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Preface

In 2007, CEB published a new edition of our popular California Real Property Sales Transactions (4th ed Cal CEB 2007). During the process of revising and updating the new edition, it became apparent that the existing chapter on real estate brokers, although long and detailed, could potentially be expanded to cover even more law. Thus, the genesis of this new book on California real estate brokers and salespersons is in chapter 2 of the third edition of California Real Property Sales Transactions (3rd ed Cal CEB 1998). We gratefully acknowledge the authors of that chapter, Alice L. Akawie, Lauren M. LaPietra, and W. Stephen Wilson; their work provided the rich groundwork for the chapters of this new book.

Real estate brokerage law is diverse and complex. Every day in California, brokers are involved in transactions ranging from the simple sale of a residence; to the sale and lease of a multi-story office, retail, and residential complex; to the sale and development of raw land for a proposed university, medical center, or vineyard. Brokers also act as property managers, mortgage brokers, and loan modifiers. Counsel for brokers must have knowledge of contract law, agency and fiduciary relationships, Department of Real Estate regulatory practice, errors and omissions liability insurance, employment and housing law, multiple listing services, trade associations, alternative dispute resolution, and trial claims and procedure—and sometimes criminal law. This book is intended as a practical guide for brokers and the lawyers who advise or defend them or litigate against them.

CEB acknowledges and thanks the attorneys and professors who consulted with CEB staff on practice strategies and procedures or reviewed chapters and provided many helpful suggestions to the text. Their names are listed in the Acknowledgments.

CEB plans to update this book on a regular basis. We eagerly solicit your suggestions and comments to help us expand its coverage, address the common issues you handle in practice, keep it accurate, and include the latest developments.

CEB Attorney Editors Kay F. Rubin (Managing Editor) and Janis L. Blanchette and Legal Editors Mary Claugus, Ragnhild Fougner, Philip Weverka, Kenneth Marr, and Carolyn Valley contributed to this book. Administrative support was provided by Nila Kanzaria and Akanke Peyton. Karen Lamoreux handled copyediting and production. Kathryn Te Selle prepared the index. Composition was performed by CEB's Electronic Publishing staff.

July 2010 Update

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Selected Developments

July 2010 Update

Recent Legislation Related to Loan Modifications and Foreclosures:

Senate Bill 36 (2009) brings California's regulation of mortgage loan originators into compliance with the Secure and Fair Enforcement Mortgage Licensing Act of 2008 (SAFE Act) (12 USC 5101-5116), which created a Nationwide Mortgage Licensing System and Registry (NMLS) to license and register residential mortgage lenders throughout the United States. SB 36, among other things, requires all California real estate brokers who originate residential mortgages to register with the NMLS and to obtain a real estate license endorsement from the California Department of Real Estate allowing them to act as a mortgage loan originator by December 1, 2010. See Bus & P C §§10150(c), 10151(e), 10166.01-10117 and §§1.5, 3.46, 5.2, 8.1, 8.3-8.4, 8.24, 8.30, 8.45B, 9.15.

Senate Bill 94 (2009) and AB 260 (2009) amend several existing statutes and add a number of new statutes applicable to loan modifications involving one to four residential units, including:

- New Bus & P C §10147.6 requires brokers involved in residential loan modifications to provide clients with a disclosure notice stating that it is not necessary to pay a third party for loan modification services and that such services are available for free from the federal government. New CC §2944.6 requires anyone involved in residential loan modifications to provide such notice. See §§8.18, 8.20.
- New Bus & P C §10085.6 prohibits brokers involved in residential loan modifications from collecting "advance fees" or a power of attorney from clients. New CC §2944.7 prohibits anyone from collecting such fees or obtaining a power of attorney from clients. Amended Bus & P C §10026 redefines "advance fee" as a fee collected before completion of each and every service a broker has contracted to perform. Amended Bus & P C §10085 provides that the Real Estate Commissioner may require brokers to submit any and all materials used in obtaining advance fee agreements to the DRE. See §§5.2, 8.20, 8.22, 8.45A.
- New subsection Bus & P C §10177(q) provides that the Real Estate Commissioner may suspend or revoke the license of a broker, or may deny the issuance of a license to an applicant, who has violated or failed to comply with certain state and federal statutes relating to mortgages. See §§2.45, 3.67, 9.11.
- New CC §2923.1 provides that a mortgage broker is a fiduciary of its borrower-client. See §§3.17, 4.39.

All persons and entities, including licensed real estate brokers, that service residential mortgage loans on properties located in California are subject to the California Foreclosure Prevention Act (CFPA) (Stats 2009, 2d Extra Sess, ch 4 §3), which regulates the nonjudicial foreclosure process. See §8.20.

