the stage, let us assume that James Adams, a real estate broker, owns and operates a one-man real estate office specializing in residential sales and property management. Broker Adams has one trust fund bank account. We will look at the trust account activity for this office for the month of *May, 2000.*

2000 ***TRANSACTIONS***

May 1 Opened a trust account with First County Bank, and deposited $100 of his own money to cover bank service charges.

May 1 Entered into agreements to manage the following rental properties:

	Address	*Owner's Name*	*Number of Units*
a.	1538 South Ave. Anycity, CA	T. Eddie	1
b.	3490 Tower St. Anycity, CA	L. Stewart	4
c.	9152 High Way Anycity, CA	W. Allen	4
d.	2351-2353 Kingston Way Anycity, CA	S. Manly	2
e.	7365 Meadow Cir. Anycity, CA	J. Bird	1

May 3 Deposited the following rents received from tenants of managed properties:

	Property	*Tenant's Name*	*Rent Received*
a.	1538 South Ave.	B. Hamns	$600
b.	3490 Tower St., Unit 1	R. Robertson	350
c.	2351 Kingston Way	I. Warren	450
			$1,400

May 5 Received a $2,000 check payable to broker from Mr. and Mrs. Dennis White as deposit for their offer to buy a house at 615 Lake Drive, Anycity, owned by Mr. and Mrs. Richard J. Jensen. Buyers' offer instructed broker to hold the check uncashed until their offer was accepted by the Jensens.

May 5 Received and deposited $750 from T. Sundance representing rent of $500 for September 5 to 30, and $250 security deposits for 7365 Meadow Circle.

May 5 Was notified by the Jensens that they accepted the offer on their property.

May 6 Deposited the $2,000 check from Mr. and Mrs. White.

May 8 Obtained an exclusive listing to sell a six-plex at 915 Galaxy St., Anycity, owned by R. Jays.

May 9 Received $1,000 from W. Allen, owner of 9152 High Way, to cover anticipated expenses for the property. Amount was deposited the same day.

May 10 Issued the following checks to pay for various expenses connected with the managed properties:

Check No.	*Payee*	*Purpose*	*Amount*
1001	ABC Mortgage Co.	Mortgage payment for 1538 South Ave.	$450
1002	Anycity Treasury	Utilities for 1538 South Ave.	35
1003	Professional Cleaners	Cleaning for 3490 Tower St.	55
1004	Mr. Handyman	Minor repairs on 2351 Kingston	25
		TOTAL	$565

May 14 Received a $4,000 check from B. Sun, payable to Title Escrow Company, with an offer to buy the 915 Galaxy property.

May 15 Received R. Jays' acceptance of the buyer's offer on 915 Galaxy Street.

May 16 Delivered the $4,000 check from B. Sun to Title Escrow Company.

May 19 Issued check number 1005 for $2,000 to First Title Co. for account of Mr. and Mrs. White, buyers of the 615 Lake Drive property.

May 22 Received an offer and a $3,000 check as deposit from R. Olive to buy a single family house at 31009 Technology Street owned by T. Evans.

May 24 Returned R. Olive's check after seller rejected the offer.

May 31 Charged property management fees to the following accounts and issued check number 1006 for $330 payable to himself:

Property Owner	*Management Fee*
T. Eddie	$45
L. Stewart	100
W. Allen	80
S. Manly	60

J. Bird	45
	Total $330

May 31 Sent statement of account to each owner of the managed properties.

Background Information

James Adams keeps four types of columnar records:

1. Record of all Trust Funds Received and Paid Out - Trust Fund Bank Account (hereinafter referred to as "Bank Account Record"). This record is required under Commissioner's Regulation 2831 for each trust account a broker has.
2. Record of all Trust Funds Received - Not Placed in Broker's Trust Account (hereinafter referred to as "Record of Undeposited Receipts"). This is required under Commissioner's Regulation 2831.
3. Separate Record For Each Beneficiary or Transaction (hereinafter referred to as "Separate Beneficiary Record"). This is required under Commissioner's Regulation 2831.1.
4. Separate Record For Each Property Managed (hereinafter referred to as "Separate Property Record"). This serves the same purpose as the Separate Beneficiary Record.

To illustrate the recording process, listed below are the entries made on the books by James Adams as well as the documents prepared or obtained as support for each transaction.

Note that:

- Each entry to any record shows all the pertinent information of the transaction, such as the date, name of payee, name of payor, amount, check number, etc.
- The daily *bank balance* is computed and posted on the Account Record after recording the transactions.
- The balance owing to the client is computed and posted on the Beneficiary Record or Separate Property Record, after posting transactions.
- Any entry made on the Bank Account Record has a corresponding entry on a Beneficiary Record or a Separate Property Record, and vice versa.
- All records except the Record of Undeposited Receipts show entries in chronological sequence regardless of transaction type. The Record of Undeposited Receipts shows the disposition of a trust fund in the same line as the receipt is entered, rather than in chronological sequence.

Step-By-Step Narrative of Trust Account Entries

Transaction Date	*Documentation*	*Entries*
May 1	Deposit slip prepared by broker.	Record the deposit on: 1. The Bank Account Record. Balance is $100. 2. A newly prepared Separate Beneficiary for James Adams. Balance is $100.
May 1	Management agreements signed by property owners and broker.	No entries needed since there was no receipt nor disbursement of trust funds.
May 3	Collection receipts Nos. 2, 3 and 4 issued to B. Hamns, R. Robertson, and I. Warren, respectively.	Record the $1,400 receipt on: 1. The Bank Account Record. New balance is $1,500. 2. Newly prepared Separate Beneficiary Records for: T. Eddie - balance is $600 L. Stewart – bal. is $350 S. Manly - balance is $450
May 5	Real Estate Purchase Contract and Receipt for Deposit signed by Mr. and Mrs. White. Collection receipt No. 1 issued to the Whites.	Enter transaction on the Record of Undeposited Receipts. No Separate Beneficiary Record is necessary since the check was not deposited.

Transaction Date	*Documentation*	*Entries*
May 5	Collection receipt No. 5 issued to T. Sundance. Receipt showed that $500 of the $750 was for rent and the other $250 was for security deposit.	Record the $750 deposit on: 1. The Bank Account Record. 2. Separate Beneficiary Records for: J. Bird - Sundance's Security Deposit, bal. is $250. J. Bird - balance is $500. (Since security deposits will be accounted to the tenant in the future, James Adams keeps a separate record for deposits. Total liability to the owner is the sum of the two records - one for security deposits, another for rents and other transactions.)
May 5	Real Estate Contract and Receipt for trust funds were received for Deposit signed by Mr. and Mrs. Jensen.	No entries were made since no trust funds were received or disbursed.
May 6	Deposit receipt prepared by broker.	Record $2,000 deposit on: 1. Bank Account record. New balance is $4,250. 2. A newly prepared Separate Beneficiary Record - Mr. and Mrs. White/Mr. and Mrs. Jensen. Account balance is $2,000. 3. Record of Undeposited Receipts. Shows disposition of check previously entered on the record.
May 8	Exclusive Listing Agreement signed by sellers and broker.	

Transaction Date	*Documentation*	*Entries*
May 9	Collection receipt No. 6 issued to W. Allen.	Record receipt on: 1. The Bank Account Record. New balance is $5,250. 2. A newly prepared Separate Beneficiary Record - W. Allen. Balance is $1,000.
May 10	Checks issued by broker. Supporting papers for each check.	Record disbursements on: 1. Bank Account Record. New Balance is $4,685. 2. Separate Beneficiary Records for: T. Eddie - New balance is $115. L. Stewart - New balance is $295. S. Manly - New balance is $425.
May 14	Real Estate Purchase Contract and Receipt for Deposit signed by B. Sun.	Record receipt on the Record of Undeposited Receipts.
May 15	Real Estate Purchase Contract and Receipt for Deposit signed by R. Jays.	No entry was needed since there was no receipt or disbursement of funds.
May 16	Receipt issued by Title Escrow Company.	Note disposition of check on the Record of Undeposited Receipts.
May 19	Check issued by broker. Receipt issued by First Title Company.	Record disbursements on the: 1. Bank Account Record. New balance is $2,685. 2. Separate Beneficiary Record - Mr. and Mrs. White/Mr. and Mrs. Jensen. New balance is $0.

Transaction Date	*Documentation*	*Entries*
May 22	Real Estate Purchase Contract and receipt for Deposit signed by R. Olive.	
May 24	Real Estate Purchase Contract and Receipt for Deposit rejected by T. Evans.	Post the return of check on the Record of Undeposited Receipts.
May 31	List showing the breakdown of the check amount, showing the charge to each owner. (NOTE: A list is necessary as support for a check disbursement chargeable to a number of beneficiaries. Posting the entries on the separate records without such a list is not sufficient.)	Record disbursements on the: 1. Bank Account Record. New balance is $2,685. 2. Separate Beneficiary Records for: New Owners — Balance T. Eddie — $70 L. Stewart — $195 W. Allen — $920 S. Manly — $365 J. Bird — $455

After recording the daily transactions, the next step in the trust fund accounting process is the reconciling of records at the end of the month. James Adams prepared reconciliation schedules by comparing the bank balance on the Bank Account Record with the bank statement balance (the bank reconciliation) and also with the total of the Separate Beneficiary Records balances (the reconciliation report).

The bank statement and reconciliations are shown on the next two pages.

FIRST COUNTY BANK **STATEMENT**

MAIN BRANCH
5 Main Avenue
ANYCITY, CA 90002

DATE OF THIS STATEMENT 05/31/00

JAMES ADAMS
TRUST ACCOUNT
8310 ORANGE AVENUE
ANYCITY, CA 90002

CHECKING ACCT. 123456 CUSTOMER SINCE 1995

SUMMARY: PREVIOUS STATEMENT BALANCE ON 04/30/00		00.00
TOTAL OF 5 DEPOSITS FOR	5,250.00	
TOTAL OF 4 CHECKS FOR	2,540.00	
TOTAL OF 1 OTHER DEBIT FOR	7.00	
STATEMENT BALANCE ON 05/31/00	2,703.00	

CHECKS/ OTHER DEBITS — CHECKS

CHECK NUMBER	DATE POSTED	AMOUNT
1001	5/14	450.00
1002	5/16	35.00
1003	5/16	55.00
1005	5/21	2,000.00

OTHER DEBITS

DATE POSTED		AMOUNT
05/31	SERVICE CHARGE	7.00

DEPOSITS/ OTHER CREDITS — DEPOSITS

DATE POSTED	AMOUNT
5/1	100.00
5/5	1,400.00
5/5	750.00
5/6	2,000.00
5/9	1,000.00

DAILY BALANCE

DATE	AMOUNT	DATE	AMOUNT
5/1	100.00	5/14	4,800.00
5/5	2,250.00	5/16	4,710.00
5/6	4,250.00	5/21	2,710.00
5/9	5,250.00	5/31	2,703.00

James Adams
Bank Reconciliation
First County Bank
May 31, 2000

Balance per bank statement, 5/31/00		$2,703.00
Add deposits in transit		-0-
Less outstanding checks:		
check #1004	$25.00	
#1006	330.00	<355.00>
Adjusted bank balance, 5/31/00		$2,348.00
Balance per books, 5/31/00		$2,355.00
Less May bank service charge		<7.00>
Adjusted balance, 5/31/00		$2,348.00

James Adams
Reconciliation Report
First County Bank
Account No. 123456
May 31, 2000

Beneficiary	*Balance*
James Adams (Broker)	$93.00
W. Allen	920.00
J. Bird	250.00
J. Bird	455.00
T. Eddie	70.00
S. Manly	365.00
L. Stewart	195.00
Total per subsidiary records	$2,348.00

(Agrees with bank account record balance.)

Note: Samples of DRE forms for trust fund record keeping can be found in the Reference Book.

QUESTIONS AND ANSWERS REGARDING TRUST FUND REQUIREMENTS AND RECORD KEEPING

Q. Are security deposits on rental units the property of the owner or should they be held in trust by the broker for the tenant?

A. *They are trust funds. As such, control and disbursement of the security deposits are at the instruction of the property owner.*

Q. Am I permitted to wait until checks deposited to my trust account have cleared before I issue a trust check to fund a customer's check?

A. *Although the Real Estate Law is silent on this, good business practice dictates that you wait until a customer's check deposited to your trust account has cleared prior to the issuing of your trust check as a refund.*

Q. How should I handle an earnest money check which is to be deposited into escrow upon acceptance of the offer?

A. *Such a check may be held until the offer is accepted and then placed in escrow but only when directed to do so by the buyer, provided you disclose to the seller the fact the check is being held in uncashed form. In such cases, it is good practice to include such a provision in the deposit receipt. You must keep a columnar record of the receipt of the check, the name of the escrow company and the date the check was forwarded to the escrow.*

Q. As a broker-owner of rentals, do I have to put security deposits in a trust account?

A. *Money you receive on your own property is received as a principal, not as an agent. As such, these are not trust funds and should not be placed in the trust account.*

Q. Must I keep a deposit receipt signed only by the buyer and rejected by the seller?

A. *Yes. Such a record must be maintained for three years.*

Q. May I maintain one trust fund account for both collections from my property management business and deposits on real estate sales transactions?

A. *Since property management funds usually involve multiple receipt of funds and several monthly disbursements, it is suggested that separate trust fund accounts be maintained for property management funds and earnest money deposits. However, all trust funds can be placed in the same trust fund account as long as separate records for each trust fund deposit and disbursement are maintained properly and the account is not an interest-bearing account.*

Q. If the buyer and seller decide to go directly to escrow and the buyer makes out a check to the escrow company and hands it directly to the escrow clerk, do I have to maintain any records of this check?

A. *No. You must maintain records only of trust funds which pass through your hands for the benefit of a third party.*

Q. How long must I keep deposit receipts?

A. Deposit receipts must be maintained for three years.

SUMMARY

We might say this section presents the three R's of trust funds: Responsibility, Requirements and Records.

It is a real estate broker's responsibility to protect clients' funds at all times and keep clients fully informed of the nature and disposition of all trust funds.

To aid brokers in carrying out this responsibility, the Real Estate Commissioner's Regulations include requirements concerning trust funds. A real estate broker also needs to meet other requirements from a practical business point of view. To protect clients' funds adequately and in the business-like fashion expected, the broker must keep accurate records.

ESCROW

An escrow is essentially a small and short-lived trust arrangement. It has become almost an indispensable mechanism in this state for the consummation of real property transfers and other transactions such as exchanges, leases, sales of personal property, sales of securities, loans, and mobilehome sales. This chapter discusses the real estate sale escrow.

Definition

California Civil Code Section 1057 provides this description of an escrow:

> "A grant may be deposited by the grantor with a third person, to be delivered on the performance of a condition, and, on delivery by the depositary, it will take effect. While in the possession of the third person, and subject to condition, it is called an escrow."

And, in Section 17003 of the Financial Code:

> "Escrow means any transaction wherein one person, for the purpose of effecting the sale, transfer, encumbering or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by such third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by such third person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of any of the latter."

Essential Elements

The two essential requirements for a valid sale escrow are a binding contract between buyer and seller and the conditional delivery of transfer instruments to a third party. The binding contract can appear in any legal form, including a deposit receipt, agreement of sale, exchange agreement, option or mutual escrow instructions of the buyer and the seller.

Escrow Holder

An escrow holder is the depositary, agent, or impartial third person having and holding possession of money, written instruments, or personal property to be held until the happening of designated conditions. (Once these conditions are met and performed the escrow agent is generally released from liability.) According to Financial Code Section 17004, "escrow agent" is any person engaged in the business of receiving escrows for deposit or delivery.

The escrow holder acts to ensure that all parties to the transaction comply with the terms and conditions of the agreement as set forth in the escrow instructions. The escrow holder may also coordinate the activities and professional services involved in the transaction, such as the activities of the lender and the title company as well as those between the buyer, seller and broker.

Instructions

The conditional delivery or transfer is accompanied by instructions to the escrow holder to deliver the instruments and funds respectively on the performance of the stipulated conditions. There are two forms of escrow instructions employed: bilateral (i.e., binding on both buyer and seller) and unilateral (separate instructions of buyer and seller). Since the escrow instructions

implement and may also supplement the original contract, both are interpreted together if possible. If, however, the instructions contain terms in conflict with the original contract, the instructions, constituting the later contract, usually control.

When instructions have been signed by the parties to the escrow, neither party may unilaterally change the escrow instructions. The parties may, by mutual agreement, change the instructions at any time and one party may waive the performance of certain conditions, provided the waiver is not detrimental to the other party to the transaction.

While an escrow holder can be held liable for violating written instructions, the escrow holder is really only a stakeholder, not legally concerned with controversies between the parties. As such, an escrow holder is entitled to file an action of interpleader to require litigation of controversies.

Complete Escrow

Properly drawn and executed escrow instructions become an enforceable contract. An escrow is termed "complete" when all the terms of the instructions have been met.

Escrow Principles

The following are major escrow principles:

1. Escrow instructions must contain mutuality and the understanding of the principals to the escrow. Properly drawn instructions are clear and certain as to the intentions of the parties, the duties of the escrow holder, and the fact that it is the principals themselves who must perform the escrow contract by complying fully with the instructions. The escrow holder does not have, and must not exercise, *discretionary* authority.
2. The escrow holder does not act as a mediator or advisor, or participate in customer controversy, or arbitrate disputes. Instructions are drawn so that the parties to the escrow make the promises, perform, and put the escrow holder in a position to close the escrow.
3. The escrow holder is prohibited from offering legal advice and must suggest that disagreeing parties consult an attorney (or real estate broker if it is a transaction matter that may be negotiated).
4. Escrow is a limited agency relationship governed by the content of the escrow instructions. As agent for *both* parties, the escrow holder acts only upon specific *written* instructions of the principals. When the escrow is closed, the escrow holder becomes agent for *each* principal with respect to those things in escrow to which the parties have respectively become completely entitled.
5. When all parties to the escrow have signed mutual (identically conforming) instructions, the escrow becomes effective. If only one party has signed, that party may terminate the proposed escrow at any time prior to the other party's signing.
6. The escrow holder must avoid vague or ambiguous terms and provisions in instructions and documents.
7. The escrow holder must forward immediately to the title company any document which is to be recorded and furnish a copy to any concerned party, so that the document's sufficiency can be determined. This will help avoid delay in closing escrow.
8. Documents and funds not contemplated by the escrow instructions should not be accepted by the escrow holder without authorization of the principals.

9. The escrow trust account must be maintained with extreme care. Overdrawn accounts (debit balances) are strictly forbidden.
10. Escrows are confidential in nature. The escrow holder must not give out any information to third parties concerning an escrow without approval of the escrow principals.
11. The escrow holder is the agent of the principals to the escrow. Legally, any facts known by the escrow agent are imputed to the principals. Any detrimental or new material information, previously undisclosed, made known to the escrow holder and affecting the principals should be disclosed to them for their instructions in the matter.
12. The escrow holder must maintain a high degree of trust, efficient customer service, and good customer relations.
13. The escrow holder must remain strictly neutral, not favoring either party. The escrow holder must not advise either party, as any gain to the one will likely be detriment to the other.
14. The escrow holder must maintain records and files on a daily basis, to be sure that a procedure is not overlooked. Neat and orderly files, complete with check sheets, will help insure smooth progression toward closing.
15. Before closing an escrow, the escrow holder must audit the file, accounting for all items to be handled, recorded and delivered, including cleared funds.
16. The escrow holder must not disburse any funds from an escrow account until all items such as checks, drafts, etc. have cleared, and thus have become available for withdrawal. This "holding period" may range from 1 to 10 days, depending on the type and location of lender.
17. Closing and settlement must be prompt, using forms which are simple and clear.

GENERAL ESCROW PROCEDURES
(may vary according to local custom)

Basic escrow procedures include the following:

1. ***Prepare Escrow Instructions*** on the escrow holder's printed form. All principals to the escrow sign instructions which fully set forth the understanding of the parties to the transaction. Usually accompanied by an initial deposit. For a home purchase, the mutual instructions of the principals set forth:
   - the purchase price and terms;
   - agreement as to mortgages;
   - how buyer's title is to vest;
   - matters of record subject to which buyer is to acquire title;
   - inspection reports to be delivered into escrow;
   - proration adjustments;
   - date of buyer's possession of the property;
   - documents to be signed by the parties, delivered into escrow, and recorded;
   - disbursements to be made, costs and charges and who pays for them; and
   - date of closing.
2. ***Order Title Search*** on the subject property, resulting in a "Preliminary Report" from the title company. The escrow holder examines this report carefully for items not contemplated in the

escrow instructions. The seller must clear any such item or it must be brought to the attention of the buyer "for information" and "expression of desire in the matter."

3. ***Request Demands and/or Beneficiary Statements*** from any lenders of record. The necessary document will be:
   - a "Demand for Pay-off" if an existing loan is to be paid in full through escrow; or
   - a "Beneficiary Statement" if buyer is purchasing "subject to" or assuming a loan.
4. ***Accept Structural Pest Control Report and Other Reports*** (such as plumbing or roofing inspections) into escrow and obtain, as instructed, any necessary approvals from the parties in connection with the reports/inspections. Hold the reports (and any funds associated therewith) for delivery to the proper party, or recording, at close of escrow.
5. ***Accept New Loan Instructions and Documents*** if the buyer is obtaining new financing. Obtain buyer's approval/execution of the documents. Satisfy all lender's instructions prior to using the lender's funds to complete the transaction.
6. ***Accept Fire Insurance Policies and Complete Settlement*** by:
   - accepting and delivering any fire insurance policy and transferring the insurance if so instructed by the parties;
   - making all prorations (e.g., property taxes and insurance) as instructed by the parties;
   - completing the accounting (settlement) details and informing the principals that escrow is ready to proceed.
7. ***Request Closing Funds.*** The law prohibits disbursal of funds from an escrow account until all items such as checks, drafts, etc. have cleared and become available for withdrawal.
8. ***Audit File in Preparation for Closing*** by:
   - accounting for all funds (Cash Reconciliation Statement) and documents;
   - determining that the parties have complied with all escrow instructions.
9. ***Order Recording*** by authorizing the title company to run the seller's title to date and record the necessary documents, provided no change has occurred in the seller's title since issuance of the preliminary title report.
10. ***Close Escrow***, after confirming recording, by:
    - preparing settlement statements for buyer and seller;
    - disbursing all funds; and
    - delivering documents to the party or parties entitled thereto.

Proration

The seller is the beneficial owner of the property until close of escrow. If possession is delivered at some time other than at the close of escrow, the principals may agree to adjust the proration date since possession normally indicates beneficial ownership. If possession is delivered sometime after close of escrow, the parties may agree to proration of taxes, rent and/or assessments, along with prepaid items for which the buyer becomes responsible upon recording of the deed, such as interest on a new loan or prepaid fire insurance obtained by buyer.

Termination

Escrows are voluntarily completed by full performance and closing or terminated by mutual consent and cancellation. It has been held that compliance with escrow instructions must be achieved within the time limit set forth in the escrow agreement and the escrow holder has no authority to enforce or accept performance after the time limit provided in the instructions. When the time limit provided in the escrow instructions has expired and either party to the escrow has not performed in accordance with the terms of the escrow agreement, the parties may cancel escrow and are entitled to the return of their respective property and documents. The escrow holder does not have authority to determine that a principal has not performed. Therefore, clear and precise instructions from the principals are necessary.

Cancellation of Escrow - Cancellation of Purchase Contract

Cancellation of escrow may not also cancel a purchase contract. In *Cohen v. Shearer (1980)* 108 C.A. 3d 939, a Court of Appeal decided that cancellation of an escrow by mutual agreement of the parties did not rescind the purchase contract between them.

Therefore, a real estate broker seeking to carry out the principal's decision to cancel a contract of purchase or sale should be sure the other party to the contract agrees in writing to do precisely that and not simply settle for written advice to cancel the escrow. As happened in the *Cohen* case, if a purchase agreement is not canceled along with the escrow, either party to the agreement may retain the right to specific enforcement of the contract or for the recovery of damages.

WHO MAY ACT AS ESCROW AGENT

The Escrow Law (Division 6 of the California Financial Code) provides that escrow agents must be licensed by the Commissioner of Corporations. However, banks, savings and loan associations, title insurance companies, trust companies, attorneys and real estate brokers have exemptions from the licensing requirements of the Escrow Law.

The exemption for real estate brokers [Section 17006 (a)(4) of the Financial Code] applies to any broker licensed by the Real Estate Commissioner while performing acts in the course of or incidental to a real estate transaction in which the broker is a party or in which the broker is an agent performing an act for which a real estate license is required.

The Department of Corporations has interpreted Section 17006 (a)(4) to mean that:

1. the exemption is personal to the broker and the duties, other than ministerial functions, cannot be delegated by the broker;
2. in a purchase and sale transaction, if the broker is not a party, he must be the selling or listing broker;
3. the exemption is not available for any association with other brokers for the purpose of conducting escrows; and
4. when the broker's escrow business is a substantial factor in the utilization of the broker's services, the escrow business is not "incidental to a real estate transaction."

A broker cannot advertise that he or she conducts escrows without specifying in the advertisement that such services are only in connection with the broker's real estate brokerage business.

A broker may not use a fictitious name or a corporate name containing the word "escrow," or advertise in any other manner which would tend to be misleading to the public.

A real estate broker who conducts an escrow under the exemption must maintain all escrowed funds in a trust account and keep proper records. The broker must follow the provisions of Commissioner's Regulations 2950 and 2951.

Escrow Companies Must Be Incorporated

An individual cannot be licensed as an escrow agent. A corporation duly organized for the purpose of conducting an escrow business must hold the license. Applicants for escrow licenses must be financially solvent and furnish a surety bond in the amount of $25,000 or more, based upon yearly average trust fund obligations. All officers, directors, trustees, and employees having access to money or negotiable securities in the possession of the corporate licensee must furnish a bond of indemnification against loss. All money deposited in escrow must be placed in a trust account which is exempt from execution or attachment.

AUDIT

An escrow agent is required to keep accurate accounts and records which are subject to examination by the Commissioner of Corporations. The corporation must also, at its own expense, submit annually an independent audit prepared by a Certified Public Accountant or Public Accountant.

PROHIBITED CONDUCT

No escrow agent licensee may disseminate misleading statements or describe as an "escrow" any transaction which is not included under the definition of "escrow" in the Financial Code.

A licensed escrow agent may not pay fees to real estate brokers or others for referral of business. Such prohibited "fees" would include gifts of merchandise or other things of value.

An escrow agent cannot disburse a real estate broker's commission prior to closing of the escrow.

Escrow licensees may not solicit or accept escrow instructions, or amended or supplemental instructions, containing any blank to be filled in after signing or initialing. They may not permit any person to make any addition to, deletion from, or alteration of an escrow instruction unless it is signed or initialed by all persons who had signed or initialed the instructions. Escrow licensees are charged by law with delivering, at the time of execution, a copy of any escrow instruction, or amended or supplemental instruction, to all persons executing it. However, escrow instructions, being confidential, may not be disclosed to nonparties.

A real estate broker may not nominate an escrow holder as a condition precedent to a transaction, but may suggest an escrow holder if requested to do so by the parties.

RELATIONSHIP OF THE REAL ESTATE BROKER AND THE ESCROW HOLDER

A real estate broker should always consult the escrow officer before telling the principals that escrow will close on a certain date. An escrow includes a myriad of details, any of which could cause delay. Submission of accurate documents will expedite closing. Some suggestions:

1. As far as possible, make certain that the deposit receipt reflects the entire intentions of the principals.

2. When opening escrow, bring the recorded grant deed whereby the seller acquired the property or the seller's title policy. These documents establish the correct legal description and the manner in which seller holds title to the property.
3. Remember that all escrow instructions and amended instructions must be in writing. If the buyers are planning to be away, the broker should check with the escrow officer before they leave to determine if their absence will in any way hold up closing of escrow. If a small amount of money is due from the buyers, the broker cannot offer to put up the money or instruct the escrow officer to deduct the amount from the broker's commission. The escrow officer cannot do this. The buyer may be deliberately withholding the deposit of closing funds until seller performs some condition known only to the principals. To accept "buyer's closing funds" from any party other than buyer is to force an escrow to close against the understanding of the parties.
4. Furnish escrow with the correct spelling of buyer's name, address and telephone number. Buyer's and seller's business phone numbers should be included.
5. Be sure the escrow officer knows how buyer wants to take title. Brokers, salespersons or escrow officers should not assist with this decision, as it may involve legal and tax consequences.
6. Give escrow holder names and addresses of all lenders or loan servicing agents and the loan numbers. Many lenders, and FHA, require a 30-day advance payoff notice or seller may be subject to additional charges on any loan payoff.
7. Check with the seller regarding bonds or other liens on the property. Those not being assumed may be paid before opening the escrow.
8. If new financing has not been arranged before escrow is opened, notify the escrow officer immediately when the loan has been obtained.
9. Before escrow is opened, determine how fire insurance is to be handled. (The buyer may want to do business with buyer's insurance agent or a certain company. The seller's policy may include other property and the seller may not want it transferred or totally canceled.)
10. Be aware of the escrow holder's time requirement relating to non-cash deposit of funds. Checks must clear before the escrow holder can make disbursements.

DESIGNATING THE ESCROW HOLDER

Because selection of an escrow holder is not usually critical to either principal in a transaction, real estate brokers have in the past played a large role in deciding where a transaction would be escrowed. In recent years, however, there has been an increasing effort on the part of federal and state regulators to minimize the influence of the broker in selection of the escrow holder. The rationale is that buyers and sellers have the right, and should have the opportunity, to compare escrow services and charges and, if they so desire, negotiate between themselves as to where escrow will be held.

DEVELOPER CONTROLLED ESCROWS - PROHIBITION

Civil Code Section 2995 prohibits any real estate developer (defined as any person or entity having an ownership interest in real property which is improved by such person or entity with single-family dwellings which are offered for sale to the public) from requiring, as a condition precedent to the transfer of real property containing a single-family residential dwelling, that

escrow services effecting such transfer be provided by an escrow entity in which the developer has a "financial interest." The phrase "financial interest" means ownership or control of 5 percent or more of the escrow entity. A developer who violates this statute is liable for damages of $250 or three times the charge for escrow services, whichever is greater, plus attorney's fees and costs. Any waiver of this prohibition is against public policy and therefore void.

REAL ESTATE RECOVERY ACCOUNT

The Real Estate Recovery Account became operative on July 1, 1964 and is funded from a portion of the fees paid by licensees. It enables a person who has been defrauded or had trust funds converted by a real estate licensee in a transaction requiring that license, and who satisfies specified requirements (California Business and Professions Code Section 10471 et seq.) to recover at least some of his or her actual loss when the licensee has insufficient personal assets to pay for that loss. Since 1964, the Department of Real Estate has paid in excess of $34 million dollars to members of the public from the Recovery Account.

In general, the requirements for payment from the Recovery Account include obtaining a final civil judgment or arbitration award, or a criminal restitution order against the licensee. The judgment, award or order must be based on intentional fraud or conversion of trust funds in connection with a transaction requiring a real estate license. The victim must make a reasonable search for the licensee's assets and, if any, a reasonable effort to collect on the judgment, arbitration award or restitution order from those assets to satisfy the judgment. In addition, the victim must name as a defendant and make a reasonable effort to collect from all other parties involved in the transaction that may be liable to and able to pay the victim.

An application for payment must be submitted to the Department within one year after the judgment, award or order becomes final. A copy of the application and required notice must be served on the judgment debtor/licensee, who is given an opportunity to respond to the allegations in the application and object to payment of the claim.

Once filed, the application is reviewed to determine if all required information has been submitted so that a decision can be made whether or not to pay. That review normally involves a series of letters between the Department and the applicant, resolving questions and obtaining necessary supporting documentation. The applicant will be notified in writing of the initial deficiencies in the application within 15 days of its receipt by the Department.

Once the application becomes complete, the Department must issue a decision granting or denying payment within 90 days. If the application is granted, the applicant will be paid an amount for his or her actual and direct loss in a transaction, up to a statutory maximum of $20,000 per transaction, with a possible total aggregate maximum of $100,000 per licensee.

If an application is denied, the applicant has the right to refile the claim in court. When there is a decision to pay, the judgment debtor/licensee has the right to file a writ of mandamus to challenge the Department of Real Estate's decision to pay (payment results in the automatic suspension of his or her real estate license until the amount paid is repaid in full plus 10% interest).

In cases where the aggregate amount of multiple claims against a licensee exceeds the $100,000 licensee limit, the Department must file an action in court to prorate payment among all eligible claimants. Whenever a Recovery Account application matter ends up in court (a refiled application, a writ or a proration), the Department is represented by the California Attorney General's office to defend the decision to deny or pay the claim or to properly distribute the funds among multiple applicants.

MORTGAGE LOANS

This section explores the role of the real estate licensee in arranging loans, or sales of loans, secured by real property. It also discusses the federal Truth in Lending Act and Regulation Z.

Broker's Role

Mortgage brokers may negotiate loans for property owners who are unable to obtain financing from more conventional sources. A broker negotiates such a loan through a private lender. The phrase "hard money" means cash, as opposed to a loan for the purchase of a property.

The Loan Application

A broker negotiating a loan must obtain information from the applicant which the broker knows will be required by the private lender, including the borrower's ability and willingness to repay the loan. Knowing a lender's guidelines serves the interests of both the lender and the borrower. Those contemplating brokering loans must ascertain the policies and guidelines of their prospective investors.

The following is the type of information the broker will need:

1. Address of the property.
2. Requested loan amount and purpose of the loan.
3. Is the property currently owned or is it being purchased?
4. If being purchased, the purchase price; if currently owned, borrower's estimate of value.
5. How long owned?
6. The vested ownership of the property.
7. Is the property encumbered? What are the loan balances, payment amounts and names and addresses of lenders.
8. Any assessment or unpaid taxes?
9. Any other liens?
10. Borrower's income and debts.

A standard FNMA/FHLMC or similar loan application will usually elicit the necessary information. A credit report and property appraisal will also be necessary.

Advance Fees

A broker may wish to collect money in advance from a loan applicant to cover the cost of services to be performed in arranging the loan. Money collected "up front" is an advance fee. An advance fee may only be collected pursuant to an agreement previously approved by the Department of Real Estate. Commissioner's Regulation 2970 sets forth the basic contents of an advance fee agreement. The broker must also submit, for the Department's prior approval, all advertising materials used in conjunction with an advance fee arrangement.

Any real estate broker who contracts for or collects advance fees from a principal must deposit the funds into a trust account. Advance fees are not the broker's funds. Amounts may be withdrawn for the benefit of the broker only when actually expended for the benefit of the principal or five days after verified accounts have been mailed to the principal. If advance fees are not handled in accordance with the Real Estate Law, it will be presumed that the broker has violated Penal Code Sections 506 and 506a. Penalties and fines may result.

The Department does not treat as advance fees funds collected in advance for appraisal and credit reports as long as the broker collects as near as possible the exact amount(s) necessary and refunds any excess as soon as it is identified. Though not treated as advance fees, these funds *are* trust funds.

Title Policy for Lender

A primary concern is that the borrower has good title to the real property which would secure the loan. Once a lender decides that serious consideration can be given to a loan application, the lender will usually request a preliminary report from a title insurance company. This "prelim" includes:

1. a description of the property;
2. the owner of record;
3. taxes, bonds and assessments then owing;
4. reference to recorded covenants, conditions and restrictions affecting the property; and
5. certain other "exceptions" which will not be insured and, therefore, often must be cured before the loan will be granted.

When all objections to title are resolved to the satisfaction of the lender, a title policy insuring the interest of the lender must ordinarily be obtained before the loan is funded. In this policy, the title insurer guarantees to defend the lender against actions founded upon claims of encumbrances or title defects which were known, or should have been discovered, by the title insurer when the policy was issued.

Usury

A loan, arranged extension, forbearance, or refinancing of a loan in which a broker had originally been compensated (even though not being specifically compensated for arranging new credit terms), secured in whole or in part by a lien on real property and made or arranged by a licensed real estate broker is exempt from the usury law. Private individuals making such loans without a broker are controlled by the usury law.

ARTICLE 5 - THE LENDER

The Real Estate Law imposes certain duties and restrictions on real estate licensees who broker mortgage loans or, as either principal or agent, buy, sell or exchange existing promissory notes secured by real property or existing real property sales contracts. Since trading in real property sales contracts is relatively rare, this chapter generally focuses on the deed of trust as a security device. Virtually everything said about the purchase, sale and exchange of loans secured by real property is true with respect to real property sales contracts.

For the sake of simplicity, the phrase "promissory note secured by a deed of trust" is frequently abbreviated to "deed of trust" or "trust deed."

Application of Article 5

The passage of Proposition 2 in November 1979 eliminated interest rate limits on real property loans "made or arranged" by real estate brokers. The Legislature responded in 1981 and 1982 by extensive additions to the Real Estate Law, specifically to Articles 5 (Transactions in Trust Deeds and Real Property Sales Contracts) and 7 (Real Property Loans).

Article 5 (Sections 10230 - 10236.2) is basically applicable to brokering either the funding of mortgage loans by private, noninstitutional investors or the buying, selling or exchanging of trust

deeds on behalf of private, noninstitutional investors. The provisions of Article 5 apply also to real estate licensees who engage as principals in buying from, selling to or exchanging deeds of trust with the public, and to brokers who make agreements with the public for the collection of payments or the performance of services in connection with deeds of trust.

Pooling of Loan Funds

Banking or pooling of lenders' or purchasers' funds, commonly referred to as multi-lender or fractionalized loans, is prohibited except as authorized by permit issued pursuant to the provisions of the Corporate Securities Law which is administered by the Department of Corporations. A multi-lender loan may be exempt under Corporation Commissioner's Regulation 260.105.30. Before arranging any multi-lender loan or pooling investor funds, a broker should contact the Department of Corporations.

Advertising

Section 10235 proscribes false, misleading or deceptive advertising by a real estate licensee engaged in the business of brokering loans or the sale of existing trust deeds. An advertisement cannot imply a yield or return on a promissory note different from the interest rate of the note itself unless the advertisement sets forth both the actual interest rate and the difference (discount) between the outstanding principal balance of the note and the price at which it is being offered for sale.

Article 5 also prohibits a real estate licensee from offering or advertising any premium, gift or other inducement to a prospective note purchaser, borrower or lender. (Section 10236.1) The Department does not consider rebates or reductions in the costs and fees of the loan to be a violation. For example, a broker can offer free appraisals as long as no other fees or costs are increased to allow for this inducement.

Real Estate Commissioner's Regulation 2848 implements the statutory provision against false, misleading or deceptive advertising in areas of mortgage loan brokerage and the marketing of trust deeds. A broker must also disclose license status and regulatory agency in all advertising for loans. A disclosure of "Real Estate Broker, CA. Dept. of Real Estate" in a broker's mortgage loan advertising complies. (Regulation 2847.3)

Exception to Article 5 Requirements

The provisions of Article 5 do not apply to negotiation of a loan or sale or exchange of a trust deed by a real estate licensee in connection with a real property sale or exchange transaction in which the broker acted as an agent, unless the broker also had a direct or indirect monetary interest as a party.

"Threshold" Criteria

Except as otherwise provided in the law, a real estate broker, acting as agent for others, meets the "threshold" criteria if he/she intends or expects in any 12-month period to do any of the following:

1. Negotiate any combination of 10 or more of the following transactions pursuant to subdivision (d) and (e) of Section 10131 or Section 10131.1 in an aggregate amount of more than $1,000,000:
   a. loans or sales of real property sales contracts or promissory notes secured by liens on real property or on business opportunities;
   b. as the owner, the sale or exchange of real property sales contracts or promissory notes secured by liens on real property or business opportunities; or

2. Make collections of payments in an aggregate amount of $250,000 or more on behalf of owners of promissory notes secured directly or collaterally by real property or owners of real property sales contracts; or
3. Make collections of payments in an aggregate amount of $250,000 or more on behalf of borrowers on promissory notes secured directly or collaterally by liens on real property or lenders (sellers) on real property sales contracts.

A threshold broker must notify the Department in writing within 30 days that the broker meets the threshold criteria. Failure to inform the Department may result in a fine of up to $10,000 and license revocation.

A broker who meets the threshold criteria must file with the Department an annual report within 90 days after the end of the broker's fiscal year and a quarterly trust fund status report within 30 days after each of the broker's first three fiscal quarters.