The DRE will apply its disciplinary procedures to brokers who act as mortgage loan originators. See 10 Cal Code of Regs §2945.4, discussed in §§8.24, 9.1.

Other Developments

The California Supreme Court ruled that a purported real property sales agreement was actually an option to purchase property because it contained a "free look" provision that provided that the offer would remain open for a fixed time, while giving the buyers the power to either accept the offer or do nothing. *Steiner v Thexton* (2010) 48 C4th 411, 106 CR3d 252, discussed in §2.57.

A court held that an attorney's signature on a stipulation to arbitrate was insufficient to obligate the objecting party to arbitrate the matter. *Toal v Tardif* (2009) 178 CA4th 1208, 101 CR3d 97, discussed in §6.5.

A court reiterated that arbitration provisions in a contract between unequal parties may be found unconscionable. See *Parada v Superior Court* (2009) 176 CA4th 1554, 98 CR3d 743, discussed in §6.28.

The supreme court will review *Tarrant Bell Prop. v Superior Court* (review granted Feb. 18, 2010, S179378; superseded opinion at 179 CA4th 1283, 102 CR3d 235), in which the lower courts denied enforcement of a judicial reference clause due to circumstances related to judicial economy. See §6.48.

A broker who enters into an agreement to provide both services that require a license and services that do not

require a license may seek compensation for the services for which no license is required. See *Venturi & Co. LLC v Pacific Mahlin Dev. Corp.* (2009) 172 CA4th 1417, 92 CR 3rd 123, discussed in §7.10.

The DRE has promulgated regulations concerning the use of the term "escrow" in broker advertisements. See 10 Cal Code of Regs §2731(d), discussed in §§8.4, 8.43.

The DRE's revocation of a broker's license for violations of municipal codes was upheld in *Robbins v Davi* (2009) 175 CA4th 118, 95 CR3d 792. See §9.12.

The Ninth Circuit Court of Appeals has held that an insured who had knowledge of a lawsuit served on its subsidiary must inform its insurer that a claim was made in order to secure coverage. *Evanston Ins. Co. v OEA, Inc.* (9th Cir 2009) 566 F3d 915, discussed in §10.9.

In *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089, a court held that an insured who secured two annual insurance policies without gap could not receive coverage under the later policy for a claim incurred during the term of the first policy. See §§10.4, 10.18, 10.27-10.30, 10.75.

A court determined that since an insured's provision of "professional services" did not extend to the creation of the dangerous condition, the insurer could not apply the professional services exclusion contained in the policy. *Food Pro Int'l, Inc. v Farmers Ins. Exch.* (2008) 169 CA4th 976, 89 CR3d 1, discussed in §§10.39, 10.103, 10.105, 10.128.

Chapter 10 contains new §10.70A covering Ins C §533 and willful acts of the insured.

In *Delgado v Interinsurance Exch. of Auto. Club of S. Cal* (2009) 47 C4th 302, 308 n1, 97 CR3d 298, the California Supreme Court held that an insured need only show that the underlying claim may fall within policy coverage; the insurer must prove it cannot. See §§10.104-10.105, 10.107.

A court has ruled that a self-insured retention clause that required certain acts from the named insured as a precondition to coverage could not be applied to an additional insured. *Forecast Homes, Inc. v Steadfast Ins. Co.* (2010) 181 CA4th 1466, 105 CR3d 200, discussed in §10.119.

Chapter 11 contains new §11.88A covering cross-complaints for indemnity or contribution.

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Cutoff Dates and CEB Citation

Cutoff Dates

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Overview of Real Estate Brokerage

Lawrence H. Jacobson
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I. INTRODUCTION

§1.1 A. What Is a Real Estate Broker?

There may be no license issued by the State of California that allows an individual to engage in more diverse activities than those permitted under a California real estate broker license. A licensed California real estate broker, or a licensed California real estate salesperson working under the supervision of a licensed California broker, may take a listing for and assist in the sale of a single-family residence or a 30-story high-rise office building. A "licensee" (the term used by the California Department of Real Estate (DRE) for both brokers and salespersons) may assist homeowners in refinancing their home or arrange financing for the acquisition of a regional shopping center. A licensee may arrange the sale of a shoe store or an industrial plant worth tens of millions of dollars. A licensee may manage a five-unit apartment house or a commercial office park.

PRACTICE TIP: Although real estate brokers provide a wide variety of services, the individual broker should be careful not to go beyond his or her area of competence. Article 11 of the National Association of Realtors® (NAR) Code of Ethics (see §1.7) provides:

> REALTORS® shall not undertake to provide specialized professional services concerning a type of property or service that is outside their field of competence unless they engage the assistance of one who is competent on such types of property or service, or unless the facts are fully disclosed to the client. Any persons engaged to provide such assistance shall be so identified to the client and their contribution to the assignment should be set forth.

Providing services for which one is not qualified may not be illegal but it may fall below the standard of care. On a broker's standard of care, see §§3.20, 3.48, 11.22, chap 13.

The activities of a licensed real estate broker are defined in Bus & P C §10131. For discussion, see §8.2.

Whether the transaction is large or small, the area of real estate brokerage law is complex and challenging. The best and most effective way of working with or representing real estate brokers is to thoroughly understand how their profession works and what their role in the transaction should be.

Attorneys representing real estate brokers should be thoroughly versed in:

- Contract law (see chap 2);
- Agency law (see chap 3);
- Broker liability law (see chaps 4, 5, 11);
- Alternative dispute resolution (see chap 6, §§7.33-7.48)
- Broker licensing law (see chap 8);
- DRE disciplinary procedures (see chap 9);
- Rules and regulations of the National Association of Realtors® and the California Association of Realtors® (see §§1.6-1.8);
- Rules and regulations of multiple listing services (see §§1.11-1.14);
- Broker error and omission liability insurance issues (see chap 10); and
- Real property sales and secured transactions (see California Real Property Sales Transactions (4th ed Cal CEB 2007).

The broker should understand that he or she should deal within the scope of Bus & P C §10131. Legal counsel should strategize with the broker to provide legal support using a cooperative team approach. Many brokers fear attorney involvement will interfere with a deal, when in reality, competent counsel and able broker together give the best service to the client. See also discussion in §§1.25-1.26.

Unless specifically stated otherwise, references in this book to "real estate broker" or "broker," singular or plural, apply to licensed real estate brokers and salespersons.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.2 B. Qualifications

§1.2 B. Qualifications

In order to qualify to become a California real estate broker the applicant must:

- Be 18 years of age or older (10 Cal Code Regs §2720);
- Pass a written broker examination (for which there are numerous license preparatory courses available) (Bus & P C §10153); and
- Meet one of the following experience requirements:
- Hold a real estate salesperson license for at least 2 years within the 5-year period immediately prior to the date of application;
- Have 2 years of general real estate experience; or
- Graduate from a 4-year college or university with courses specializing in real estate (Bus & P C §§10150.6, 10153.2-10153.5).

An application for a real estate salesperson license is less demanding, requiring completion of only a minimal number of courses at an accredited institution, including schools whose sole purpose is to prepare its students to take the real estate sales exam. See Bus & P C §§10130, 10132. For further discussion of licensing requirements of salespersons, see §8.32.

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§1.3 C. Brokers and Salespersons

It is important to understand the difference between a broker and a salesperson. A salesperson or "real estate agent" works under a supervising broker. See Bus & P C §10032. The listing agreement is entered into with, and the services are performed by, the broker, usually through the salesperson. The listing is a contract with the broker, *not* the salesperson, and the commission is payable to the *broker,* not the salesperson. The broker in turn compensates the salesperson. See §§7.10-7.11.

PRACTICE TIP: It is important at the inception of a broker and salesperson relationship to determine whether the broker has an obligation to pursue a commission on the salesperson's behalf. The California Association of Realtors® (CAR) Independent Contractor Agreement (CAR form ICA) provides that a "Broker is under no obligation to pursue collection of compensation from any person or entity responsible for payment." Thus the salesperson and broker should address the issue in their employment agreement. On documenting the relationship between the broker and salesperson, see §8.42.

If the salesperson transfers his or her license to another broker, the listing stays with the original broker, unless the brokers and the principal agree otherwise.

It is also important to understand the issues involved in the relationship between the broker and the salesperson. A salesperson may be considered an independent contractor for some purposes but an employee for others. For example, the designation of a salesperson as an independent contractor will never insulate the broker from liability for the salesperson's acts within the scope of his or her employment. For a detailed discussion of the relationship between brokers and salespersons, see §§8.32-8.42. On the broker's duty to supervise salespersons, see §§3.56-3.58. On broker's liability for actions of salespersons, see §§11.15-11.17.

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II. APPLICABLE LAW

§1.4 A. Contract Law and Agency Law

The broker-principal relationship is governed by both agency and contract law. Although the broker's right to compensation depends on the existence of a written agreement (CC §1624(a)(4)), an agency relationship may be created without either consideration (CC §2308; *Leno v YMCA* (1971) 17 CA3d 651, 658, 95 CR 96) or a writing (*Steiner v Rowley* (1950) 35 C2d 713, 221 P2d 9). Thus, a broker without an enforceable contractual claim for a commission may still be subject to the fiduciary duties of the principal-agent relationship, the breach of which may render the broker liable for damages (*Steiner v Rowley, supra*) or subject to disciplinary action by the Real Estate Commissioner (*Buckley v Savage* (1960) 184 CA2d 18, 7 CR 328).