Loans or sales negotiated by a broker, or for which the broker collects payments, are not counted in determining whether the broker meets the threshold criteria if the lender or purchaser is an institutional lender or if the loan or sale is under the authority of a securities permit issued by the Department of Corporations. Generally speaking, only those brokers dealing with private investors and small pension trusts will satisfy the threshold criteria. (Section 10232)

Disclosure Statement

Sections 10232.4 and 10232.5 require that a real estate broker furnish a non-institutional lender or purchaser of a trust deed with a disclosure statement setting forth:

1. the loan terms;
2. pertinent information about the borrower (identity, occupation, income, credit data, as represented to the broker by the prospective borrower);
3. pertinent information about the property which will secure the loan, including address or other means of identification, fair market value, age, size, type of construction and description of improvements;
4. provisions for loan servicing;
5. pertinent information concerning all encumbrances which are currently liens against the property and which the borrower discloses as prospective liens.

The statement must be delivered before the lender (or purchaser of a note) becomes obligated to complete the loan (or purchase).

A real estate broker who advertises for or solicits funds from the public that are to be used for the broker's direct or indirect benefit must submit the format of the disclosure statement to the Department prior to any solicitation and then an individual statement to each prospective lender or purchaser before the broker accepts any funds from the person solicited. (Section 10231.2)

Disbursing Funds

Unless a lender has given written authorization to the broker, the broker may not disburse loan funds until after recording the trust deed which conveys the property to a trustee as security for the loan. If the lender has given the broker authority to release funds prior to recordation, the securing trust deed must be recorded, or delivered to the obligee with a written recommendation for immediate recordation, within ten days following disbursement of loan funds. The broker is similarly responsible for the execution and recordation of the assignment of a real property sales

contract or deed of trust when the sale of the contract or trust deed has been negotiated by the broker.

Servicing - Broker Advances
A real estate broker servicing a note or contract may advance his or her own funds to protect the security of the note being serviced, including an advance to pay debt service on a senior note secured by the same real property. If the broker does advance funds for taxes, hazard insurance or debt service on a senior note secured by the same real property, the broker must, within ten days, give written notice of the advance to the beneficiary of the note being serviced. (Section 10233.1)

Retention of funds. If a broker receives funds from the obligor (borrower) in payment of a promissory note or contract, as is ordinarily the case when servicing the note or contract for the obligee (lender), the broker may not retain the funds for more than 25 days without written authorization from the obligee. The authorization from the obligee may not provide for payment of interest to the broker on funds retained by the broker. Moreover, the agreement between the broker and the obligee (or obligor) authorizing the broker to service the instrument must be in writing.

Commissioner's Regulations
Real estate licensees active in the mortgage loan business should be familiar with Commissioner's Regulations 2845 (interpretative opinion request); 2846 (approved lender/purchaser disclosure statement); 2846.5 (report of annual trust fund accounts review); 2847, 2847.3 and 2848 (advertising); and 2849.01 (annual report format).

ARTICLE 7 - THE BORROWER

The Real Estate Law has long required the licensing of one who negotiates, for another and for compensation, a loan secured by real property. The statutory scheme now found in Article 7 of Chapter 3 (Sections 10240 - 10248.3) was enacted to curb a variety of abuses: exorbitant commissions; inflated costs and expenses; short term loans with large balloon payments; and misrepresentation or concealment of material facts by licensees negotiating loans. Article 7 is variously referred to as the Real Property Loan Law, the Mortgage Loan Brokers' Law and the Necessitous Borrowers' Act.

Application of Article 7
Except for the disclosure statement requirement, Article 7 applies only to loans secured by real property which includes a dwelling. For this purpose, a dwelling is a single dwelling unit in a condominium or cooperative or a parcel containing only residential units if the total number of units on the parcel is four or less. (Sections 10240.1 and 10240.2)

Except for its disclosure statement, late charges, and loan prepayment provisions, Article 7 applies only to first trust deed loans under $30,000 and junior trust deed loans under $20,000. (Section 10245)

Article 7 applies only to loans made or negotiated by real estate brokers acting within the meaning of subdivision (d) of Section 10131 (the basic definition of a real estate broker) or subdivision (b) of Section 10240. Subdivision (b) of Section 10240 brings under Article 7 loan

transactions in which a broker solicits a borrower with express or implied representations that the broker will arrange a loan as an agent but in fact makes the loan with the broker's own funds.

Mortgage Loan Disclosure Statement

The Mortgage Loan Disclosure Statement is at the heart of Article 7. The statement's purpose is to provide a prospective borrower with information concerning the important features of a loan.

A real estate broker negotiating, or, under the circumstances described above, making, a mortgage loan of any kind or in any amount to be secured directly or collaterally by a lien on real property must present a completed Mortgage Loan Disclosure Statement to the prospective borrower within 3 days of receipt of a completed written loan application or before the borrower is obligated to take the loan, whichever is earlier. A broker (or, of course, a salesperson employed by the broker) must obtain the borrower's signature on the statement prior to the time that the borrower becomes obligated to complete the loan. In addition, if the loan is subject to Article 7, the licensee must certify in the statement that the loan complies with Article 7.

Section 10241 sets forth the information that must be included in the statement. The form of the statement must be approved by the Commissioner prior to its use. The Commissioner has established two approved forms in Regulations 2840 and 2840.1. RE Forms 882 and 883 can be obtained at any Department office.

The disclosure statement set forth in Commissioner's Regulation 2840.1 is believed to satisfy the disclosure requirements of the federal Real Estate Settlement Procedures Act.

Broker-controlled funds. Both forms of the Mortgage Loan Disclosure Statement provide for disclosure that the broker anticipates that the loan will be made with broker-controlled funds. The phrase "broker-controlled funds" means funds owned by the broker, by the broker's spouse, child, parent, grandparent, brother, sister, father-in-law, mother-in-law, brother-in-law or sister-in-law, or by any entity in which the broker alone or together with any of the above relatives has an ownership interest.

Disclosures - Case Law

In *Realty Projects, Inc. v. Smith* (1973 32 C.A. 3d 204), the court held that the statutory obligation of a licensee to act fairly and honestly demanded that the licensee inform prospective borrowers of the difference between commissions and other charges for loans in amounts subject to the Real Property Loan Law as against loans not covered by that law. While the court referred to the respondent/licensee as the agent of a prospective borrower, the court did not rely upon an agency theory in reaching its decision regarding the disclosure duty. Rather, the duty was declared to stem simply from the respondent's status as a licensee.

In the case of *Wyatt v. Union Mortgage Co.* (1979 24 C.A. 3d 773), the court held that a mortgage loan broker's duty to disclose information about late charges and the effective interest rate of a loan was based upon a fiduciary relationship between the broker and the prospective borrower.

Commissions and Other Charges

Article 7 limits the amount that may be charged as commission or fees for arranging or making a loan and as "costs and expenses" of making the loan. (Again, these limitations do not apply to a first loan of $30,000 or more or a junior loan of $20,000 or more.) The maximum commissions for loans subject to Article 7 are:

1. First loans:
   a. 5 percent of the principal of a loan of less than 3 years;
   b. 10 percent of the principal of a loan of 3 years or more;
2. Second or other junior loans:
   a. 5 percent of the principal of a loan of less than 2 years;
   b. 10 percent of the principal of a loan of at least 2 years but less than 3 years;
   c. 15 percent of the principal of a loan of 3 years or more.

Costs and expenses of making a loan subject to Article 7, including appraisal fees, escrow fees, notary and credit investigation fees (but excluding actual title charges and recording fees) charged to a borrower cannot exceed 5 percent of the loan or $390, whichever is greater, to a maximum of $700. The amount charged cannot exceed the actual costs and expenses paid, incurred or reasonably earned. No charge can exceed the amount customarily charged for the same or comparable service in the community where the service is rendered. (Regulation 2843)

Balloon Payment

A balloon payment is defined as an installment payment that is greater than twice the amount of the smallest installment payment required by the promissory note.

Generally, no loan subject to Article 7 may have a balloon payment if the term of the loan is less than 3 years.

If the property securing the loan is an owner-occupied dwelling, a balloon payment is not permissible if the term of the loan is 6 years or less. As in the case of the 3-year balloon payment provision, the restriction does not apply to a promissory note given back to the seller by the purchaser of the dwelling place on account of the purchase price.

The Mortgage Loan Disclosure Statement includes a notice regarding balloon payments. Section 10241.4 requires an expanded disclosure if provisions have been made, or will be sought, for extension, refinancing or renegotiation of an Article 7 loan which includes a balloon payment.

Other Restrictions

Other restrictions on loans subject to Article 7 include:

1. A mortgage loan broker is prohibited from charging or negotiating any loan servicing or loan collection fee to be paid by the borrower.
2. A borrower may not be required to purchase credit life or credit disability insurance as a condition of obtaining a loan.
3. A licensee may collect only one premium for credit life or credit disability insurance provided through duly licensed agents. Only borrowers whose earnings are reasonably relied upon by the lender for repayment of the loan may be insured.
4. Regardless of the amount of the loan, charges for late payment of an installment are limited to 10 percent (or $5, whichever is greater) of the principal and interest part of the installment payment. If a payment is made within ten days of its due date, no late charge may be imposed.
5. Regardless of the amount of the loan, the penalty that may be charged to a borrower for prepayment is limited if the security for the loan is a single family, owner-occupied dwelling. No charge may be assessed for a prepayment made more than seven years from the date of

the loan. During the first six years of the loan, twenty percent of the principal balance of the loan may be paid off during any 12-month period without penalty. The maximum prepayment penalty allowed is six months' interest on the amount prepaid above 20 percent of the unpaid principal balance. This provision applies to loans of any dollar amount if negotiated by a real estate licensee for compensation.

6. The term of an exclusive right to secure financing cannot exceed 45 days.

TRUTH IN LENDING ACT

The Truth in Lending Act (hereinafter, the Act) became effective July 1, 1969. The principal purpose of the Act is to promote the informed use of consumer credit by requiring creditors to disclose credit terms in order to enable consumers to make comparisons between various credit sources. To implement the Act, the Board of Governors of the Federal Reserve System issued a regulation known as Regulation Z.

After a decade of experience with the Act and Regulation Z, it became clear that the requirements placed too great a burden on creditors, provided too many disclosures for consumers, and fostered too much litigation. This prompted Congress to amend the Act in 1980 by passing the Truth in Lending Simplification and Reform Act. To reflect the amendments to the Act the Federal Reserve Board substantially revised Regulation Z. Compliance with the simplified Act and revised Regulation Z became mandatory on October 1, 1982.

At the time revised Regulation Z was promulgated, the Federal Reserve Board adopted model disclosures for closed-end transactions such as purchases of real property, and model language for certain other disclosures. The Board also announced that its staff would no longer provide written responses to individual requests for interpretations of the Regulation, but would issue a staff commentary from time to time to address questions of interpretation.

Creditor

The creditor is responsible for furnishing Truth in Lending disclosures to the consumer. Regulation Z defines a creditor as a person who extends consumer credit more than 25 times a year or more than 5 times a year for transactions secured by a dwelling. The credit extended must be subject to a finance charge or be payable by written agreement in more than four installments. Another requirement that must be met to render a person a creditor is that the obligation be initially payable on its face or by agreement to that person.

In its definition of "creditor," revised Regulation Z included "arranger of credit," which it defined as a person who initially arranged for the extension of credit by persons who did not meet the "creditor" definition. The Federal Reserve Board, in considering the necessity for a more specific description of the type of activity which would constitute "arranger of credit," inquired whether real estate brokers who arrange seller financing of homes should be considered "arrangers of credit." In 1982, Congress resolved the question by passing the Garn-St. Germain Depository Institutions Act, which amended the Truth in Lending Simplification and Reform Act of 1980 by deleting "arranger of credit" from the definition of "creditor." To implement the amendment, the Federal Reserve Board amended revised Regulation Z by removing "arranger of credit" from the "creditor" definition, effective October 1, 1982. The effect of the Board's action is to release real estate brokers or other arrangers of credit from the responsibility for providing

Truth in Lending disclosures unless such persons otherwise come within the definition of "creditor."

Exempt Transactions

There are two basic types of transactions that are exempt from coverage under Regulation Z. The first exemption is for credit extended primarily for a business, commercial, or agricultural purpose. If property is not, or is not intended to be, owner-occupied, and the creditor extends credit to acquire, improve, or maintain a rental property, regardless of the number of family units, the transaction will be considered to be for a business purpose.

Special rules apply for credit to acquire, improve, or maintain rental property that is, or will be, owner-occupied within a year. If the property contains more than two family units and the purpose of the credit is to acquire the property, the credit is deemed to be for a business purpose. However, if the credit is extended to improve or maintain the property, it is deemed to be for a business purpose if it contains more than four housing units. These rules should not be construed to prevent an extension of credit for property containing fewer than the aforesaid prescribed number of units from being considered business credit. Credit involving fewer numbers of units may be considered business credit depending on the circumstances of the transaction.

The second exemption is for credit over $25,000. The dollar limitation does not apply if the loan is secured by real property, or by personal property which is used or expected to be used as the consumer's principal dwelling.

Form of Disclosures

Regulation Z requires all Truth in Lending disclosures concerning the credit sale or loan to be grouped together and segregated from other information. The Regulation prohibits the inclusion of any information not directly related to the disclosures required by Regulation Z. It also provides that any itemization of the amount financed be made separately from the other required disclosures. In addition, Regulation Z requires that the terms "finance charge" and "annual percentage rate" be more conspicuous than other required disclosures.

The disclosures may be segregated by putting them on a separate sheet of paper, or if the disclosures are on a contract or other document they may be set off from other information by outlining them in a box or by printing them in a different type style, with bold print dividing lines, or with a different color background. The portion of the sale or loan document that contains these disclosures is commonly called "the federal box."

Before its revision, Regulation Z required that all Truth in Lending disclosures be made on one side of a page. Under revised Regulation Z, the Truth in Lending disclosures must be separate from everything else, but may be continued from one page to another.

Regulation Z contains several model forms, including forms which contain disclosures required for transactions involving loan assumptions, variable rate mortgages, and graduated payment mortgages. Lenders may duplicate these forms or modify them by including disclosures required for particular transactions.

Required Disclosures

There are as many as eighteen disclosures required by Regulation Z for closed-end credit transactions such as mortgage loans. A creditor is only required to make those disclosures that are relevant to a particular transaction. The disclosure statement must have simple descriptive phrases next to five of the most important items disclosed. These items are: the amount financed,

the finance charge, the annual percentage rate, the total of payments, and, in credit sales, the total sale price. Regulation Z provides suggested phrases for the five required terms. These phrases are not required to be used verbatim.

The following is a summary of the required disclosures:

Identity of creditor. The creditor making the disclosures must be identified.

Amount financed. Regulation Z requires the use of the term "amount financed" together with a brief description of the term. The suggested phrase is "the amount of credit provided to you or on your behalf."

Itemization of amount financed. The disclosure of the itemization of the amount financed may be eliminated in those cases where good faith estimates of settlement costs have been supplied for transactions subject to the Real Estate Settlement Procedures Act (RESPA). If the transaction is not subject to RESPA, the creditor must either provide a written itemization of the amount financed, or provide a statement that the consumer has the right to receive a written itemization of the amount financed together with a space for the consumer to indicate whether an itemization is desired. However, many state laws require that the creditor provide the itemization even if the consumer does not specifically request it. The itemization must be separate from the "federal box."

Finance charge. Regulation Z requires the use of the term "finance charge" together with a brief description such as "the dollar amount the credit will cost you."

The requirement that the components of the finance charge be itemized has been eliminated from revised Regulation Z. In fact, the new rules prohibit creditors from itemizing the finance charge with the other disclosures. Only the total amount may be given. In addition, Regulation Z requires the disclosure of the finance charge in all real estate transactions. Prior to its revision, Regulation Z did not require either the total dollar amount of the finance charge or the total of payments to be disclosed on a first loan to finance the purchase of the borrower's dwelling.

The finance charge must include any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as incident to or a condition of the extension of credit. Regulation Z provides examples of charges that must be included in the finance charge and examples of charges that are excluded from the finance charge.

Charges of particular importance in real estate and residential mortgage transactions which Regulation Z lists among those charges included in the finance charge are:

1. interest;
2. loan fees, assumption fees, finder's fees and buyer's points;
3. investigation and credit report fees;
4. premiums for mortgage guaranty or similar insurance; and
5. borrower-paid mortgage broker fees.

Charges which are not finance charges include seller's points and the following fees when charged in a transaction secured by real property or in a residential mortgage transaction (which may include the purchase of a mobilehome), if they are bona fide and reasonable in amount:

1. fees for title examination, abstract of title, title insurance, property survey, and similar purposes;
2. fees for preparing loan-related documents;

3. notary, appraisal, credit report, and pest infestation and flood hazard inspection fees;
4. amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge; and
5. third-party closing agent fees (including those charged by settlement agents, attorneys, and escrow and title companies).

Annual percentage rate. The disclosure of the annual percentage rate requires the use of that particular term together with a brief description such as "the cost of your credit as a yearly rate." In a regular transaction, the disclosed annual percentage rate is considered accurate if it is not more than 1/8 of 1 percentage point above or below the actual annual percentage rate determined. However, in an irregular transaction, the annual percentage rate is considered accurate if it is not more than 1/4 of 1 percentage point above or below the actual annual percentage rate determined. Irregular transactions include multiple advances, irregular payment periods (other than an odd first period), or irregular payment amounts (other than an odd first or final payment).

Variable rate. If the annual percentage rate may increase within a term of one year or less after consummation in a transaction secured by the consumer's principal dwelling, there must be disclosure of:

1. the circumstances under which the rate may increase;
2. any limitations on the increase;
3. the effect of an increase; and
4. an example of the payment terms that would result from an increase.

If the annual percentage rate may increase within a term greater than one year after consummation in a transaction secured by the consumer's principal dwelling, there must be disclosure of:

1. the fact that the transaction contains a variable-rate feature; and
2. a statement that variable-rate disclosures have been provided earlier.

Payment schedule. The creditor must disclose the number, amounts, and timing of payments scheduled to repay the obligation. Regulation Z provides for an abbreviated disclosure of payment schedule for transactions in which a series of payments vary solely because of the application of a finance charge to the unpaid principal balance. This situation arises most frequently in graduated payment mortgages or in mortgages where mortgage insurance premiums are based on the unpaid principal balance. In these transactions creditors need to disclose only the amount of the largest and smallest payments in the series and that the other payments may vary.

Total of payments. Regulation Z requires the creditor to use the term "total of payments" as well as a brief description such as "the amount you will have paid when you have made all scheduled payments." The total of payments (which is the sum of the payments disclosed in the payment schedule) must be disclosed for all real estate transactions under revised Regulation Z.

Demand feature. Regulation Z requires that if the obligation has a demand feature, that fact be disclosed. This disclosure is required only for a demand feature contemplated by the parties as part of the legal obligation. Transactions that convert to a demand status as a result of the consumer's default are not within the purview of this requirement. Nor is a due-on-sale clause.

Total sale price. In a credit sale (a sale in which the seller is a creditor) Regulation Z requires the use of the term "total sale price" together with a brief description such as "the total price of your purchase on credit, including your down payment of $___."

Prepayment penalties and rebates. Creditors are required to make a disclosure of the existence of a penalty on prepayment in full. Even if a creditor does not charge a prepayment penalty, a statement to that effect must be included. However, this disclosure is only required if the finance charge is computed from time to time by application of a rate to the unpaid principal balance. In any other type of transaction, a statement must be included indicating whether the consumer is entitled to a rebate of any portion of the finance charge in the event of prepayment. It is no longer necessary to disclose a particular method of rebate, such as the rule of 78s.

Late payment charge. A disclosure is required only for those charges imposed before maturity due to a late payment. The disclosure may reflect the fact that late charges may be determined as either a percentage or a specified dollar amount.

Security interest. Regulation Z requires the creditor to disclose what security interest is or will be retained in the property purchased in the transaction or other property. In transactions in which the credit is being used to purchase the collateral, the creditor is required to give only a general identification such as "the property purchased in this transaction." In the revision of Regulation Z, the requirement that a security interest in after-acquired property must be disclosed was deleted.

Insurance. If charges for credit life, accident, health, or loss-of-income insurance are excluded from the finance charge, there must be a disclosure of the premium and that the insurance is not required to obtain credit, and the consumer must sign or initial a request for the insurance. If the charges for property insurance are excluded from the finance charge there must be a disclosure setting forth the cost of the insurance if obtained from the creditor and stating that the insurance may be obtained from a person of the consumer's choice. The disclosure may be made on the disclosure form, or, at the creditor's option, on a document different from the disclosure form.

Certain security charges. If disclosed, taxes and fees paid to a public official with respect to a security interest may be excluded from the finance charge. The charges may be aggregated, or may be broken down by individual charge. No special form is required for this disclosure, which could be labeled "filing fees and taxes." This disclosure may be made on the disclosure form, or, at the creditor's option, on a document different from the disclosure form.

Reference to contract terms. Regulation Z requires that creditors include in their disclosures a statement that refers consumers to appropriate contract documents for information about non-payment, default, the right to accelerate the maturity of the obligation, and prepayment rebates or penalties. At the creditor's option, the statement can also include a reference to the contract for more information about security interests and the creditor's assumption policy.

Assumption policy. In a residential mortgage transaction, the creditor must state whether a subsequent purchaser of the dwelling from the consumer may be permitted to assume the remaining obligation on its original terms.

Required deposit. An example of a required deposit is a savings account created as a condition of a loan. If a creditor requires the consumer to maintain the deposit as a condition of the extension of credit, the creditor must state that the annual percentage rate does not reflect the effect of the required deposit.

Time of Disclosure
Regulation Z requires disclosures to be made before consummation of the credit transaction, which is usually the time of closing. Consummation is defined as the time that a consumer becomes contractually liable on a credit obligation as determined by state law. In some situations, special variable rate and other disclosures (discussed below) must be provided at an earlier point in time.

Certain residential mortgage transactions. Creditors, as a whole, have been encouraged, through liberalized provisions on estimates in the revised Regulation Z, to use early disclosures in order to enable consumers to have ample time to shop for credit. However, creditors involved in residential mortgage transactions subject to the Real Estate Settlement Procedures Act, known as RESPA, are required to make Regulation Z disclosures before consummation, or deliver or place them in the mail within three business days after receiving the consumer's written application, whichever is earlier. If the estimates turn out to be inaccurate, it may be necessary to make another disclosure at consummation.

Certain variable-rate transactions. If the annual percentage rate may increase after consummation in a transaction secured by the consumer's principal dwelling with a term greater than one year, the following disclosures must be provided at the time an application form is provided or before the consumer pays a nonrefundable fee, whichever is earlier:

1. the booklet titled *Consumer Handbook on Adjustable Rate Mortgages* published by the Board and the Federal Home Loan Bank Board, or a suitable substitute; and
2. a loan program disclosure for each variable-rate program in which the consumer expresses an interest.

Redisclosure. In general, an event occurring after delivery of the disclosures to the consumer, which renders the disclosures inaccurate, does not result in a violation of Regulation Z and does not require redisclosure. However, if disclosures are given before the date of consummation and a subsequent event makes them inaccurate prior to consummation, redisclosure is required before consummation, if the actual annual percentage rate is above or below the disclosed rate by more than 1/8 of 1 percent in a regular transaction, or more than 1/4 of 1 percent in an irregular transaction, as described above.

If redisclosure is required, the creditor has the option of providing the consumer with either a complete set of new disclosures or a disclosure of *only* the terms that vary from those originally disclosed.

Subsequent Disclosure
After consummation, three events require the creditor to make disclosures: refinancing, assumption, and variable-rate adjustments.

Refinancing. Regulation Z states that a "refinancing" is a new transaction requiring new disclosures to the consumer, and that a refinancing occurs when an existing obligation is satisfied and replaced by a new one undertaken by the same consumer. In addition, the Regulation sets forth examples of what does not constitute a refinancing, which include, among others: (1) a renewal of a single payment obligation with no change in the original terms; (2) a reduction in the annual percentage rate with a corresponding change in the payment schedule; and (3) a change in the payment schedule or a change in collateral requirements as a result of the consumer's default or delinquency.

Assumption. Regulation Z states that an "assumption" is a new transaction requiring new disclosures to the consumer, and that an assumption occurs when a new party becomes obligated on an existing obligation. Whenever a creditor agrees in writing to accept a new consumer as a primary obligor on an existing residential mortgage transaction, before the assumption occurs the creditor must make new disclosures to the new obligor based on the remaining obligation. The mere addition of a guarantor to an obligation for which the original consumer remains primarily liable does not constitute an "assumption."

Variable-rate adjustments. Certain new disclosures are required when an adjustment is made to the interest rate (with or without an accompanying change in the payment rate) in a variable rate transaction secured by the consumer's principal dwelling and with a term greater than one year. The creditor must provide the following information at least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25 but not more than 120 calendar days before a payment is due at a new level:

1. the current and prior interest rates;
2. the index values on which the current and prior interest rates are based;
3. the extent to which the creditor has foregone any interest rate increase;
4. the contractual effects of the adjustment, including the new payment amount and the loan balance; and
5. the payment (if different from the payment disclosed above) that would be required to fully amortize the loan at the new interest rate over the remaining loan term.

Additional Disclosures Required for High-Rate, High-Fee Mortgages

The "Home Ownership Equity Protection Act of 1994" amended the Truth in Lending Act to establish new requirements for certain loans with high rates and/or high fees. The requirements do not apply to loans to purchase or initially construct a consumer's principal dwelling, to reverse mortgages, or to home equity lines of credit. Loans are covered if they meet the following tests: (1) the annual percentage rate exceeds by more than 10 percentage points the rate on Treasury notes of comparable maturity; or (2) the total fees and points exceed the larger of 8 percent of the total loan amount or $424 (for 1997 - dollar amount adjusted annually by the Federal Reserve Board, based on changes in the Consumer Price Index). The amendments primarily affect refinancing and home equity installment loans that also meet the definition of a high-rate or high-fee loan.

In addition to the other Truth in Lending Act disclosures described above, high-rate or high-fee loans, also referred to as "Section 32 mortgages," must include the following disclosures:

1. a written notice stating that the loan need not be completed, even though the consumer has signed the loan application and received the required disclosures;
2. a warning that failure to make required payments could result in the consumer losing the home;
3. disclosure of the APR and regular payment amount; and
4. in the case of variable rate transactions, a statement that the interest rate and monthly payment may increase, as well as the amount of the single maximum monthly payment (based on the maximum interest rate).

The consumer has three business days to sign the loan agreement after receiving the Section 32 disclosures.

The 1994 amendments also ban the following features from high-rate, high-fee loans:

1. all balloon payments for loans with less than five-year terms (with an exception for bridge loans of less than one year used by consumers to acquire or construct a home);
2. negative amortization;
3. default interest rates higher than predefault rates;
4. rebates of interest upon default calculated by any method less favorable than the actuarial method;
5. a prepayment schedule that consolidates more than two periodic payments that are to be paid in advance from the proceeds of the loan; and
6. most prepayment penalties, including refunds of unearned interest calculated by any method less favorable than the actuarial method.

Creditors also are prohibited from engaging in a pattern or practice of lending based on the collateral value of property without regard to the consumer's ability to repay the loan. In addition, proceeds for home improvement loans must be disbursed either directly to the consumer, jointly to the consumer and home improvement contractor, or, in some instances, to the escrow agent.

Consumer's Right to Rescind

As a general rule, the right of rescission applies to all consumer credit transactions where the obligation is secured by a lien against the consumer's principal dwelling. A consumer can have only one "principal dwelling" at a time. Since the definition of a dwelling is not limited to real property, transactions involving mobilehomes can be rescindable even if they are treated as personal property under state law.

Exemptions. There are a number of important exemptions applicable to residential real estate transactions. One of these exemptions concerns "residential mortgage transactions." Under this exemption, the right of rescission does not apply to transactions made to finance acquisition or initial construction of the consumer's principal dwelling and secured by that dwelling, regardless of lien status. In other words, second mortgages for the purpose of financing an acquisition are no longer subject to the right of rescission.

Another exemption is for a refinancing by the same creditor of a loan already secured by the principal dwelling, provided no new money is advanced. If new money is advanced, the transaction is rescindable to the extent of the new money if the loan is secured by the consumer's principal dwelling. This exemption is most likely to arise in connection with renewals, extensions, or refinancing of balloon notes.

By restricting the right of rescission to transactions in which the secured property is currently used as the consumer's principal dwelling, revised Regulation Z has exempted from the rescission requirements loans secured by property that is expected to be used as other than a principal dwelling, such as vacant lots, vacation homes, and retirement homes.

Notice of right to rescind. The creditor must provide each consumer entitled to rescind (any consumer with an "ownership interest" in the principal dwelling subject to the security interest) with two copies of the notice of right to rescind. Creditors are not required to use any specific language when making rescission disclosures. Regulation Z contains a model rescission form that meets the requirements.

Rescission period. The consumer has the right to rescind until midnight of the third business day following the last to occur of these events:

1. consummation of the transaction;
2. delivery of all material Truth in Lending disclosures; or
3. delivery of the notice of right to rescind. A business day is any calendar day, except Sundays and federal legal holidays.

Waiver of right to rescind. Regulation Z provides that the consumer may waive the right to rescind if the consumer determines that the extension of credit is needed to meet a bona fide personal financial emergency. To waive the right, the consumer must give the creditor a dated written statement that describes the emergency and specifically waives the right to rescind. The use of preprinted waiver forms is prohibited by the Regulation.

See Section 226.23 of Regulation Z. (A parallel provision exists in Section 226.15 of Regulation Z for liens against principal dwellings securing open-end credit.)

Advertising Consumer Credit

Anyone placing an advertisement for consumer credit must comply with the advertising requirements of the Truth in Lending Act and Regulation Z. Thus, real estate brokers and home builders who place ads must comply even if they are not creditors in the financing being advertised.

Disclosures in credit advertisements must be made "clearly and conspicuously." This standard requires that disclosures be made in a reasonably understandable form, but does not prescribe the type size or the placement of disclosures in the ad.

An advertisement may state specific credit terms only if the creditor is actually prepared to offer those terms. A creditor may advertise terms that will be offered for only a limited period, or terms that will become available at a future date.

Advertising the rate of finance charge. If the finance charge in a credit advertisement is expressed as a rate, it must be stated as an "annual percentage rate," using that term or the abbreviation "APR." If a component of that finance charge is interest computed at a simple annual rate, that rate *may* also be included. However, it must not be displayed more conspicuously than the annual percentage rate. For example, an advertisement for mortgage credit may include the contract rate of interest together with the annual percentage rate, which reflects insurance, discounts, points, and other charges, as well as interest.

Variable rate mortgages. If the annual percentage rate offered may be increased after consummation of the transaction, the advertisement must state that fact. An advertisement for a variable rate mortgage with an initial annual percentage rate of 9% that may vary after settlement without any limit could be advertised as "9% annual percentage rate, subject to increase after settlement." This disclosure may be used for any type of mortgage instrument with a variable interest rate. It may not be used in advertisements of graduated payment mortgages that have a fixed interest rate and payments that may increase during the loan. Fixed-rate "buydowns" and "step-rate" mortgages are also *not* variable rate mortgages. These mortgages involve different interest rates in effect during the life of the loan, all of which are known at settlement. A variable rate transaction involves future interest rates unknown at settlement.

The Official Staff Commentary to Regulation Z, which is published by the staff of the Federal Reserve Board, sets forth special rules for advertising rates other than simple annual or periodic rates, i.e., for "buydowns" and "payment" or "effective" rates.

Buydowns. A seller or creditor may advertise a reduced simple interest rate resulting from a "buydown" so long as the advertisement shows the limited term to which the reduced rate applies and the simple interest rate that applies to the balance of the term, as well as the annual percentage rate that is determined in accordance with the commentary to Section 226.17(c) of Regulation Z. (Where more than one reduced rate applies, the advertisement must show each rate and the respective term for which each rate is effective.) The advertisement may also show the effect of the buydown on the payment schedule without triggering additional disclosures under Section 226.24(c) of Regulation Z.

Discounted variable rates. Adjustable rate mortgages (ARMs) often have a first-year "discount" or "teaser" feature in which the initial rate is substantially reduced. In these loans, the first year's rate is not computed in the same way as the rate for later years. Often the "spread" or "margin" that is normally added to an "index" (such as the one-year Treasury-note rate) to determine changes in the interest rate in the future is not included in the first year of a discounted ARM offered by a creditor. Special rules, similar to those for buydowns, apply to advertising a discounted variable rate. An advertisement for this type of plan can show the simple interest rate during the discount period, as long as it also shows the annual percentage rate. However, in contrast to buydowns, the ad need not show the simple interest rate applicable after the discount period. For example, a plan with a low first year's interest rate (8%), but with a 10.25% rate in subsequent years, and additional credit costs, could be advertised as follows: "8% first-year financing. APR 10.41%. APR subject to increase after closing." As in buydowns, the annual percentage rate in discounted plans is a composite figure that must take into account the interest rates that are known at closing. In the above example, the disclosed APR must reflect the 8% rate for the first year, as well as, for example, the 10.25% rate applicable for the remainder of the term, plus any additional credit costs (such as buyer's points). An ad for a discounted variable-rate loan, like an ad for a buydown, may show the effect of the discount on the payment schedule during the discount period *without* triggering other disclosures. An example of a disclosure that complies with Regulation Z is: "Interest rate only 8% first year. APR 10.50% subject to increase. With this discount, your monthly payments for the first year will be only $587."

Payment or effective rates. In some transactions, particularly some graduated payment loans, the consumer's payments for the first few years of the loan may be based upon an interest rate lower than the rate for which the consumer is liable (a situation referred to as "negative amortization"). As with buydowns, special rules apply when the "effective" or "payment" rates are advertised for such transactions. The following information must be included in any advertisements containing effective rates: (1) the "effective" or "payment" rate; (2) the term of the reduced payments; (3) the "note rate" at which interest is actually accruing; and (4) the annual percentage rate. The advertised annual percentage rate must take into account the interest for which the consumer is liable, even though it is not paid by the consumer during the period of reduced payments. This type of financing could be advertised as: "An effective first-year rate of only 7-1/2 percent. Interest being charged at 10-1/2 percent. 10-3/4% APR." In contrast to an ad for a buydown or a discounted variable rate, an ad for an "effective" or "payment" rate may *not* show the monthly payments without triggering the disclosures listed in the following section.

Advertising terms that require additional disclosures. If only the annual percentage rate is disclosed, additional disclosures are not required. If, however, an advertisement contains any one of the following terms, the ad must also disclose other credit terms:

1. the amount or percentage of any downpayment;
2. the number of payments or period of repayment;
3. the amount of any payment; or
4. the amount of any finance charge.

These provisions apply even if the so-called "triggering term" is not stated explicitly but may be readily determined from the advertisement. An ad that states "80% financing" implies that a 20 percent down payment is required. However, an ad that states "100% financing" requires no further disclosures because no downpayment is required.

If any triggering term is used, then the following three disclosures must also be included in the advertisement:

1. the amount or percentage of the down payment;
2. the terms of repayment; and
3. the "annual percentage rate," using that term or the abbreviation "APR." If the annual percentage rate may be increased after consummation of the credit transaction, that fact must be disclosed.

Regulation Z also permits the advertiser to substitute examples of one or more typical extensions of credit for required disclosures that are specific to a particular transaction. Where typical examples are used, the advertisement must contain all of the terms that apply to each example. The examples must be typical of the credit terms that are actually available.

The Official Staff Commentary to Regulation Z provides additional guidance and illustrative examples of these general rules. It also prescribes special rules for advertising complex transactions such as graduated payment mortgages and wrap-around loans.

In addition, the Federal Trade Commission publishes a manual for business entitled "How to Advertise Consumer Credit: Complying with the Law." This manual is available from the U.S. Government Printing Office.

Administrative Enforcement

The Federal Trade Commission (FTC) enforces the Truth in Lending Act and Regulation Z with respect to real estate brokers, mortgage loan brokers, mortgage bankers, and other creditors and advertisers not regulated by the following federal agencies, which have jurisdiction over the indicated financial institutions:

Comptroller of the Currency (national banks);

Federal Deposit Insurance Corporation (FDIC - insured banks that are not members of the Federal Reserve System);

Federal Reserve Board (state member banks of the Federal Reserve System),

Office of Thrift Supervision (Federally-insured savings institutions and members of the Office of Thrift Supervision System not insured by FDIC); and

National Credit Union Administration (federally chartered credit unions).

The FTC may determine that a creditor or advertiser has violated the law and order the creditor or advertiser to cease and desist from further violations. Violations of such an administrative order may result in an $11,000 civil penalty each day the violation continues.

If creditors or advertisers engage in practices which they know the Commission has previously determined to be unfair or deceptive, the Commission may file an action in federal district court seeking penalties of up to $11,000 for each violation.

In addition, where a creditor inaccurately discloses an annual percentage rate or finance charge, the FTC can require the creditor to adjust the accounts of persons to whom credit was extended to assure that the obligors will not be required to pay a finance charge in excess of the finance charge actually disclosed or the dollar equivalent of the disclosed annual percentage rate, whichever is lower. Section 108(e) of the Truth in Lending Act sets forth the conditions under which these administrative restitution cases may be brought, as well as defenses the creditor can assert in such cases.

Civil Liability

Under the amended Truth in Lending Act, a creditor may be liable to a consumer for a statutory penalty of twice the amount of the finance charge, with a minimum of $100 and a maximum of $1,000. Statutory liability applies only to seven specific violations: Failing to properly disclose the right of rescission, where applicable; and the improper disclosure of the amount financed, the finance charge, the annual percentage rate, the total of payments, the payment schedule, or the security interest taken by the creditor. In addition, the creditor is liable for actual damages suffered by the consumer and, if the consumer prevails, for the consumer's reasonable attorney's fees and costs. The creditor can avoid such liability if it notifies the consumer within 60 days after discovering the error and adjusts the account to reflect the correct annual percentage rate or finance charge, provided the consumer has not instituted suit, or the creditor has not received written notice of its error, prior to its notification.

Creditors are not liable for violations that were unintentional and resulted from bona fide errors. They must show that they have procedures reasonably adapted to prevent such errors. Examples of bona fide errors include clerical, calculation, computer malfunction and programming, and printing errors. Errors of legal judgment do not qualify as bona fide errors.

Creditors are deemed to be in compliance with the nonnumerical disclosure provisions of the Truth in Lending Act if the creditor: (1) uses any appropriate model form or clause as published by the Federal Reserve Board; or (2) uses any such model form or clause and changes it by (a) deleting any information that is not required by the Act, or (b) rearranging the format, if in making such deletion or in rearranging the format, the creditor does not affect the substance, clarity, or meaningful sequence of the disclosure.

Criminal Liability

A creditor is also subject to a fine of not more than $5,000 or imprisonment for not more than one year, or both, for willfully and knowingly violating the Act or Regulation Z by giving false or inaccurate information, failing to provide required disclosures, or consistently understating the annual percentage rate.

Conclusion

The foregoing summary of the Truth in Lending Act and Regulation Z incorporates the Federal Reserve Board's official staff commentary issued in October, 1981, and the updates to the

commentary through March, 1996. The summary is intended to be a guide to the new law; it does not cover all contingencies.

PREDATORY LENDING LAW

Assembly Bill 489, as amended by Assembly Bill 344, became effective July 1, 2002. This legislation, generally known as the Predatory Lending Law, adds Sections 4970 through 4979.8 to the California Financial Code and imposes restrictions and limitations on specified consumer loans secured by real property for which an application is made on or after July 1, 2002. The law defines *covered loan* as a consumer loan in which the original principal balance is $250,000 or less and either the annual percentage rate or the total points and fees, as defined, exceed specified limits. A *consumer loan* is defined as a consumer credit transaction secured by real property located in this state that is used, or is intended to be used, as the principal residence of the consumer and is improved by one to four residential units. Consumer loans do not include reverse mortgages, open lines of credit (as defined), loans secured by rental property or second homes and bridge loans (as defined).