On contract law issues governing real estate brokerage, see chap 2. Agency law as applicable to brokers is the subject of chap 3.

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§1.5 B. Regulation of Brokers

The real estate brokerage industry in California is regulated by statute (see Bus & P C §§10000-10580, commonly known as the Real Estate Law) and by administrative regulations adopted by the Real Estate Commissioner (see 10 Cal Code Regs §§2705-2781, 2830.1-3109). The Commissioner, who is appointed by the governor (Bus & P C §10051), is the chief officer of the DRE and is responsible for enforcing the Real Estate Law (Bus & P C §10050). Specifically, the Commissioner is responsible for the licensing and disciplining of real estate professionals.

NOTE: Unlike attorneys, who in California are governed and served by a single entity, the State Bar, which administers licensing and discipline and also acts as a trade association; real estate professionals are governed by the DRE as to licensing and discipline, but they have separate, nongovernmental trade associations at the local, state, and national levels. See §§1.6-1.9.

Effective July 1, 2010, any broker or salesperson who is also a mortgage loan originator must include on their first-point-of-contact materials the identifier assigned by the Nationwide Mortgage Licensing System and Registry (NMLS). Bus & PC §10140.6. For further discussion of the NMLS, see §§3.46, 8.1, 8.24, 8.30, 9.15.

For an in-depth discussion of the regulation of brokers, see chap 8. On broker disciplinary procedures, see chap 9.

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III. TRADE ASSOCIATIONS

§1.6 A. National Association of Realtors®

The National Association of Realtors® (NAR) is the primary national trade association for real estate professionals. Brokers become members by joining a local association of realtors® (sometimes called a board of realtors®), which automatically enrolls them as members of both the state association (the California Association of Realtors® (CAR); see §1.8), and NAR. A list of local associations in all 50 states is available on the NAR website listed in the Directory.

The goals of NAR include providing a facility for education, research, and the exchange of information for those in the real estate business; preserving the right of property ownership in the interest of the public welfare; and promoting and maintaining high standards of conduct in the transaction of the real estate business. NAR Const art II, §§1-2.

By becoming a member of NAR, a broker automatically agrees to be bound by the NAR Code of Ethics (see §1.7, App A) and may use the designation "Realtor®." Laypeople frequently confuse the term "Realtor®" as a synonym for any real estate broker or salesperson. The term "Realtor®" is a registered collective membership mark that identifies a real estate professional who is a member of NAR and subscribes to its Code of Ethics. Only those persons who have become members of NAR and subscribe to the Code of Ethics are allowed to use the designation. Someone who uses the designation "Realtor®" when not entitled to do so is subject to license suspension or revocation (Bus & P C §10177(e)) as well as criminal penalties (Bus & P C §10185).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.7 B. NAR Code of Ethics

§1.7 B. NAR Code of Ethics

The National Association of Realtors® (NAR) Code of Ethics establishes principles regarding the following:

- Loyalty to clients;
- Fiduciary (legal) duty to clients;
- Cooperation with competitors;
- Truthfulness in statements and advertising; and
- Non-interference in exclusive relationships that other Realtors® have with their clients.

A violation of the code exposes the member to discipline by the local association of realtors®. Disciplinary action may be brought by either a member of the public or another broker. It should be remembered, however, that licenses are issued by the California DRE and only DRE may revoke or suspend a license. An association of realtors® does not have the power to do so. The only power available to an association for a violation of the Code of Ethics by one of its members is suspension or expulsion from the association. The suspension or expulsion does not prevent the former member from continuing to work as a real estate broker, only from using the designation "Realtor®." Note that brokers who do not belong to the local, state, or national associations are not governed by the NAR Code of Ethics.

Although a disciplinary proceeding may not directly affect a license, it may indirectly do so. If the local association has adopted the California Code of Ethics and Arbitration Manual (see §1.8), then the following provision of the Manual applies:

> Section 39(x). Final ethics decisions holding members in violation of the Code of Ethics shall be forwarded by the Association to the California Department of Real Estate in instances where there is reason to believe that the "public trust" may have been violated. "Public trust" as used in this subsection refers to demonstrated misappropriation of client or customer funds or property, willful discrimination, or fraud resulting in substantial economic harm.

Thus discipline by the local association may have serious implications that the careful practitioner should consider.

The NAR Code of Ethics may be used by a court to establish standards of practice. Under Evid C §452(h), courts may take judicial notice of relevant criteria promulgated by private professional associations. *Easton v Strassburger* (1984) 152 CA3d 90, 101 n5, 199 CR 383. See also *Pepper v Underwood* (1975) 48 CA3d 698, 714, 122 CR 343, disapproved on other grounds in *Stout v Turney* (1978) 22 C3d 718, 730, 150 CR 637. A copy of the NAR Code of Ethics may be found in Appendix A.