Covered loans arranged or made by real estate brokers, finance lenders, residential mortgage lenders, as well as commercial banks, industrial banks, savings associations and credit unions organized in this state are subject to the provisions of the Predatory Lending Law. It establishes remedies available to victims (borrowers) for a violation of its provisions and authorizes the licensing and regulatory agencies with jurisdiction over the person or entity making or arranging a covered loan to take license disciplinary action.

Some of the prohibited acts and limitations for covered loans are summarized below.

- Prepayment fees or penalties after the first thirty-six months after the date of the loan closing are prohibited. A prepayment penalty may be included for the first thirty-six months only under specified conditions.
- Loans with terms of five years or less must be fully amortized.
- Loans other than first liens may not include negative amortization. First lien loans may include negative amortization only with proper disclosure of the terms.
- Advance payments required to be paid from the proceeds are prohibited.
- Increases of the interest rate as the result of a default are prohibited.
- Persons originating covered loans must reasonably believe that the consumer(s) obtaining the loan will be able to make the specified payments from resources other than the consumer's equity in the dwelling. The law establishes criteria upon which the person may rely.
- Payments from the proceeds of the loan made directly to contractors under a home-improvement contract are prohibited. Payments made jointly to the consumer and contractor or into a third-party escrow are allowed with specified requirements.
- Encouraging or recommending to the consumer to default on an existing loan or other debt is prohibited.

- A loan that contains a call provision that permits the lender, in its sole discretion, to accelerate the indebtedness unless under specified conditions, is prohibited.
- Refinancings that do not result in an identifiable, tangible benefit to the consumer are prohibited.
- A specified "Consumer Caution and Home Ownership Counseling Notice" must be given to the consumer no later than three days prior to the signing of the loan documents.
- Steering, counseling, or directing a consumer to accept a loan product with a risk grade less favorable than the consumer would otherwise qualify or with higher costs than the consumer would qualify is prohibited.
- Structuring the transaction as an open line of credit, or otherwise, in an attempt to avoid or circumvent the statute is prohibited.
- Acting in a manner that constitutes fraud is prohibited.

The law requires that any failure in compliance that is not willful be corrected not later than forty-five days after receipt of a complaint or discovery of the error. The law further provides for both substantial civil and administrative remedies against any person who willfully and knowingly violates the law.

This summary should not be construed as an all-inclusive description of the statute, and therefore, a complete and careful reading of the law is highly recommended.

For more information regarding predatory lending and the loan process, please read "Protect Yourself in the Loan Process" which is available on the Department's web site at www.dre.ca.gov. It was developed as a guide to consumers to help keep them from falling prey to predatory lending practices and you may wish to recommend it to your clients.

SUBDIVISIONS

If communities were allowed to grow without public controls, development would likely be accompanied by many problems: improper lot design and physical improvements; inadequate streets and parking facilities; insufficient water supplies; lack of adequate police and fire protection; deterioration of air quality; excessive noise; and inadequate utility services.

Through state laws, local master plans, zoning laws and building codes, cities and counties strive to achieve livability and protection of land values.

This chapter discusses the subdivision laws and related controls.

BASIC SUBDIVISION LAWS

The two basic California subdivision laws are the Subdivision Map Act (Government Code Sections 66410, et seq.) and the Subdivided Lands Law (Sections 11000 - 11200 of the Business and Professions Code; hereinafter, the Code).

Subdivision Map Act

The Subdivision Map Act sets forth the conditions for approval of a subdivision map and requires enactment of subdivision ordinances by which local governments have direct control over the types of subdivision projects to be undertaken and the physical improvements to be installed. This act has two major objectives:

1. To coordinate a subdivision's design (lots, street patterns, rights-of-way for drainage and sewers, etc.) with the community plan; and
2. To insure that the subdivider will properly complete the areas dedicated for public purposes, so that they will not become an undue burden upon the taxpayers of the community.

The Subdivision Map Act is discussed in detail later in this chapter.

Subdivided Lands Law

The Real Estate Commissioner administers the Subdivided Lands Law to protect purchasers from fraud, misrepresentation, or deceit in the initial sale of subdivided property.

With a few important exceptions, no subdivision can be offered for sale in California until the Commissioner has issued a subdivision public report. A public report includes important information and disclosures concerning the subdivision offering.

The Commissioner does not issue the public report until the subdivider has met all statutory requirements, including financial arrangements to assure completion of improvements and facilities included in the offering and a showing that the lots or parcels can be used for the purpose for which they are being offered.

SUBDIVISION DEFINITIONS

There are some differences and some similarities between the concept "subdivision" under the Subdivided Lands Law and the Subdivision Map Act. The common part of the definition for "subdivision" is "division of improved or unimproved land for the purpose of sale or lease or financing whether immediate or future."

The main differences or similarities are:

Subdivided Lands Law	*Subdivision Map Act*
5 or more lots or parcels	2 or more lots or parcels
improved standard residential subdivisions within city limits exempted	included
a "proposed division" is included	"proposed division" not included
no contiguity requirement	land must be contiguous units
160 acre and larger parcels designated as such by government survey are excepted	no exception for 160 acre and larger parcels
community apartments included	same
condominiums included	same
stock co-operatives included	not included unless 5 or more existing dwelling units converted
leasing of apartments, offices, stores or similar space in apartment building, industrial building or commercial building excepted	same
long term leasing of spaces in mobilehome parks or trailer parks included	leasing or financing of mobilehome parks or trailer parks not included
undivided interests included	not included
expressly zoned industrial or commercial subdivisions are exempt	included
agricultural leases included	not included
time-shares included	not included
limited-equity housing cooperatives, with some exemptions, per Section 11003.4 of the Code	not included

TYPES OF SUBDIVISIONS

Standard

A standard subdivision is a subdivision with no common or mutual rights of either ownership or use among the owners of the lots.

Common Interest

Purchasers in a common interest subdivision own or lease a separate lot, unit, or interest, along with an undivided interest or membership interest in the common area of the entire project. Normally, an association of the owners manages the common area. Condominiums, planned

developments, stock cooperatives, community apartment projects and timeshare projects are types of common interest subdivisions.

A **condominium** consists of an undivided interest in common in a portion of real property coupled with a separate interest in space called a unit, the boundaries of which are described on a recorded final map, parcel map, or condominium plan in sufficient detail to locate all boundaries thereof. The description of the unit may refer to: (i) boundaries described in the recorded final map, parcel map, or condominium plan; (ii) physical boundaries, either in existence, or to be constructed, such as walls, floors, and ceilings of a structure or any portion thereof; (iii) an entire structure containing one or more units; or (iv) any combination thereof. The portion or portions of the real property held in undivided interest may be all of the real property, except for the separate interests, or may include a particular three-dimensional portion thereof, the boundaries of which are described on a recorded final map, parcel map, or condominium plan. An individual condominium may include, in addition, a separate interest in other portions of the real property. A condominium may, with respect to the duration of its enjoyment, be (l) an estate of inheritance or perpetual estate; (2) an estate for life; or (3) an estate for years, such as a leasehold or a subleasehold.

Typically, an owner of a condominium owns in fee simple the air space in which the particular unit is situated and an undivided interest in common in certain other defined portions of the whole property involved. An association and its elected governing board perform the management functions.

A **planned development** is defined in Civil Code Section 1351 (k) as consisting of parcels owned separately and lots or areas owned in common and reserved for the use of some or all of the individual lot owners. Generally, an owner's association provides management, maintenance and control of the common areas and has the power to levy assessments and enforce obligations which attach to the individual lots.

A **stock cooperative** is defined in Section 1351 (m) of the Civil Code as a corporation which is formed or availed of primarily for the purpose of holding title to improved real property, either in fee simple or for a term of years. All or substantially all of the shareholders receive a right of exclusive occupancy of a portion of the real property, which right is transferable only concurrently with the transfer of the share(s) of stock.

Most stock cooperative projects are of the apartment house type, operated by a board of directors and including community recreation facilities. The homeowners' governing association is usually a nonprofit mutual benefit corporation.

A **limited equity housiug cooperative** is a corporation which meets the criteria of a stock cooperative and complies with the requirements of Section 33007.5 of the Health and Safety Code. Residents sometimes form a limited equity housing cooperative to purchase a mobilehome park.

In a **community apartment project**, a purchaser receives an undivided interest in the land coupled with the right of exclusive occupancy of an apartment located thereon. The owners elect a governing board which operates and maintains the project.

A **time-share project** involves long-term rights to use real property for short-term use periods into which the offering has been divided (e.g., the right to use **a** dwelling unit for two weeks of each year for the next 10 years). In some cases, a time-share purchaser receives an undivided

interest in the real property (a time-share estate) as well as the periodic use right. Or, a purchaser may acquire only a right to use (a time-share use). In either case, the right to use may be specified (e.g., the first two weeks in July), or set on a first reserved, first served basis.

Section 11004.5 of the Code provides that the terms "subdivided lands" and "subdivision" include a time-share project, as defined in Section 11003.5, consisting of 12 or more time-share estates or time-share uses. To qualify, time-share uses must have terms of five years or more, or terms of less than five years which also include options to renew.

An offering of (12 or more) time-share use rights, whether or not assignable or irrevocable, in real property other than structural dwelling places does not constitute a subdivision. A time-share estate offering of 12 or more interests in real property other than structural dwelling places (e.g., campgrounds and recreational vehicle parks) is a subdivision.

A developer of a time-share subdivision located outside of California, but within the United States, must obtain a permit pursuant to Section 10250, et seq. of the Code before offering the time-share interests in California.

A real estate license is required of a person negotiating in this state, for another and for compensation, the sale of ***any*** time-share interest. This position is consistent with a Court of Appeal decision which declared that memberships in a club conferring time-share use rights in condominiums constituted interests in real property which the court characterized as being in the nature of a lease.

Undivided Interest

A partial/fractional interest in an entire parcel of land is called an undivided interest. The land itself has not been divided, but its ownership has been divided.

The creation, for sale, lease, or financing, of five or more undivided interests in land, whether or not improved, constitutes a subdivision and a public report is required prior to marketing the interests. Section 11000.1(b) of the Code provides for several exemptions, including purchase of the undivided interests by people related by blood or marriage or by ten or fewer persons who: are informed concerning the risks of ownership; are not purchasing the property for resale; and waive the protections offered by the Subdivided Lands Law.

COMPLIANCE WITH THE SUBDIVIDED LANDS LAW

The Subdivided Lands Law is designed to protect purchasers from misrepresentation, deceit and fraud in subdivision sales. This is accomplished in two ways: by making it illegal to commence sales until DRE determines that the offering meets certain affirmative standards and issues a public report; and by disclosing in the public report pertinent facts about the property and the terms of the offering.

Affirmative Standards

Affirmative standards deal with two major aspects of the proposed subdivision offering:

1. suitability for intended use; and
2. fair dealing regarding the sale or lease of the offering.

The Subdivided Lands Law requires that the Commissioner deny issuance of a public report if the offering is not suitable for the use proposed by the subdivider. The suitability test is, of

course, paramount in residential offerings. These must include vehicular access, a potable water source, available utilities, offsite improvements, etc.

To insure fair dealing and receipt of the subdivision interest for which the purchaser has bargained, the affirmative standards include: the security of buyer's deposit money; satisfactory arrangements to clear mechanic's liens; release of the interest from any blanket encumbrance (mortgage lien); and conveyance of proper title.

Disclosures in Public Report

The public report discloses significant information about the subdivision. Disclosures in the public report may alert consumers to any negative aspects of the offering (e.g., unusual present or future costs; hazards or adverse environmental factors; unusual restrictions or easements; necessary special permits for improvements; unusual financing arrangements).

Filing Notice of Intention/Application

Before subdivided land can be offered for sale or lease, a Notice of Intention must be filed with the Commissioner. The Notice of Intention is combined with a Questionnaire and Application and must be completed on forms provided by DRE. The questionnaire is specifically designed to obtain pertinent details about all aspects of the offering.

Usually, the owner files the application for public report. Anybody filing on behalf of the owner must furnish DRE with the owner's written authorization to do so.

Use of Public Report

A copy of the public report must be delivered to a prospective purchaser, who must have time to read the report before any offer is made to purchase or lease a lot or interest covered by the report. The prospective purchaser will sign a receipt for the report on a form approved by the Commissioner. The subdivider must retain the receipt for three years for the Commissioner's inspection.

As stated in a notice required to be posted in the sales office, the subdivider must, upon request, give a copy of the public report to any member of the public.

Violations - Penalties

In addition to disciplinary actions which may be imposed by the Commissioner against licensees for violations of the Subdivided Lands Law, anyone who willfully violates or fails to comply with Sections 11010, 11010.1, 11010.8, 11013.1, 11013.2, 11013.4 11018.2, 11018.7, 11019 or 11022 of the Code shall be guilty of a public offense punishable by a maximum fine of not to exceed $10,000, or up to one year's confinement in county jail or in state prison or by both fine and imprisonment.

The district attorney of each county in the state is charged with prosecuting violators.

HANDLING OF PURCHASERS' DEPOSIT MONEY

Common to all types of subdivision filings are the requirements for the handling of the purchasers' deposit money as set forth in Sections 11013, 11013.1, 11013.2 and 11013.4 of the Code.

Blanket Encumbrance
A blanket encumbrance exists when more than one lot in a subdivision is made security for the payment of a trust deed note or other lien or encumbrance.

When, as is usually the case, there is no agreement for unconditional release of individual parcels from a blanket encumbrance, the owner or subdivider must comply with one of the following conditions:

1. Impoundment of the purchase money, in an escrow depository acceptable to the Commissioner, until a proper release is obtained from the blanket encumbrance or one of the parties defaults and there is a determination as to disposition of the money <u>or</u> the owner or subdivider orders the return of the money to the purchaser or lessee.
2. Title is placed in trust, under an agreement acceptable to the Commissioner, until a proper release from the blanket encumbrance is obtained and the trustee conveys title to the purchaser. This alternative is not practical if the lots are to be sold by real property sales contract.
3. The subdivider furnishes a bond to the State of California in an amount and subject to such terms as the Commissioner may approve. The bond must provide for the return of purchase money if a proper release from the blanket encumbrance is not obtained.

The Commissioner may approve other methods which protect purchasers' payments until receipt of title or other interest contracted for.

No Blanket Encumbrance
Even if a subdivision is not subject to a blanket encumbrance, the deposit money of the purchaser must be impounded in an escrow or trust account unless the subdivider elects an alternative method.

The most common alternative to impounding is an acceptable bond to the State of California to assure return of the deposit money if the seller does not deliver title within the time specified in the contract. Note that a bond cannot be used to secure reservation deposits taken under a preliminary public report.

As in the case of a subdivision subject to a blanket encumbrance, the Commissioner is given discretionary power to approve alternative plans submitted by subdividers which assure adequate protection of purchasers' deposits.

Impound Requirements - Real Property Sale Contracts
A real property sales contract is defined in Section 2985 of the California Civil Code as an agreement wherein one party agrees to convey title to real property to another party upon the satisfaction of specified conditions and which does not require conveyance of title within one year from the date of formation of the contract.

When lots in a subdivision are to be sold using contracts of sale, the subdivider will usually convey the subdivision in trust as detailed in Commissioner's Regulation 2791.9. This is an acceptable alternative under Section 11013.2(d) or Section 11013.4(f) of the Code.

MONEY PAID FOR OPTIONAL EXTRAS SUBJECT TO IMPOUND LAWS

Optional extras are frequently ordered by subdivision homebuyers. Sometimes the specially-installed items may cost thousands of dollars and once installed, cannot be removed without additional expense to the installer or the homebuyer. A problem arises when a buyer fails to complete the transaction and the property, improved to their specifications, cannot be sold to another buyer for a sufficient amount to recapture the subdivider's additional costs.

In an attempt to forestall problems of this type, some developers extract the full cost for *optional extras* from the purchaser and use that money to install the requested improvements. Also, the monies paid by the purchaser for the *optional extras* are frequently deposited in an account, other than the designated purchase money impound account. Subdividers who use purchase money in this fashion act in violation of the Subdivided Lands Law.

Under the Subdivided Lands Law, all monies received from a purchaser towards the purchase or a long term lease of subdivided property is *purchase money*. Subdividers are precluded from using purchase money for any purpose until the purchaser receives title to the property, or whatever other interest for which he/she contracted. This means that the subdivider-builder must usually install all such *extras* with his/her own funds and if there is a default by a purchaser, the subdivider may then lay claim to funds expended for extras under the *liquidated damages* provisions of the contract. The procedures for making a claim against purchase money must be in accordance with Section 2791 of the Regulations of the Real Estate Commissioner.

Instead of using his/her own money to install the *extras* the subdivider can use *purchase money* by furnishing a bond to the Department of Real Estate under the provisions of Section 11013.2(c) or 11013.4(b) of the Business and Professions Code. The bond could be for the total amount intended to be used for these special installations or for all the purchase monies the subdivider believes he may expend for any reason. If such a bond (RE 600 or 600A) is furnished the subdivider may still be liable to the purchaser for purchase monies expended if a court or arbitrator determines that the subdivider is not entitled to the liquidated damages he is claiming.

If purchasers contract separately with contractors or suppliers who are in no way associated with a subdivider and these contractors are paid separately by the purchaser for extras, the amounts paid are not considered to be monies paid for the purchase or lease of a subdivision interest and are exempt from the impound provisions of the Business and Professions Code. Because many subdivider-builders object to work being performed on their property at this stage of development by independent contractors outside the builder's control, this procedure is not widely used.

Feedback from subdividers who have used the bonding procedures indicate that it is the most acceptable and practical procedure.

Most Common Enforcement Violations

The Department's Enforcement Section receives and processes a large number of complaints each year that are investigated and referred to the Department's Legal Section for disciplinary action. In many cases, the violations that resulted in disciplinary action could have been avoided if appropriate office procedures had been in place. The following is a list of the six most common violations of the Real Estate Law that have resulted in disciplinary action and some suggested remedies to avoid the violations. All references are to Sections of the California Business and Professions Code and the Regulations of the Real Estate Commissioner.

Trust Fund Record Keeping Violations

Trust fund handling and record keeping is one of the most common problem areas. We see case after case in which brokers handle trust monies on behalf of others and either convert the monies to their own use, or do not have the expertise to maintain proper accounting records and end up with shortages in their trust accounts. To avoid problems in this area, all real estate brokers should be familiar with the following laws and regulations that govern the handling of trust funds by real estate brokers.

Section 10145 — General statute governing the handing of trusts funds.

Regulation 2831 — Maintaining columnar records of trust funds received.

Regulation 2831.1 — Maintaining separate records for each beneficiary.

Regulation 2831.2 — Performing monthly reconciliation of trust fund accounts.

Regulation 2834 — Allowing unlicensed and unbonded signatories on a trust account.

Remedy

Deficiencies in the area of trust fund records usually stem from one of two common deficiencies by real estate brokers.

The most common problem found among brokers who maintain poor trust fund records is a lack of knowledge of what the law requires in the area of trust fund record keeping and a lack of basic bookkeeping or accounting skills. Brokers often attempt to handle large amounts of trust funds without any specific training in the area. This often results in a trust fund disaster.

Brokers should understand that simply because they are able to handle large amounts of trust funds by virtue of their license, it doesn't necessarily follow that they should. Before accepting any trust funds, brokers should make sure that they have the proper knowledge and skills necessary to handle and account for the trust funds that are received in their business operations. The level of knowledge and skill that is necessary will vary with the type of operation and the amount of trust funds that are handled. Brokers must be able to recognize the limitations of their knowledge and skills as their business operations expand and either get further training or hire professionals with appropriate training.

A second common problem found among brokers who maintain poor trust fund records is a general lack of supervision over their trust fund operations. It is common to find brokerage

operations where the responsible broker has simply turned this aspect of the operation over to office personnel. A broker must always exercise vigilant and consistent oversight of the trust fund operation to ensure that there is compliance with the law.

The Real Estate Law is very specific as to how trust fund monies are to be handled and how records are to be maintained. Real estate brokers who handle trust fund monies have a responsibility to become knowledgeable in this area. A good place to start is by reviewing the DRE's publication entitled Trust Funds which is available on our Web site.

Trust Fund Shortage Violations

Section 10145 — General statute governing the handling of trust funds.

Regulation 2832 — Trust fund handling.

Regulation 2832.1 — Trust fund shortages.

Remedy

Often, trust fund shortages in brokerage operations are caused by poor record keeping and lack of control on the part of the responsible broker. The remedies to this problem were previously discussed.