PRACTICE TIP: Because the Code of Ethics may be used to establish a standard of care, and a violation of the Code may have an impact on the determination of a violation of the standard of care in civil litigation (as well as on the broker's reputation), it may be advisable for brokers to be represented by legal counsel in hearings on Code of Ethics violations. On the use of standard of care experts in broker disputes, see chap 13.

For further discussion of whether the NAR Code of Ethics (and other private association standards) establishes custom and practice, see §§3.14-3.16. For discussion of a broker's duties to his or her clients generally, see chap 3.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.8 C. California Association of Realtors

§1.8 C. California Association of Realtors®

The California Association of Realtors® (CAR) provides continuing education for its members, is a strong legislative advocate for the (primarily residential) real estate industry, and generates and encourages the use of standard form agreements. CAR is an active advocate for the real estate profession. CAR's mission statement describes the purpose of the organization as follows:

> to serve its membership in developing and promoting programs and services that will enhance the members' freedom and ability to conduct their individual businesses successfully with integrity and competency, and through collective action, to promote the preservation of real property rights.

The CAR mission statement is available on the CAR website listed in the Directory.

Local associations of realtors® throughout the state (*e.g.,* the Beverly Hills/Greater Los Angeles Association of Realtors®, the San Francisco Association of Realtors®, the Fresno Association of Realtors®, or the San Diego Association of Realtors®) are member associations of CAR. CAR produces a California Code of Ethics and Arbitration Manual as a service to these local member associations. CAR recommends that if local associations want to adopt a different set of rules for the administration of professional standards, or want to change the model provisions, that they obtain review by legal counsel and approval from NAR. The Manual is available on the CAR website listed in the Directory.

For further discussion of CAR procedures for broker versus broker disputes, see §§7.33-7.48. For discussion of arbitration and other alternative dispute resolution procedures in broker versus principal disputes, see chap 6.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.9 D. BOMA and ICSC

§1.9 D. BOMA and ICSC

Brokers who work in the area of commercial real estate tend not to join CAR and NAR but instead join organizations focusing on particular property types, markets, and activities (*e.g.,* the AIR Commercial Real Estate Association (AIREA), the International Council of Shopping Centers (ICSC), and the Building Owners and Managers Association (BOMA)). These organizations provide oversight, education, and advocacy specific to the needs of their members. Further information is available at the AIREA, BOMA, and ICSC websites listed in the Directory.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.10 E. Standard Forms

§1.10 E. Standard Forms

CAR and private companies like Professional Publishing publish a number of residential purchase, sale, and engagement forms for use statewide. In addition, local CAR member associations may produce forms for use in areas with unique features, customs, and local laws.

Commercial brokers generally rely on their clients and their clients' attorneys to provide the necessary documentation and to implement transactions. But AIREA and the larger brokerages tend to have standard forms available for use, particularly for leasing and, of course, engagement.

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IV. MULTIPLE LISTING SERVICES

§1.11 A. Purpose

In addition to being members of various trade associations, brokers and salespersons may join their local or regional multiple listing service (MLS). It is not necessary to belong to CAR or one of its local member associations in order to participate in a multiple listing service. *Marin County Bd. of Realtors, Inc. v Palsson* (1976) 16 C3d 920, 130 CR 1. See §7.29. Local associations generally operate or are otherwise affiliated with these services to disseminate listing information among their members. The California Model MLS Rules, produced by CAR, describe the purpose of an MLS as follows:

> A Multiple Listing Service is a means by which authorized MLS broker participants establish legal relationships with other participants by making a blanket unilateral contractual offer of compensation and cooperation to other broker participants; by which information is accumulated and disseminated to enable authorized participants to prepare appraisals, analyses and other valuations of real property for bonafide clients and customers; by which participants engaging in real estate appraisal contribute to common databases; and is a facility for the orderly correlation and dissemination of listing information among the participants so that they may better serve their clients, customers and the public. Entitlement to compensation is determined by the cooperating broker's performance as a procuring cause of the sale or lease.

California Model MLS Rules, Rule 2, available on the CAR website listed in the Directory.

An MLS may be operated by a single local association or by a regional group of associations. There are about nine major regional multiple listing services jointly owned by associations of realtors® throughout California, mostly in the larger metropolitan areas. Some of these have data sharing agreements among them. Efforts are currently under way to create a statewide MLS—CALMLS—which would provide a single source for all property information in the state. See the CAR website listed in the Directory.

PRACTICE TIP: Attorneys representing brokers should be familiar with CC §§1086-1090, and in particular CC §1088, with regard to accurate listing information.

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§1.12 1. MLS Regulations; Dispute Resolution

An MLS, under the prevailing contractual structure, requires any broker representing a seller who lists a property for sale on the MLS to make an "irrevocable, unilateral offer of compensation" to any other broker who matches that seller with a buyer. Special mediation and binding arbitration rules generally apply to resolve any commission disputes between brokers. These rules are implemented by fairly detailed rules and regulations that must be accepted by brokers seeking to use the MLS. Under these rules, brokers are typically called "participants" and salespeople "subscribers." On broker compensation, including dispute resolution, see chap 7.

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§1.13 2. Commercial Subscription Services

Most commercial real estate brokers do not use a residential MLS in their practices. Instead, they often use separate commercial subscription services (*e.g.,* LoopNet or the Costar Group; see Directory for websites) to market properties for their clients, as well as their own internal databases and client contact lists. Commercial subscription services significantly differ from a residential MLS in that they generally only list properties for sale or lease and do not provide private regulations or dispute resolution services.

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§1.14 B. Why Use an MLS?

Most residential sellers prefer to use the MLS for maximum market exposure, fastest sale, and highest price. It may be a breach of the broker's fiduciary duty to persuade the seller to keep the listing out of the MLS. See 2 Miller & Starr, California Real Estate §5:32 (3d ed 2000). On broker's fiduciary duties, see chap 3. On "pocket listings," which often avoid use of the MLS, see §7.4.

PRACTICE TIP: Under CC §1088, a broker placing a listing in the MLS is responsible for the truth of all representations and statements made by the broker of which the broker had knowledge or reasonably should have had knowledge. Brokers thus need to take great care in the accuracy of the information submitted. Counsel should recommend that their broker clients have their principals review and sign off in writing as to the accuracy of the information about to be placed in the MLS.

A listing may not be placed in an MLS unless authorized or directed by the owner in the listing. CC §1088. However, Rule 7.5 of the California Model MLS Rules (see §1.11) provides that the submission of listings in certain categories is mandatory unless the seller specifically directs the listing to be withheld. Almost every MLS in the state uses this provision of the model rules. Under this rule, subscribing brokers are required by the terms of the MLS to submit all their listings or submit a waiver of the MLS signed by the seller.

Some localities have an MLS that will accept commercial listings as well as residential, but an MLS is not generally used for commercial transactions. Some commercial associations provide an MLS, and some larger associations have a separate commercial MLS, both of which may have different rules relating to the sharing of commissions. In listings involving a variable commission (meaning that the seller pays one amount if sold by the listing broker and a different amount if sold with a cooperating broker or the seller), the MLS rules require disclosure of this arrangement up front. The CAR standard form listing agreement provides an option for the seller to specify the amount of commission to be offered to the cooperating broker through the MLS. In any event, both broker and seller would be served by a clear written expression of their understanding.

MLS listings, originally available in book form, are now accessible online, providing subscribers with immediate access to current information about the property, mapping services, and extensive photographs. Information about properties for sale is also available to the public through online sources, including local real estate brokerage websites and websites such as Zillow.com and NAR's Realtor.com.

PRACTICE TIP: When ascertaining fair market value, nationwide websites should always be considered subordinate to local appraisal opinion or even local broker price opinion.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.15 V. FUNCTIONS OF A BROKER

§1.15 V. FUNCTIONS OF A BROKER

The functions of a broker may include:

- Finding property for clients (see §1.16);
- Listing property for sale (see §1.17);
- Evaluating market conditions (see §1.18);
- Negotiating terms of sale (see §1.19); and
- Providing referrals to other professionals (see §1.20).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.16 A. Finding Property

§1.16 A. Finding Property

Finding suitable property for clients is a common function of a real estate broker. Buyers and sellers should always use a local broker, and brokers who are asked to find property or negotiate a purchase outside their usual geographic territory should at least associate with local brokers who have local community knowledge.

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§1.17 B. Listing Property

Listing property for sale is a common function of a real estate broker. See Bus & P C §10131, discussed in §8.2. The listing of property is governed by CC §1088. Under that section, a listing may not be placed in an MLS unless authorized or directed by the owner in the listing. Further, if the broker places a listing or other information in the MLS, the broker is responsible for the truth of all representations and statements he or she made of which he or she had knowledge, or reasonably should have had knowledge. For discussion of multiple listing services, see §§1.11-1.14. For discussion of listing agreements, see chap 2.

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§1.18 C. Evaluating Market Conditions

Typically, brokers provide their sellers with a comparative market analysis (CMA) in assisting to set an asking price. Cooperating or buyers' brokers do not typically provide comparable sales price information, but it is recommended that the buyer's broker make the appraisal of the property a contingency of the buyer's obligation to buy. Note that CAR's Buyer's Inspection Advisory (CAR form BIA) provides, just above the buyer's and seller's signature lines, that "Buyer and Seller acknowledge and agree that Broker: (i) Does not decide what price Buyer should pay or Seller should accept."