Of even more concern than poor record keeping, are trust fund shortages resulting from the deliberate conversion of trust funds for personal use by the broker or by employees of the broker. When this occurs, it is taken very seriously. Real estate brokers who are found to have converted trust funds can be assured that disciplinary action will be taken against their license. Also, the potential for criminal prosecution exists.

Failure to Supervise Violations

Section 10177(h) — As a real estate broker, failed to exercise reasonable supervision over the activities of salespersons, or as the designated officer of a corporation, failed to exercise reasonable supervision over the activities conducted by the corporation for which a real estate license is required.

Lack of supervision on the part of a broker is a recurring problem. In case after case, the Department has to address the problem of real estate brokers becoming designated officers of corporations owned by salespersons or unlicensed individuals and then not properly supervising the operations.

While it is not illegal for brokers to become designated officers of corporations they do not own, they must remain mindful of their duty to supervise the licensed activities of the corporation. All too often, real estate brokers do not take this responsibility seriously and the public suffers as a result.

Remedy

Brokers need to understand the responsibility that they take on when they become the designated officer of a corporation or allow a group of salespersons to work under their individual broker license. The absentee broker may find himself/herself not only the subject of a DRE disciplinary action, but also

the subject of a civil lawsuit. In the end, the costs greatly outweigh any benefit received in the income that is usually paid for the use of a license.

Unlicensed Activity Violations

Section 10130 — Unlicensed activity.

Section 10137 — Unlawful employment or payment to an unlicensed individual or to a real estate salesperson who is not employed by the broker.

The real estate licensing requirement is the cornerstone to providing consumer protection to the purchasers of real property and those persons dealing with real estate licensees (Section 10050). Therefore, the enforcement of these requirements must be vigorous. Real estate brokers who pay unlicensed individuals for performing acts that require a real estate license will be disciplined and held accountable to pay appropriate fines and penalties.

Remedy

Real estate brokers should establish systems within their offices to ensure that salespersons working for them complete their continuing education, renew their licenses on time, and do not continue to work in the event that their license expires.

Misrepresentation Violations

Section 10176(a) — Making a substantial misrepresentation in a transaction for which a real estate license is required. The term misrepresentation not only applies to a direct statement regarding a material fact that is untruthful or incorrect, but it also includes the failure of a real estate licensee to disclose material facts that the principal should be made aware of.

Remedy

Real estate licensees should avoid making any statement they do not know to be true to a principal in a transaction. And because failure by licensees to disclose material facts to principals in real estate transactions is a continuing problem, licensees should remember the simple admonition — ***When in doubt, disclose, and do it in writing.***

Criminal Conviction Violations

In addition to the above-referenced violations, individuals are very often either denied licenses or disciplined by the Department for failing to disclose a criminal conviction on an application for licensure [Sections 10177(a) and 480(c)], and for being convicted of a substantially related criminal offense [Section 10177(b)].

Remedy

The one remedy that should be discussed in connection with criminal convictions is that persons applying for a real estate license should take great care to disclose all past criminal convictions. If the conviction is not disclosed, DRE will find out and the applicant's chances of receiving a license will be diminished as a result of their nondisclosure.

Ten Most Common Violations Found In DRE Audits

As the real estate industry moves into a new millennium, new things pop up everyday to change the way we do business. New terms, such as E-Loans, Internet Marketing, and E-Form have become jargons of the trade. Yet, certain things have not changed – the most common violations found in DRE Audits. In this regard, the top ten common violations are listed below. The purpose of this article is to call your attention to these common deficiencies and to provide you with procedures that you can follow to ensure compliance with these laws and regulations.

B & P Code Section 10148 – Retention of Records

Business and Professions Code Section 10148(a) states that a real estate broker shall retain for three years copies of all listings, deposit slips, canceled checks, trust records, and other documents executed by him or her or obtained by him or her in connection with any transactions for which a real estate license is required. This section requires that, after notice, the books, accounts, and records shall be made available for examination, inspection, and copying by the commissioner or his or her designated representative during regular business hours; and shall, upon the appearance of sufficient cause, be subject to audit without further notice, except that the audit shall not be harassing in nature.

A broker who fails to keep transaction files, canceled checks, deposit slips or other records prepared or obtained for a period of three years may be cited for violation of this section. Some brokers cited for violation of this section have simply failed to provide records after reasonable attempts by the Department to examine them. Other brokers cited have lost control of or destroyed records that should have been maintained. Formal legal action can result from a broker's failure to provide records. You should review the record retention policies for your office to make sure you are in compliance with this code section.

Regulation 2731 – Use of False or Fictitious Name

Commissioner's Regulation 2731 states that a licensee shall not use a fictitious name in the conduct of any activity for which a license is required under the Real Estate Law unless the licensee is the holder of a license bearing the fictitious name. Brokers should periodically check their license status with the Department to be sure that their license bears the fictitious name(s) they are using. Many brokers cited for violation of this regulation believed that having the dba registered with the county was sufficient to allow them to use it in their real estate business. Other brokers who are cited for this violation state that they had the fictitious name on their license at one time but may have had their license lapse for a brief period of time and failed to add the dba back on to their license.

Regulation 2831 – Trust Fund Records To Be Maintained

This regulation requires the broker to maintain, in columnar form, a record of all trust funds received and deposited by the broker. At a minimum, the following information must be indicated in columnar form in chronological order: date funds were received; name of payee or payor; amount received; date of deposit; amount paid out; check number and date; and the daily running balance of the trust account. If any of these columns are not present, then there is a violation of Regulation 2831. The accurate use of DRE form RE 4524 fully complies with this regulation.

When we cite this regulation, most of the time it is for one or more of the following reasons:

- The broker did not maintain any trust fund records.
- If trust fund records were maintained, they were either not in columnar form or a column (noted above) was missing. We have seen many brokers utilize a standard checkbook as trust fund records. These records do not comply with Regulation 2831.
- In some instances, columnar records were maintained by a licensee but he/she was still cited because the items posted were not accurate, e.g., when posting a check, it was the wrong amount; or, for a deposit, "the amount" was wrong and/or "the date of deposit" was the wrong date.
- A broker maintaining columnar records can still be cited if a daily running balance is not maintained or is inaccurate. Brokers must always keep a daily running balance of the aggregate amount of trust funds in their bank accounts.

(For trust funds not deposited into a trust account, the columnar record should show the date trust funds were received, the form of the trust funds, amount received, description of the property, identity of the person to whom funds were forwarded, and date of disposition. The accurate use of DRE form RE 4524 fully complies with this part of the regulation.)

It should be noted that records maintained under an automated data processing system in accordance with generally accepted accounting principles should be in compliance as long as they contain the elements previously noted.

Regulation 2831.1 – Separate Record for Each Beneficiary or Transaction

This regulation requires the broker to maintain, in columnar form, a separate record of trust funds for each beneficiary or transaction accounting for all funds which have been deposited into a trust account. This record identifies which beneficiary has funds in the trust account. This record must indicate the following in chronological order and in columnar form: date of deposit, amount of deposit, name of payee or payor, check number, date and amount, and running balance of the separate record after each transaction on any date.

This regulation is cited mostly due to one or more of the following reasons:

- The broker did not maintain separate records for each beneficiary.
- Separate records were maintained, but the broker was cited because information was missing.
- Separate records were maintained, but the broker was cited because the items posted were not accurate, e.g., when posting a check, it was the wrong amount; or, for a deposit, "the amount" was wrong and/or "the date of deposit" was the wrong date.
- Separate records were maintained, but a daily running balance for each record was not maintained or it was not accurate. Brokers must always keep a daily balance for each separate record.

It should be noted that records maintained under an automated data processing system in accordance with generally accepted accounting principles should be in compliance as long as they contain the elements previously noted.

Regulation 2831.2 – Trust Account Reconciliation

Regulation 2831.2 requires that the total of all Separate Beneficiary or Transaction Records maintained pursuant to Regulation 2831.1 be reconciled with the balance of the Record of All Trust Funds Received and Paid Out required by Regulation 2831, at least once a month except when the bank account did not have any activities. The requirement is that the *accounting records* be reconciled to each other. This is not only a legal requirement, this is also part of a sound internal control for trust fund handling.

In order for this procedure to have a reliable result, the Record of All Trust Funds Received and Paid Out must be reconciled first with the bank account statements as of a certain cut-off date. This procedure is commonly known as bank reconciliation and is performed basically to determine the accuracy of the records. A cut-off date is the calendar date (usually end of the month), when no transaction or activity thereafter is considered. This process is completed once all adjustments and corrections of any reconciling items have been made to the ending balance on each record to arrive at an adjusted cash balance. In other words, the balance of the record of all trust funds received and paid out has to equal the adjusted cash balance.

The next step is to compare and reconcile the total of all beneficiary or transaction records with the adjusted cash balance as of the cut-off date of the bank reconciliation. The main objective of this procedure is to determine, based on the records, whether all trust funds held on behalf of others are on deposit in the corresponding trust account. Another purpose of this procedure is to ascertain that there is no unidentified overage or broker's funds in excess of $200 in the trust account. Any discrepancy must be corrected accordingly. The broker is required to maintain a record of the trust account reconciliation showing the name of the bank account and number, date of the reconciliation, account number or name of the principals, beneficiaries or transactions and the amount of trust funds held by the broker for each of the principals, beneficiaries or transactions. Failure to comply with this Regulation could result in substantial loss of trust funds and disciplinary action against the broker by the Department.

Regulation 2832.1 - Trust Fund Handling for Multiple Beneficiaries (Trust Fund Shortage)

Regulation 2832.1 requires the real estate broker to obtain written consent from every owner of the trust funds in the bank account prior to each disbursement if the disbursement will reduce the balance of the funds in the bank account to an amount less than the existing trust fund liability of the broker to all owners of the funds. A trust fund shortage therefore exists when the following conditions are present:

- The balance of the bank account is less than the total trust fund liability of the broker to all owners of the funds; and
- There is no written authorization from all owners of the trust funds allowing this.

The most obvious reason for a trust fund shortage is the intentional misuse (conversion) of trust funds. However, simple record keeping errors that remain undetected could result in trust fund shortages and an actual loss of funds. Failure to record a disbursement, or understating the amount of a check disbursed, or overstating the amount of a deposit on the beneficiary ledger to show a balance that is larger than the true amount owed to the individual beneficiary. This

overstated balance on the ledger is more likely to be paid and, consequently, the beneficiary will be paid more than what is due. The end result is a trust fund shortage.

Performing the proper trust account reconciliation pursuant to Regulation 2831.2 should enable the broker to detect such causes of a trust fund shortage.

Regulation 2832 - Trust Fund Handling

The most common violations of this section found in audits relate to Commissioner's Regulation 2832(a), which requires that a broker place funds accepted on behalf of another into the hands of the owner of the funds, into a neutral escrow depository or into a trust fund account in the name of the broker, or in a fictitious name if the broker is the holder of a license bearing such fictitious name, as trustee at a bank or other financial institution not later than three business days following receipt of the funds by the broker or by the broker's salesperson. Two of the most common problems related to this regulation are:

- A broker's *failure* to designate accounts receiving trust funds as *trust fund accounts* in the *name of the broker or broker's dba as trustee;* and
- Failure to deposit trust funds received by a broker or broker's employee into a trust fund account within three business days of receipt.

Other violations of this section relate to a broker's use of an improper interest-bearing account {Regulation 2832(b)}, a broker's failure to place checks received from an offeror into a neutral escrow depository or trust fund account in a timely manner following acceptance of an offer {Regulations 2832(c & d)} and failure of a broker acting as an escrow holder in a transaction in which the broker is performing acts for which a real estate license is required to place trust funds received as required not later than the next business day following receipt of the funds {Regulation 2832(c)}.

Regulation 2834 - Trust Account Withdrawals

Commissioner's Regulation 2834(a) states that withdrawals may be made from a trust fund account of an individual broker only upon the signature of the broker or one or more of the following persons if specifically authorized in writing by the broker:

- A salesperson licensed to the broker.
- A person licensed as a broker who has entered into a written agreement pursuant to Section 2726 with the broker.
- An unlicensed employee of the broker with fidelity bond coverage at least equal to the maximum amount of trust funds to which the employee has access to at any time.

Regulation 2834(b) also states that withdrawals may be made from a trust fund account of a corporate broker only upon the signature of:

- An officer through whom the corporation is licensed pursuant to Section 10158 or 10211 of the Code; or

- One of the persons enumerated in paragraph (1), (2) or (3) of Regulation 2834(a), provided that specific authorization in writing is given by the officer through whom the corporation is licensed and the officer is an authorized signatory of the trust fund account.

Regulation 2834(c) states that a broker or broker-officer is responsible or liable for the handling of trust funds regardless of the existence of any authorization given regarding signature authority.

The most common violations found in audits related to Regulation 2834 are:

- The failure of the broker or designated officer to be a signatory on the trust account (this *may* indicate a supervision problem).
- Presence of an unlicensed signatory on the trust account who does not have fidelity bond coverage.
- Fidelity bond coverage in an inadequate amount and/or has a deductible.
- The failure of the broker or designated officer to give specific written authorization permitting a salesperson, broker or unlicensed person to sign on the trust account.

B & P Code Section 10145/Regulation 2835 - Commingling

A broker shall not commingle with his or her own money or property the money or property of others which he or she receives and holds. Common causes of this violation are the deposit of trust funds received into the broker's general business account or maintenance of over $200 in broker funds in a trust account holding trust funds.

A common example of this violation is when a broker deposits credit report fees and/or appraisal fees received into his or her general bank account instead of a trust account when he or she has not yet paid the bill. Often, the reason for this violation is that the broker does not maintain a trust account or the broker was not aware that credit report and appraisal fees are trust funds.

B & P Code Section 10240 - Written Disclosure Statement

Another often-cited violation is Section 10240 of the code which requires brokers to provide a borrower with a mortgage loan disclosure statement within three business days after receipt of a completed loan application or before the borrower becomes obligated on the note, whichever is earlier. Real estate brokers often fail to provide the Mortgage Loan Disclosure Statement (Borrower) or, in a federally regulated residential mortgage loan transaction, fail to comply with Section 10140(c). Other brokers fail to maintain completed copies for their files.

In conclusion, as you race to keep up with the ever-changing opportunities that present themselves in business today, take a moment to stop and ensure that your business is operating in compliance with these and other critical real estate laws.

APPENDIX

State of California
Department of Real Estate

Broker Compliance Evaluation Manual

February 2002

This Broker Compliance Evaluation Manual was prepared primarily to assist the real estate broker conducting residential sales in ascertaining his/her compliance with Department of Real Estate requirements. It contains many of the questions that you would be asked if visited by a Department of Real Estate representative.

This manual was not designed to encompass all of your obligations and responsibilities under the Real Estate Law but rather as one of the tools you may use when reviewing your records and office procedures. We hope that it will assist you.

– Department of Real Estate

SECTION 1 – General Business Practices

1. **Are the broker's salespersons properly licensed?**
   Correct Procedure:

   All persons performing activities requiring a real estate license for compensation must hold a valid real estate license.

   The broker should have some procedure in place to monitor the expiration dates of the licenses of his/her salespersons. Standard broker and salesperson licenses expire four years after issuance. However, a conditional salesperson license expires 18 months after issuance unless the salesperson has submitted evidence to the Department of completion of the mandatory educational requirements. The broker should also retain possession of the licenses of his/her salespersons while in the broker's employ.

   Once the license has expired, no licensed activity can be performed by the licensee until the license has been renewed. The late renewal period (often referred to as the "grace" period) simply allows the licensee to renew on a late basis without retaking the examination; it does not allow the licensee to conduct licensed activity during the late renewal period.

   It is unlawful for any broker to employ or compensate, directly or indirectly, any person for performing licensed activity unless that person is a licensed broker, or a salesperson licensed to the broker. A salesperson may not accept compensation for

licensed activity nor pay compensation for licensed activity except through the broker under whom he/she is at the time licensed.

It is a misdemeanor, punishable by a fine of $100 for each offense, for any person, whether obligor, escrow holder or otherwise, to pay or deliver to anyone compensation for performing any licensed acts who is not known to be or who does not present evidence that he/she is a licensed real estate broker at the time such compensation is earned.

Reference:
Real Estate Law Book, Sections 10130, 10131, 10132, 10137, 10138, 10153.4, 10160
(Unless otherwise noted, all "Section" references are to the Business and Professions Code.)

2. Does the broker notify the Department of Real Estate upon the hiring and termination of salespersons?
Correct Procedure:

Whenever a real estate salesperson enters the employ of a broker, the broker shall notify the commissioner of that fact within five days. This notification shall be given on a form prepared by the Department and shall be signed by the broker and the salesperson. The form of notification shall provide at least the following information:

1. Name and business address of the broker.
2. Mailing address of the salesperson, if different from the business address.
3. Date when the salesperson entered the employ of the broker.
4. Certification by the salesperson that he/she has complied with the provisions of Section 10161.8(d) of the Business & Professions Code.
5. Name and business address of the real estate broker to whom salesperson was last licensed and the date of termination of that relationship.
6. Certification by the salesperson that the predecessor broker has notice of the termination of the relationship.

As an acceptable alternative to 5 and 6 above, the form may be utilized by the predecessor broker to give notice of the termination of the broker/salesperson relationship as required by Section 10161.8(b) of the Business & Professions Code if this notice is mailed to the commissioner not more than ten days following such termination.

Reference:
Real Estate Law Book, Section 10161.8; Regulation 2752

3. Does the broker have a written broker-salesperson agreement with each of his/her salespersons?
Correct Procedure:

Every broker must have a written agreement with each of his/her salespersons, whether licensed as a salesperson or as a broker under a broker-salesperson arrangement. The agreement shall be dated and signed by the parties and shall

cover material aspects of the relationship between the parties, including supervision of licensed activities, duties and compensation.

Reference: Real Estate Law Book, Regulation 2726

4. Is the broker properly supervising?

Correct Procedure:

A broker shall exercise reasonable supervision over the activities of his or her salespersons. Reasonable supervision includes, as appropriate, the establishment of policies, rules, procedures and systems to review, oversee, inspect and manage:

1. Transactions requiring a real estate license.
2. Documents which may have a material effect upon the rights or obligations of a party to the transaction.
3. Filing, storage and maintenance of such documents.
4. The handling of trust funds.
5. Advertising of any service for which a license is required.
6. Familiarizing salespersons with the requirements of federal and state laws relating to the prohibition of discrimination.
7. Regular and consistent reports of licensed activities of salespersons.

The form and extent of such policies, rules, procedures and systems shall take into consideration the number of salespersons employed and the number and location of branch offices.

A broker shall establish a system for monitoring compliance with such policies, rules, procedures and systems. A broker may use the services of brokers and salespersons to assist in administering the provisions of this section so long as the broker does not relinquish overall responsibility for supervision of the acts of salespersons licensed to the broker.

Reference:
Real Estate Law Book, Regulation 2725

5. Does the broker retain copies of all documents?

Correct Procedure:

A licensed broker must retain for 3 years copies of all listings, deposit receipts, canceled checks, trust account records, and other documents executed by him or her or obtained by him or her in connection with any transaction for which a broker's license is required. The retention period shall run from the date of the closing of the transaction or from the date of the listing if the transaction is not consummated. After reasonable notice, the books, accounts and records shall be made available for audit, examination, inspection and copying by a Department representative during regular business hours.

Reference:
Real Estate Law Book, Section 10148

6. **Do the documents disclose the negotiability of commissions?**
Correct Procedure:

Any printed or form agreement which initially establishes, or is intended to establish, or alters the terms of any agreement which previously established a right to compensation to be paid to a licensee for the sale of residential real property containing not more than four residential units, or for the sale of a mobilehome, shall contain the following statement in not less than 10-point boldface type immediately preceding any provision of such agreement relating to compensation of the licensee:

> **Notice: The amount or rate of real estate commissions is not fixed by law. They are set by each broker individually and may be negotiable between the seller and broker.**

As used above, "alters the terms of any agreement which previously established a right to compensation" means an increase in the rate of compensation, or the amount of compensation if initially established as a flat fee, from the agreement which previously established a right to compensation.

The broker must make certain that his/her agreements and forms are not preprinted with any amount or rate of compensation.