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.19 D. Negotiating Terms

§1.19 D. Negotiating Terms

Negotiation is a large part of a real estate broker's job. Business and Professions Code §10131, which describes the activities of a broker, provides that brokers negotiate:

- The purchase, sale, or exchange of real property or a business opportunity (Bus & P C §10131(a));
- The sale, purchase, or exchange of leases on real property or on a business opportunity (Bus & P C §10131(b)); and
- Loans (Bus & P C §10131(d)).

PRACTICE TIP: Brokers should limit the negotiations they engage in on behalf of their clients to business terms and refer legal matters to competent real estate counsel. See discussions in §§1.23-1.24, 3.69.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/1 Overview of Real Estate Brokerage/§1.20 E. Providing Referrals to Other Professionals

§1.20 E. Providing Referrals to Other Professionals

Real estate brokers effectively act as a gatekeeper for providers of affiliated or third party services such as mortgage brokers, title companies, and property inspectors. Generally, the first step for someone who is thinking of buying a home is to contact a real estate broker to help them find a suitable property. Although occasionally a prospective buyer may talk to a mortgage broker first to prequalify or obtain preapproval for a loan, a buyer almost certainly would not consider, as the first order of priority, finding a title company or an escrow company. Buyers normally do not turn their attention to these services until they have drafted the purchase agreement, and their real estate broker is normally the person they ask for advice and referrals. The broker, therefore, is a source of tremendous potential business to affiliated real estate services, providers of which hotly compete for the referral. This is particularly true in a competitive market in which providers of affiliated services are competing for a share of a diminishing pool of transactions.

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§1.21 1. Referral Fees Restricted

In a perfect world, competition among third party providers of affiliated real estate services would be limited to convincing the broker that they provide the best quality service at the lowest price and will do the most effective job for the client. In reality, however, the competition may take the form of compensation to the broker for referring the business. With some *very* limited exceptions, the payment of a referral fee is prohibited in residential transactions and restricted in nonresidential transactions, under both state and federal law.

California law prohibits payment of referral fees to brokers who refer customers to an escrow agent, a structural pest control firm, a home protection company, a title insurer, a controlled escrow company, or an underwritten title company. Bus & P C §10177.4(a). Exceptions include payments for goods or services actually provided by the broker, moderate expenses for food and beverages provided in the context of customary business, educational or promotional practices, and certain promotional items. Bus & P C §10177.4(b). Insurance Code §12404 makes it illegal for any title insurer, title company, or controlled escrow company to pay, directly or indirectly, any compensation or consideration for the placement of business. This statute very broadly defines what is prohibited compensation, although it delegates authority to the Insurance Commissioner to promulgate regulations defining proscribed conduct. See Ins C §§12404-12413.5.

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§1.22 2. RESPA

Federal consumer protection legislation also regulates referral fees. The Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) was enacted to ensure that borrowers receive adequate and timely information on the costs of obtaining a loan and to protect borrowers from unnecessarily high costs associated with borrowing funds to purchase a home. 12 USC §2601. RESPA applies to one- to four-unit residential real property transactions involving federally related mortgage loans. 12 USC §2602(1). One of the goals of RESPA is to eliminate kickbacks or referral fees (12 USC §2601(b)(2)). See 12 USC §2607(a); 24 CFR §3500.14. As under California law, there are exceptions for certain types of payments. These include payments for goods or services actually provided, and certain promotional and educational activities. See 24 CFR §3500.14(g)(1). For further discussion of RESPA, see §§3.37, 8.16; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 12 (4th ed Cal CEB 2009).

PRACTICE TIP: Attorneys practicing in the area of real estate brokerage law should thoroughly familiarize themselves with both state and federal law on referral fees.

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VI. UNAUTHORIZED PRACTICE OF LAW

§1.23 A. Historical Context

In many states, lawyers represent the parties in the purchase and sale of residential real estate. In California, lawyers do not routinely get involved in these transactions when the purchase and sale of a single dwelling is involved. That role is performed in California by real estate brokers. It is the custom and practice of real estate brokers and salespersons to complete a form agreement in connection with a transaction. Normally residential brokers and salespersons use form agreements provided by (1) the California Association of Realtors®, (2) a private for-hire company such as Professional Publishing, or (3) their local association of realtors®. In industrial or commercial transactions, brokers use forms of agreements and leases generated by (1) their clients or clients' counsel, (2) a local brokers association, such as AIREA (see §1.9), or (3) their own commercial brokerage firm. While forms abound, there is usually a dominant form used by brokers in each market area, probably because use of a single form makes transactions easier in that brokers know what the form in use in their area says. This raises the issue of whether filling out such a form agreement constitutes the unauthorized practice of law.