Reference:
Real Estate Law Book, Section 10147.5

7. **Does the broker have a license for each business location?**
Correct Procedure:

A broker is authorized to conduct business only at the address listed on his/her license. If the broker maintains more than one place of business within the State, he/she shall apply for and procure an additional license for each branch office so maintained. The application for a branch office license must state the name of the person and the location of the place or places of business for which the license is desired.

Reference:
Real Estate Law Book, Section 10163

8. **Is the broker using an unlicensed fictitious name?**
Correct Procedure:

A broker shall not use a fictitious name in the conduct of any activity requiring a real estate license unless the broker first obtains a license bearing the fictitious name. (A fictitious business name is frequently referred to as a "dba" - doing business as.)

To obtain a license bearing a fictitious name, the broker must apply to the Department and attach a certified copy of the fictitious business name statement filed with the county clerk.

The Real Estate Commissioner may refuse to issue a license bearing a fictitious name to a broker if the fictitious name:

1. Is misleading or would constitute false advertising.

2. Implies a partnership or corporation when a partnership or corporation does not exist.
3. Includes the name of a real estate salesperson.
4. Constitutes a violation of the provisions of Sections 17910, 17910.5, 17915 or 17917 of the Code. (These Sections provide the procedures for issuance of a fictitious business name.)
5. Is the name formerly used by a licensee whose license has since been revoked.

Reference:
Real Estate Law Book, Section 10159.5 and Regulation 2731

9. Is the broker providing the Real Estate Transfer Disclosure Statement?
Correct Procedure:

The obligation to prepare and deliver the Real Estate Transfer Disclosure Statement (TDS) to the prospective buyer is imposed upon the seller and the seller's broker and any broker acting in cooperation with the seller's broker. If more than one broker is involved in the transaction, the broker obtaining the offer is required to deliver the TDS to the prospective buyer, unless instructed otherwise by the seller.

The TDS must be given to the prospective buyer as soon as practicable before the transfer of title, or, in the case of a lease option, sales contract, or ground lease, before the execution of the contract. If the TDS or amended TDS is delivered after the execution of an offer to purchase, the buyer has three days after delivery in person, or five days after delivery by deposit in the mail, to terminate the offer by delivering a written notice of termination to the seller or to the seller's broker.

In addition, the listing broker and the selling broker each have the duty to conduct a reasonably competent and diligent visual inspection of the property and to disclose to a prospective buyer all material facts affecting the value or desirability of the property that an investigation would reveal.

Reference:
Civil Code Sections 1102 et seq. and 2079
Real Estate Law Book, Section 10176.5

10. Is the broker maintaining pest control documentation?
Correct Procedure:

In a real estate transaction subject to the provisions of Section 1099 of the Civil Code, the real estate broker acting as agent for the seller in the transaction shall effect delivery of the inspection report, certification and the notice of work completed, if any, to the transferee in accordance with said section.

If more than one real estate broker licensee is acting as an agent of the transferor in the transaction, the broker who has obtained the offer made by the transferee shall effect delivery of the required documents to the transferee unless the transferor has given written directions to another real estate broker licensee acting as agent of the transferor in the transaction to effect delivery.

If the agent cannot obtain the required documents to deliver to the transferee and does not have written assurance from the transferee that all of said documents have been received, the agent shall advise the transferee in writing of the transferee's rights under Section 1099.

The broker shall maintain a record of the action taken to effect compliance with this regulation in accordance with Section 10148 of the Business and Professions Code.

Section 1099 of the Civil Code sets forth the requirements for delivery of a Structural Pest Control Inspection Report and any Notice of Work Completed, if certification or preparation of a report is a condition of the contract effecting transfer, or is a requirement imposed as a condition of financing.

Reference:
Civil Code Section 1099
Real Estate Law Book, Regulation 2905

11. Is the broker conducting escrows?

Correct Procedure:

Section 17006(a)(4) of the Financial Code exempts a licensed broker from the Escrow Law when the broker is performing acts in the course of or incidental to a real estate transaction in which the broker is an agent or a party to the transaction and in which the broker is performing an act for which a real estate license is required. The exemption is personal to the broker and the broker shall not delegate any duties other than duties performed under the direct supervision of the broker.

The broker's exemption provided for above is not available for any arrangement entered into for the purpose of performing escrows for more than one business.

Section 17403.4 of the Financial Code requires all written escrow instructions executed by a buyer or seller to contain a statement in not less than 10-point type which shall include the license name and the name of the department issuing the license or authority under which the person is operating. This section does not apply to supplemental escrow instructions or modifications to escrow instructions.

Real Estate Commissioner's Regulation 2950 sets forth acts which are prohibited and may be grounds for disciplinary action:

(a) Soliciting or accepting an escrow instruction (or amended or supplemental escrow instruction) containing any blank to be filled in after signing or initialing of such escrow instruction (or amended or supplemental escrow instruction).

(b) Permitting any person to make any addition to, deletion from, or alteration of an escrow instruction (or amended or supplemental escrow instruction) received by such licensee, unless such addition, deletion or alteration is signed or initialed by all persons who had signed or initialed such escrow instruction (or amended or supplemental escrow instruction) prior to such addition, deletion or alteration.

(c) Failing to deliver at the time of execution of any escrow instruction or amended or supplemental escrow instruction a copy thereof to all persons executing the same.

(d) Failing to maintain books, records and accounts in accordance with accepted principles of accounting and good business practice.

(e) Failing to maintain the office, place of books, records, accounts, safes, files and papers relating to such escrows freely accessible and available for audit, inspection and examination by the Commissioner.

(f) Failing to deposit all money received as an escrow agent and as part of an escrow transaction in a bank trust account, or escrow account on or before the close of the next full working day after receipt thereof.

(g) Withdrawing or paying out any money deposited in such trustee account or escrow account without the written instruction of the party or parties paying the money into escrow.

(h) Failing to advise all parties in writing if he/she has knowledge that any licensee acting as such in the transaction has any interest as a stockholder, officer, partner or owner of the agency holding the escrow.

(i) Failing upon closing of an escrow transaction to render to each principal in the transaction a written statement of all receipts and disbursements together with the name of the person to whom any such disbursement is made.

(j) Delivering or recording any instrument which purportedly transfers a party's title or interest in or to real property without first obtaining the written consent of that party to the delivery or recording.

Reference:
Financial Code Sections 17006(a)(4) and 17403.4
Real Estate Law Book, Regulation 2950

SECTION 2 - Trust Fund Handling

Trust Fund Handling Questionnaire

1. Is the bank account used for trust fund handling in the name of the broker as trustee?
2. Is the bank account used for trust fund handling an interest-bearing account?
3. Are control records complete and accurate?
4. Are the separate transaction records complete and accurate?
5. Is monthly reconciliation of the control records and separate records performed and documented?
6. Are trust funds deposited in a timely manner?
7. Are authorized signatories either employed by the broker and licensed or unlicensed but bonded?
8. Are broker's funds commingled with trust funds?

1. **Is the bank account used for trust fund handling in the name of the broker as trustee?**
   Correct Procedure:

   1. If broker holds an individual broker's license, the account should be set up in his or her name or in the name of a fictitious business name if the broker is the holder of a license bearing such fictitious name and designated a "Trust Account."

      For example:

      John Doe Trust Account
      or
      Jane Doe Trust Account

      or, assuming broker has registered dba of 25th Century Realty:

      25th Century Realty Trust Account

   2. If broker is a corporate broker licensee, the account should be set up in the corporation's name or in the name of a fictitious business name if the corporate broker is the holder of a license bearing such fictitious name and designated a "Trust Account."

      For example:

      ABC, Inc. Trust Account

      or, assuming corporate broker has registered dba of ABC Realty:

      ABC Realty Trust Account

   Reference:
   Real Estate Law Book, Regulation 2832

2. **Is the bank account used for trust fund handling an interest-bearing account?**
   Correct Procedure:

   Trust funds may, at the request of the owner of the funds, be placed into an interest-bearing account at a bank or savings and loan association if the following requirements are met:

   1. The account is in the name of the broker as trustee for the specified beneficiary or principal of a transaction or series of transactions.
   2. All of the funds in the account are covered by insurance provided by an agency of the federal government.
   3. The funds in the account are kept separate, distinct, and apart from funds belonging to the broker or to any other person for whom the broker holds funds in trust.
   4. The broker discloses to the beneficiary of the funds the nature of the account, how interest will be calculated and paid under various circumstances, whether

service charges will be paid to the depository and by whom, and the possible penalty for withdrawals.

5. No interest earned on the funds shall inure directly or indirectly to the benefit of the broker nor to any person licensed to the broker.
6. In an executory sale, lease, or loan transaction in which the broker accepts funds in trust to be applied to the purchase, lease, or loan, the parties to the contract shall have specified in the contract or by collateral written agreement the person to whom interest earned on the funds is to be paid or credited.

It should be noted that this would require the broker to maintain a separate bank account for each beneficiary who wishes to earn interest.

Reference:
Real Estate Law Book, Section 10145(d)(1)-(6)

3. Are control records complete and accurate?

Correct Procedure:

Every broker shall keep a record of all trust funds received, including

uncashed checks.

1. If a broker does not maintain a trust account or maintains a trust account but forwards all trust funds received to either the escrow or to the owner of the funds, then he/she must maintain a Record of Trust Funds Received but not Deposited to the Trust Fund Bank Account (for example, DRE Form RE 4524). This record should show the following in chronological sequence:
   a. Date funds received.
   b. Form of payment.
   c. Amount received and from whom received.
   d. Description of property or other identification.
   e. Identity as to whom funds were forwarded.
   f. Date of disposition.

   However, a broker is not required to keep the above records of passing through checks made payable to service providers (e.g., escrow, credit and appraisal services) when the total of such checks from any one principal for any transaction does not exceed $1,000. Upon request of the Department or the maker of such checks, a broker shall account for the receipt and distribution of such checks. A broker shall retain for three years copies of receipts issued or obtained in connection with the receipt and distribution of such checks.
2. If a broker does maintain a trust account, he/she must maintain a Columnar Record of all Trust Funds Received and Paid Out of the Trust Fund Bank Account (for example, DRE Form RE 4522). This record should show the following in chronological sequence:
   a. Date funds received.

b. From whom funds received.

c. Amount received.

d. Date of deposit.

e. Check number and date of related disbursement.

f. Daily balance of trust bank account.

Reference: Real Estate Law Book, Regulation 2831

4. Are the separate transaction records complete and accurate?
Correct Procedure:

Brokers must maintain a Separate Record for Each Beneficiary or Transaction (for example, DRE Form RE 4523). This record accounts for the funds received from, or for the account of, each beneficiary or each transaction and deposited to the trust fund bank account. These records are necessary for the broker to ascertain the total owed to each of the beneficiaries. The record should show in chronological sequence the following:

1. Date of deposit.
2. Amount of deposit.
3. Date of each related disbursement.
4. Check number of each related disbursement.
5. Amount of each related disbursement.
6. If applicable, dates and amounts of interest earned and credited to the account.
7. Balance after posting transactions on any date.

Reference:
Real Estate Law Book, Regulation 2831.1

5. Is monthly reconciliation of the control records and separate records performed and documented?
Correct Procedure:

The balance of all separate beneficiary or transaction records (for example, DRE Form RE 4523) must be reconciled with the record of all trust funds received and disbursed (for example, DRE Form RE 4522) at least once a month. A record of reconciliation must be maintained and it must identify the following:

1. Bank account name.
2. Account number.
3. Date of reconciliation.
4. Name of beneficiary.
5. Trust fund liabilities of the broker to each beneficiary.

For example:

ABC Realty, Inc. Trust Account
0339-000011
5/31/99

Balances per Separate Beneficiary Records:	
Jones	$500.00
Smith	$250.00
Thompson	$100.00
Total of Separate Records	$850.00
Balance per Record of All Trust Funds Received:	$850.00
Difference (if any, should be fully explained)	$0.00

Reference:
Real Estate Law Book, Regulation 2831.2

6. **Are trust funds deposited in a timely manner?**
Correct Procedure:

Unless otherwise specified in writing by the beneficiary of the funds, a broker is required to do one of the following three things with trust funds no later than three business days following receipt of the funds by the broker or the broker's salesperson:

1. Deposit the funds into a neutral escrow depository.
2. Place funds accepted on behalf of the owner into the hands of the owner of the funds.
3. Deposit the funds into a trust fund bank account maintained by the broker.

When broker is handling escrow funds:

A real estate broker who is not licensed under the Escrow Law (Section 17000 et seq. of the Financial Code), when acting in the capacity of an escrow holder in a real estate transaction in which the broker is performing acts for which a real estate license is required, shall place all funds accepted on behalf of another into one of the three places listed above **not later than the next business day** following receipt of the funds by the broker or the broker's salesperson.

Reference:
Real Estate Law Book, Regulation 2832

7. **Are authorized signatories either employed by the broker and licensed or unlicensed but bonded?**

Correct Procedure:

Withdrawals may be made from the trust account only upon the signature of the broker or one or more of the following persons with written authorization from the broker:

1. A salesperson licensed to the broker.
2. A person licensed as a broker who has entered into a written agreement with the employing broker.
3. An unlicensed employee of the broker with fidelity bond coverage at least equal to the maximum amount of trust funds to which the employee would have access.

Withdrawals may be made from the trust account of a corporate broker only upon the signature of an officer through whom the corporation is licensed or one of the persons detailed above. The corporate broker should always be a signatory on the trust account.

Concerning an unlicensed employee with fidelity bond coverage, it is recommended that the fidelity bond specifically identify the trust account which is being covered. The fidelity bond must not include a deductible clause.

Reference:
Real Estate Law Book, Regulation 2834

8. Are broker's funds commingled with trust funds?
Correct Procedure:

Funds belonging to a broker should not be commingled with trust funds. Common examples of commingling are:

- personal or company funds deposited into the trust fund bank account;
- trust funds deposited into the general or personal bank account; and
- funds collected on real property wholly owned by the broker handled through the trust account.

A broker, however, is allowed to maintain up to $200 of personal funds in a trust account to cover checking account service fees and other bank charges.

Commissions, fees, other income earned by a broker, and funds belonging in part to the broker's principal and in part to the broker when it is not reasonably practicable to separate such funds, must be withdrawn from the trust account within 25 days from the date of deposit.

Reference:
Real Estate Law Book, Section 10176(e); Regulation 2835

Frequently Asked Questions
Mortgage Loan Brokering in California

RE 50 (Revised January 2002)

Published by the California Department of Real Estate, Mortgage Lending Section

The purpose of this informational pamphlet is to provide answers to some of the most frequently asked questions regarding licensing and other related issues for those who are interested in some aspect of the mortgage business in California. Questions come from both licensees and non-licensees from other states and California expressing an interest in California licensing requirements to engage in mortgage activity. The following questions and answers are intended to answer many, but by no means all, of these inquiries from the standpoint of the Department of Real Estate requirements.

Q. As a mortgage broker in Kansas (or any other state), my plan is to move to California and pursue this same business. Does California issue mortgage broker licenses and is there any reciprocity in licensing with other states?

A. California does not issue a "mortgage broker" license. A majority of those engaged in mortgage loan brokering do so with a real estate broker license. To the surprise of some, the license that allows the listing and sale of real property (the traditional activities associated with a real estate broker license) is the same license that allows the solicitation of borrowers or lenders, the negotiation of loans secured by real property and the collection of payments on notes secured by real property. For further details concerning the definition of licensed activity, review Business and Professions Code Sections 10130 and 10131.

It should be noted there are other licenses that allow mortgage loan brokering under a limited set of circumstances, such as the California finance license and the residential mortgage lending license. For information about these licenses contact the California Department of Corporations. (See addresses at end of pamphlet.)

California does not have reciprocity with any other state as far as a real estate license is concerned. Information regarding obtaining either an individual or corporation real estate broker license is explained in a booklet titled **Instructions to License Applicants**. The booklet is available at any Department of Real Estate office, the locations of which are listed at the end of this pamphlet and on the DRE Web site **www.dre.ca.gov**.

Q. As a mortgage broker working outside of California, I occasionally have clients who are moving to California and have asked me to broker a loan for them to be secured by their new home. Although I am not licensed in California, can I broker a loan secured by California real estate? Does California have a rule that allows me to broker a small number of loans in California before I would have to be licensed?

A. No. To broker even one loan in California you need to be licensed here. However, California Real Estate Law does allow a California broker to share a commission with a broker from another state. Therefore, it may be possible to co-broker the loan with a licensed California broker.

Q. I am a licensed California real estate broker and I specialize in the sale of real property, primarily residential homes. I would like to branch out and engage in mortgage brokering. What additional licensing must be obtained?

A. As a licensed real estate broker, you may engage in mortgage brokering without any additional license. A real estate broker may engage in a variety of real estate related activities including residential home sales, mortgage brokerage, and property management, among others. You may, however, wish to consult with the Department of Housing and Urban Development to determine their rules regarding real estate sales and the arranging of FHA loans. Additionally, if you represent a buyer or seller in a real estate transaction, and will also be compensated for obtaining the loan for the buyer, Commissioner's Regulation 2904 requires you to disclose, to all parties in the transaction, the form, amount, and source of the compensation received or expected for the loan.

Q. Another broker told me that the kind and volume of mortgage brokerage activity I engage in makes me a "threshold" broker. What does that mean?

A. Determining whether a broker meets the "threshold" criteria takes a careful reading of Section 10232 of the Business and Professions Code. Generally, the criteria is met by brokers who arrange, sell, or service "private investor" or "private lender" loans, sometimes referred to as "hard money" loans. The "threshold" criteria is satisfied by negotiating 10 or more loans or sales of notes or real property sales contracts in any 12-month period in an aggregate amount of more than $1,000,000 (all of which were funded or purchased by private investors or small pension trusts).

A broker can also meet the "threshold" criteria by servicing loans on behalf of investors or on behalf of obligors. If the aggregate amount of payments collected is $250,000 in any 12-month period, the "threshold" criteria has been met. Included in the $250,000 aggregate is any amount the broker collects on loan payoffs. Brokers who collect payments on behalf of obligors are typically those who collect payments from homeowners on a bi-weekly mortgage payment plan.

Within 30 days of meeting the "threshold" criteria, a broker is required to submit a Threshold Notification (RE 853) to the Department. The notification form is available at any DRE office or may be downloaded from the DRE Web site at www.dre.ca.gov.

Q. Once I've submitted a notification (RE 853) to the Department advising of my "threshold status," what happens next?

A. After receipt of the "threshold" notification, the Department sends the broker information and necessary documents for required quarterly and annual reporting to the Department and adds the broker to the "threshold" list. The Department then tracks and records each required report from the broker.

Q. What kind of reporting requirements are necessary if I satisfy the "threshold" criteria?

A. "Threshold" brokers make quarterly and annual reports to the Department on their trust fund bank accounts and an annual report on their business activities. Except for the annual trust fund report (which is done by a public accountant per instructions from the Department), the Department provides the necessary forms for the quarterly trust account and annual business

activity reports. These are provided to the broker upon receipt of the "threshold" notification form.

Q. I am a broker who arranges loans for, and sells notes to, private investors and small pension trusts. May I also borrow personally from any of these investors?

A. Yes. However, these "self-dealing" loans are highly scrutinized and require notice to DRE before the transaction is completed. Before a broker, or salesperson acting on behalf of a broker, solicits and accepts funds for the direct or indirect use or benefit of the broker, the broker must submit to DRE a true copy of the Lender/Purchaser Disclosure Statement (**RE 851**) prior to obtaining the signature of the investor/purchaser. The **RE 851** must be accompanied by the broker's statement that the submittal is being made pursuant to Business and Professions Code Section 10231.2. While the broker need not wait for DRE's approval of the transaction, the Lender/Purchaser Disclosure Statement must be presented to the investor/lender not less than 24 hours prior to that person becoming obligated to make the loan or purchase the note. The Lender/Purchaser Disclosure Statement must also give a detailed explanation of the intended use of the funds, including an explanation of the nature and extent of the benefits to be derived directly or indirectly by the broker. It is very important to understand that "self-dealing" is not permitted in multiple investor (fractionalized) transactions except under the limited circumstances set forth in Business and Professions Code Section 10229(d)(1).

Q. When engaged in mortgage loan brokering, are there any special trust fund record keeping requirements?

A. Yes. In addition to the trust fund record keeping requirements of the Business and Professions Code that apply to all real estate brokers, mortgage brokers must also maintain quarterly trust fund reconciliations of their trust account on special forms available from the Department. These forms are completed, maintained in the broker's office, and made available upon request to a Department representative for review. The quarterly reconciliation forms, **RE 855** and **RE 856**, can be downloaded from the DRE Web site **www.dre.ca.gov**.

Q. Are there specific disclosure statements that must be used by a real estate broker in the mortgage business?

A. Every real estate broker who negotiates a loan to be secured directly or collaterally by a lien on real property shall, within three business days after receipt of a completed written loan application or before the borrower becomes obligated on the note, whichever is earlier, cause to be delivered to the borrower a statement in writing (borrower's disclosure statement), containing all the salient features of the loan to be negotiated by the broker. The statement must be personally signed by the borrower and by the real estate broker negotiating the loan or by a real estate licensee acting for the broker in negotiating the loan. When so executed, an exact copy thereof shall be delivered to the borrower at the time of its execution.

A federal Good Faith Estimate (GFE) may also be required in a loan transaction under the Real Estate Settlement Procedures Act (RESPA). The GFE may contain some similar disclosures but it cannot, without modification pursuant to Business and Professions Code Section 10240(c), be a substitute for the disclosure statement required by state law. The state disclosure statement is called the Mortgage Loan Disclosure Statement (MLDS). If a GFE is necessary in the loan transaction, the Department has available a Mortgage Loan Disclosure Statement/Good Faith

Estimate (MLDS/GFE). The MLDS/GFE satisfies the state disclosure requirement and the federal GFE requirement.

In addition to a disclosure statement for the borrower in a loan transaction, there are lender disclosure statements that a broker may be required to use. Unlike the MLDS or MLDS/GFE which must be provided to a borrower in virtually every loan transaction, the disclosure statement for a lender/investor is limited to private and small pension trust lenders/investors. Lenders/investors such as banks, savings and loan associations, credit unions, and a variety of others need not receive the lender/investor disclosure statement which is called the Lender/Purchaser Disclosure Statement (LPDS).

Every real estate broker, in making a solicitation to a private investor and in negotiating with that investor to make a loan secured by real property or to purchase a real property sales contract or a note secured by a deed of trust, is required to deliver to the investor solicited the applicable completed statement as early as practicable before he or she becomes obligated to purchase or make the loan. The statement shall be signed by the prospective lender or purchaser and by the real estate broker, or by a real estate salesperson licensed to the broker, on the broker's behalf. When so executed, an exact copy shall be given to the prospective lender or purchaser. The Department has available three versions of the LPDS, depending on the type of transaction. There are statements for loan origination, sale of an existing note and one for a collateralized loan. Please note that collateralized loans are not permitted in multi-lender transactions.

Q. Are there specific rules or laws that pertain to advertising by real estate brokers engaging in mortgage activity?

A. Yes. The law states, in part, that:

> "No real estate licensee shall knowingly advertise, print, display, publish, distribute, telecast or broadcast, or cause or permit to be advertised, printed, displayed, published, distributed, televised or broadcast, in any manner any statement or representation with regard to the rates, terms, or conditions for making, purchasing or negotiating loans or real property sales contracts which is false, misleading or deceptive."

To assist licensees in complying with the law, Commissioner's Regulation 2848 sets forth sixteen (16) subsections of "don'ts" of mortgage loan advertising. A copy of this advertising regulation is available from the Mortgage Loan Section in Sacramento. The regulation is also contained in the **Real Estate Law** book available on the DRE Website **www.dre.ca.gov** or for purchase at any DRE office or **by mail** from the Sacramento Office.

Q. What about those who advertise from outside of California via the Internet?

A. Advertising real estate services on the Internet, including mortgage loan services, is considered solicitation of a California resident when read by a resident of California. Either the out-of-state advertiser on the Internet must be properly licensed in California or the ad must contain a disclaimer to the effect that the ad is not valid in California. The Department has prepared information regarding Internet advertising which is available from any Department district office and is partially reproduced here:

Internet Advertising

These guidelines have been prepared by the California Department of Real Estate to assist real estate brokers and businesses that are **not licensed in California** who are considering advertising real estate services on the Internet.

If you are not properly licensed in California, you may not solicit California residents. To do so would be considered conducting activity for which a real estate license is required. Because the Internet can be read by anyone in any location, advertising your services on the Internet would be considered soliciting a California resident when read by a resident of this state.

If you conduct activity which requires a California real estate license, but you are not a California licensee, you could be subject to administrative sanction such as a Desist and Refrain Order.

If you are now conducting, or plan to conduct, the above activity in California, you need to apply for a real estate broker license. To obtain information on becoming licensed in California, you may contact the Licensing Section of the California Department of Real Estate at 2201 Broadway, Sacramento, California 95818, Telephone 916-227-0931. Information is also available on the DRE Web site **www.dre.ca.gov**.

If you don't plan to become licensed in California, you should make sure your Internet advertising contains a disclaimer such as the following: "Notice: This offer is valid only in State 1, State 2..." (states wherein you are licensed or authorized to do business). If you are licensed in numerous states, you may want the disclaimer to read: "Notice: This offer is not valid in State 1, State 2..." (states in which you are not licensed or authorized to do business).

Q. Are there some advertising violations that are more often encountered than others?

A. Yes. Some of the more common advertising violations are:

- Using terms in a comparative or superlative degree to describe any aspect of the business or any terms applicable to loans negotiated by the broker, without setting forth in the ad additional information to render the superlative or comparative terms unambiguous in the context in which they are used. For example, a broker who advertises "FAST LOANS" must also set forth in the ad how "fast is fast" (e.g. "most loans closed in 90 days from application"). A broker who advertises "LOW RATES" should also set forth in the ad what rates are available so that the term "LOW" is actually defined. It should be noted that the Department may require the broker to substantiate any claims made in an ad or require additional qualifiers in the ad to ensure the ad is not misleading to the public.

- Advertising a specific payment for a loan without including in the ad an equally prominent disclosure of the loan's interest rate, APR, principal amount, number, amount and period of payments scheduled to maturity and the balance due at maturity if not a fully amortized loan.

- Advertising an interest rate without disclosing whether the rate is for first mortgages, junior loans or both.

- Advertising a loan program with special qualifying restrictions or special requirements without setting forth those requirements or restrictions in the ad.

- Advertising an interest rate without an equally prominent disclosure of the APR. It should be noted that if a rate appears in an ad without an APR, a disclosure of "APR NOT CALCULATED" is **not** sufficient. An APR must be disclosed if a rate appears in the ad.

In addition to the above examples, which are based on specific subsections of the regulation, phrases and words used in advertising can be misleading in themselves. "No Cost" loans and "No Fee" loans are such words. All real property secured loans have certain inherent costs, such as title insurance, escrow, appraisal, recording fees, etc. These services are bought and paid for by the borrower in all loan transactions. In the cases where a broker arranges a premium priced loan where a lender rebate is used to pay for these services, the services are still performed and the costs incurred. The borrower pays the costs of the services via a higher interest rate than would be available if the borrower paid for the services out-of-pocket. In effect, the borrower finances the closing costs over the entire life of the loan. Although there may be no out-of-pocket costs to the borrower, clearly there are fees and costs involved, contrary to the claims in these ads.

Q. I understand something called the "multi-lender rule" was transferred from the California Department of Corporations to the Department of Real Estate. What is this and how may I as a mortgage broker be affected?

A. The Department of Corporations enforces the state securities laws which require that any security in an issuer transaction be qualified prior to sale with certain exemptions. Such an exemption was the "multi-lender rule" (Section 260.105.30) which permitted the sale of interests in notes secured by real property to not more than 10 persons as defined. This "rule" was legislatively transferred by Assembly Bill 754 (Kuykendall) to the Department of Real Estate as Section 10229 of the Business and Professions Code.

Any real estate broker (mortgage broker) involved in loan transactions secured by real property where the investors number 10 or less, but more than one, known as fractionalized notes, must notify the Department of Real Estate of the engagement in "multi-lender" activity. Any broker who arranges, sells or services such fractionalized notes must file a Multi-Lender Transaction Notice (**RE 860**) with the Department within 30 days of the first such transaction. Quarterly, CPA-prepared reports must be filed by any broker who acts as the servicing agent for such notes where the payments due during any period of three consecutive months exceeds $125,000, or the number of persons entitled to payments exceeds 120. The quarterly reports are in addition to the "threshold reports" previously discussed. Section 10229 is very detailed and should be carefully reviewed before becoming involved in multi-lender transactions.

Q. As a mortgage broker, can I collect fees from a borrower to cover certain costs in a loan transaction when a loan application is taken, such as a fee to cover my expenses in processing the application or fees for credit report and appraisal?

A. Fees that are collected by the broker from a borrower prior to the services being rendered are defined as "advance fees." To preclude the inappropriate use of such fees, a broker can only collect "advance fees" if the contract or agreement to do so has been submitted to and approved by the Department in advance of use. This agreement specifically tells a borrower how the "advance fees" are to be used by the broker. The broker must also maintain all "advance fees" in a trust fund bank account and they must be expended only on behalf of the borrower. In addition, whatever other materials the broker might use in collecting "advance fees" must also be submitted to the Department, prior to use, for review and approval.

Credit report and appraisal fees, although technically "advance fees" are not considered as such and may be collected without adhering to the prescribed advance fee procedures. These fees are invariably passed to third parties performing the services. They must, however, be maintained in a trust fund bank account and expended appropriately. A broker may not profit from the collection of credit report and appraisal fees. If actual costs are less than collected, the excess must be refunded to the borrower.

Q. I am not licensed as a real estate broker or real estate salesperson and I am only going to assist private parties who wish to sell their notes (secured by real property) for cash to another party (investor), perhaps in another state. Is a real estate license required if I conduct this activity in California?

A. The activity described, so-called note brokering, requires a real estate license if performed in California. This includes the solicitation of California note owners, whether in person, by mail, telephone, or other means of communication. One of the definitions of a real estate broker is:

> "...a person who, for a compensation or in expectation of a compensation, regardless of the form or time of payment, does or negotiates to do one or more of the following acts for another or others:
>
> > ...(e) Sells or offers to sell, buys or offers to buy, or exchanges or offers to exchange a real property sales contract, or a promissory note secured directly or collaterally by a lien on real property or on a business opportunity, and performs services for the holders thereof."

There are companies engaged in the discounted purchase of certain mortgages, primarily those carried back by residential sellers and secured by the transferred real property. The companies hold seminars to recruit people to solicit and negotiate the sale of these mortgages. Seminar attendees are informed that they do not need a real estate license to engage in this activity. In California, this is wrong because the activity fits the definition quoted above.

Q. Is a real estate licensee in the mortgage business required to show any specific disclosure of his or her license status in an ad?

A. All California real estate licensees, when acting as such, must disclose licensure in advertising. For a broker engaged in mortgage loan activity, the following also applies:

> "No real estate licensee shall place an advertisement disseminated primarily in this state for a loan unless there is disclosed within the printed text of that

advertisement, or the oral text in the case of a radio or television advertisement, the license under which the loan would be made or arranged."

A real estate broker must include one of the following disclosures in any mortgage loan advertising:

"Real estate broker, California Department of Real Estate" or "California Department of Real Estate, real estate broker." The words "California" and "Department" may be abbreviated as "CA", "CAL" or "CALIF" and "DEPT."

In addition to the license and licensing department identifiers, mortgage brokers must include their 8 digit broker license identification number in the ad.

In the borrower and lender/purchaser disclosure statements (MLDS and LPDS), a broker must disclose the license identification number **and** the information telephone number established by the Department that a consumer can call to inquire about the license status of the broker.

Q. Has there been a change in the retention period that brokers are required to keep records?

A. The general rule is that brokers are required to keep records for a three-year period. However, pursuant to Business and Professions Code §10229(e)(1),the investor qualification statement required on a multi-lender loan has a four-year retention period requirement. Also, self-dealing statements, pursuant to Business and Professions Code §10231.2(b), must be retained for four years by the broker.

Real estate brokers are not only affected by laws and regulations enforced by the Department of Real Estate, but also many others at both the state and federal level. The foregoing questions and answers are based on the California Business and Professions Code and the Regulations of the Real Estate Commissioner. Real estate brokers should be familiar with the other laws affecting their business. In this regard, they may receive assistance from other enforcement agencies, private legal advisors, and/or professional trade organizations.

EXCERPTS FROM BUSINESS AND PROFESSIONS CODE

Section 10176. The commissioner may, upon his own motion, and shall, upon the verified complaint in writing of any person, investigate the actions of any person engaged in the business or acting in the capacity of a real estate licensee within this state, and he may temporarily suspend or permanently revoke a real estate license at any time where the licensee, while a real estate licensee, in performing or attempting to perform any of the acts within the scope of this chapter has been guilty of any of the following:

(a) Making any substantial misrepresentation.

(b) Making any false promises of a character likely to influence, persuade or induce.

(c) A continued and flagrant course of misrepresentation or making of false promises through real estate agents or salesmen.

(d) Acting for more than one party in a transaction without the knowledge or consent of all parties thereto.

(e) Commingling with his own money or property the money or other property of others which is received and held by him.

(f) Claiming, demanding, or receiving a fee, compensation or commission under any exclusive agreement authorizing or employing a licensee to perform any acts set forth in Section 10131 for compensation or commission where such agreement does not contain a definite, specified date of final and complete termination.

(g) The claiming or taking by a licensee of any secret or undisclosed amount of compensation, commission or profit or the failure of a licensee to reveal to the employer of such licensee the full amount of such licensee's compensation, commission or profit under any agreement authorizing or employing such licensee to do any acts for which a license is required under this chapter for compensation or commission prior to or coincident with the signing of an agreement evidencing the meeting of the minds of the contracting parties, regardless of the form of such agreement, whether evidenced by documents in an escrow or by any other or different procedure.

(h) The use by a licensee of any provision allowing the licensee an option to purchase in an agreement authorizing or employing such licensee to sell, buy, or exchange real estate or a business opportunity for compensation or commission, except when such licensee prior to or coincident with election to exercise such option to purchase reveals in writing to the employer the full amount of licensee's profit and obtains the written consent of the employer approving the amount of such profit.

(i) Any other conduct, whether of the same or a different character than specified in this section, which constitutes fraud or dishonest dealing.

(j) Obtaining the signature of a prospective purchaser to an agreement which provides that such prospective purchaser shall either transact the purchasing, leasing, renting or exchanging of a business opportunity property through the broker obtaining such signature, or pay a compensation to such broker if such property is purchased, leased, rented or exchanged without the broker first having obtained the written authorization of the owner of the property concerned to offer such property for sale, lease, exchange or rent.

Section 10177. The commissioner may suspend or revoke the license of a real estate licensee, or may deny the issuance of a license to an applicant, who has done any of the following, or may suspend or revoke the license of a corporation, or deny the issuance of a license to a corporation, if an officer, director, or person owning or controlling 10 percent or more of the corporation's stock has done any of the following:

(a) Procured, or attempted to procure, a real estate license or license renewal, for himself or herself or any salesperson, by fraud, misrepresentation, or deceit, or by making any material misstatement of fact in an application for a real estate license, license renewal, or reinstatement.

(b) Entered a plea of guilty or nolo contendere to, or been found guilty of, or been convicted of, a felony or a crime involving moral turpitude, and the time for appeal has elapsed or the judgment of conviction has been affirmed on appeal, irrespective of an order granting probation following that conviction, suspending the imposition of sentence, or of a subsequent order under Section 1203.4 of the Penal Code allowing that licensee to withdraw his or her plea of guilty and to enter a plea of not guilty, or dismissing the accusation or information.

(c) Knowingly authorized, directed, connived at, or aided in the publication, advertisement, distribution, or circulation of any material false statement or representation concerning his or her business, or any business opportunity or any land or subdivision (as defined in Chapter 1 (commencing with Section 11000) of Part 2) offered for sale.

(d) Willfully disregarded or violated the Real Estate Law (Part 1 (commencing with Section 10000)) or Chapter 1 (commencing with Section 11000) of Part 2 or the rules and regulations of the commissioner for the administration and enforcement of the Real Estate Law and Chapter 1 (commencing with Section 11000) of Part 2.

(e) Willfully used the term "realtor" or any trade name or insignia of membership in any real estate organization of which the licensee is not a member.

(f) Acted or conducted himself or herself in a manner that would have warranted the denial of his or her application for a real estate license, or has either had a license denied or had a license issued by another agency of this state, another state, or the federal government revoked or suspended for acts that, if done by a real estate licensee, would be grounds for the suspension or revocation of a California real estate license, if the action of denial, revocation, or suspension by the other agency or entity was taken only after giving the licensee or applicant fair notice of the charges, an opportunity for a hearing, and other due process protections comparable to the Administrative Procedure Act (Chapter 3.5 (commencing with Section 11340), Chapter 4 (commencing with Section 11370), and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code), and only upon an express finding of a violation of law by the agency or entity.

(g) Demonstrated negligence or incompetence in performing any act for which he or she is required to hold a license.

(h) As a broker licensee, failed to exercise reasonable supervision over the activities of his or her salespersons, or, as the officer designated by a corporate broker licensee, failed to exercise reasonable supervision and control of the activities of the corporation for which a real estate license is required.

(i) Has used his or her employment by a governmental agency in a capacity giving access to records, other than public records, in a manner that violates the confidential nature of the records.

(j) Engaged in any other conduct, whether of the same or a different character than specified in this section, which constitutes fraud or dishonest dealing.

(k) Violated any of the terms, conditions, restrictions, and limitations contained in any order granting a restricted license.

(l) Solicited or induced the sale, lease, or listing for sale or lease of residential property on the ground, wholly or in part, of loss of value, increase in crime, or decline of the quality of the schools due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry, or national origin.

(m) Violated the Franchise Investment Law (Division 5 (commencing with Section 31000) of Title 4 of the Corporations Code) or regulations of the Commissioner of Corporations pertaining thereto.

(n) Violated the Corporate Securities Law of 1968 (Division 1 (commencing with Section 25000) of Title 4 of the Corporations Code) or the regulations of the Commissioner of Corporations pertaining thereto.

(o) Failed to disclose to the buyer of real property, in a transaction in which the licensee is an agent for the buyer, the nature and extent of a licensee's direct or indirect ownership interest in that real property. The direct or indirect ownership interest in the property by a person related to the licensee by blood or marriage, by an entity in which the licensee has an ownership interest, or by any other person with whom the licensee has a special relationship shall be disclosed to the buyer.

(p) Violated Section 10229.

If a real estate broker that is a corporation has not done any of the foregoing acts, either directly or through its employees, agents, officers, directors, or persons owning or controlling 10 percent or more of the corporation's stock, the commissioner may not deny the issuance of a real estate license to, or suspend or revoke the real estate license of, the corporation, provided that any offending officer, director, or stockholder, who has done any of the foregoing acts individually and not on behalf of the corporation, has been completely disassociated from any affiliation or ownership in the corporation.

Section 10177.1. The commissioner may, without a hearing, suspend the license of any person who procured the issuance of the license to himself by fraud, misrepresentation, deceit, or by the making of any material misstatement of fact in his application for such license.

The power of the commissioner under this section to order a suspension of a license shall expire 90 days after the date of issuance of said license and the suspension itself shall remain in effect only until the effective date of a decision of the commissioner after a hearing conducted pursuant to Section 10100 and the provisions of this section.

A statement of issues as defined in Section 11504 of the Government Code shall be filed and served upon the respondent with the order of suspension. Service by certified or registered mail directed to the respondent's current address of record on file with the commissioner shall be effective service.

The respondent shall have 30 days after service of the order of suspension and statement of issues in which to file with the commissioner a written request for hearing on the statement of issues filed against him. The commissioner shall hold a hearing within 30 days after receipt of the request therefor unless the respondent shall request or agree to a continuance thereof. If a hearing is not commenced within 30 days after receipt of the request for hearing or on the date to which continued with the agreement of respondent, or if the decision of the commissioner is not rendered within 30 days after completion of the hearing, the order of suspension shall be vacated and set aside.

A hearing conducted under this section shall in all respects, except as otherwise expressly provided herein, conform to the substantive and procedural provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code applicable to a hearing on a statement of issues.