In the 1950s, a dispute arose between the State Bar of California and the California Real Estate Association (CREA) (now the California Association of Realtors® (CAR)) as to whether completing standard form agreements constituted the unauthorized practice of law. In April 1967, the State Bar Board of Governors finally approved the CREA purchase contract (then referred to as the "Deposit Receipt") for use by real estate brokers and entered into an agreement with CREA which incorporated guidelines approved by the State Bar's Committee on Unauthorized Practice of the Law. As part of the agreement, CREA was to discourage its members from modifying or changing the form, adding provisions or clauses not required by the printed form, or adding extensive riders except on advice of an attorney. In turn, no changes to the form would be made without consulting with the State Bar. At the time, the two-page standard form purchase agreement had almost all blank lines, giving rise to original drafting by those completing the form. The CAR form was the only form endorsed by the State Bar and in the early 1980s, other publishers requested review of their forms. In 1981, CAR and the State Bar mutually agreed to terminate their agreement, thus leaving CAR free to modify its forms without State Bar involvement and relieving the State Bar of the task of responding to requests from rival publishers to review their forms. The current CAR purchase contract is replete with extensive clauses that have been vetted by attorneys across the state and have a check box or simple fill in of terms (*e.g.*, price, interest rate, days to close escrow). The forms explicitly advise clients to seek legal advice for legal questions. If extensive drafting or extensive modification of the form is required, brokers are well advised to get legal counsel involved.

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§1.24 B. When Is It "Practicing Law"?

There is a lack of reported case authority on the extent of legal competence required of brokers, but brokers will incur liability for negligently giving legal advice to their clients or for negligently drafting legal documents. See, *e.g., Biakanja v Irving* (1958) 49 C2d 647, 320 P2d 16, in which a notary public was held liable for negligence in drafting a will. In *People v Sipper* (1943) 61 CA2d Supp 844, 142 P2d 960, disapproved on other grounds in *Murgia v Municipal Court* (1975) 15 C3d 286, 301, 124 CR 204, a real estate broker (not involved in the sale or purchase of property) who prepared, for a fee, a document to secure a loan with real property was held liable for the unauthorized practice of law in violation of Bus & P C §6125. The court held that the practice of law includes "legal advice and counsel and the preparation of legal instruments and contracts by which legal rights are secured." 61 CA2d Supp at 846.

There is no clear definition of what constitutes "basic" real estate legal principles that a broker should understand, or when the line is crossed into the unauthorized practice of law. The cases at either extreme may be easy to identify, but there is a sizeable gray area in between. A broker who merely fills in the blanks on a form with information provided by the client, or who merely acts as a scrivener to record the agreement of the parties, is not practicing law. *Sipper*, 61 CA2d Supp at 846. However, if the broker provides recommendations or advice, or suggests alternative language, the broker could be deemed to be drafting the agreement and practicing law without a license. In such situations, the broker should instead refer the client to an attorney. A broker who "clarifies" or expands on the language of the form may be exposed to liability if the agreement is unenforceable because it is ambiguous, contains drafting errors, or does not accurately reflect the understanding of the parties.

PRACTICE TIP: Brokers are more likely to be accused of failing in the broker's standard of care (see §3.20) than practicing law without a license. In any event, brokers should stick to deal and business points in preparing contracts and related addenda. Legal issues should be referred to real estate counsel.

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VII. REPRESENTING REAL ESTATE BROKERS

§1.25 A. Extent of Knowledge Required

Attorneys who work in the area of real estate, whether in litigation, representing brokers or other parties, in the transactional arena, working with real estate brokers as co-professionals, or representing brokers in business (see §1.26), should be aware of the scope of law that may be involved. While a thorough grounding in real estate law is necessary, equally necessary is an understanding of the laws of agency and fiduciary duty (see chap 3), which impact every aspect of real estate brokerage practice. See also the Checklist of basic broker "do's and don'ts" found in Appendix B.

Attorneys who practice in this area should also be familiar with fair trade practices, unfair business practices, antitrust law, fair housing laws, licensing, MLS rules and regulations, errors and omissions insurance coverage (see chap 10), disclosure law (see chap 3), subdivision map act issues, and new and proposed legislation. An attorney who represents or works with an association of realtors® needs a thorough grounding in trade association law as well. Effectively representing a real estate broker or working in this area requires a complete understanding of how the profession functions. The attorney should be familiar with the law and practice of dual agency (see chap 3), how the multiple listing service works, and the nature of the relationship between the salesperson and the broker (see chap 8).

In addition, counsel representing a broker in a DRE proceeding (see chap 9) or in a civil court (see chaps 11-13) should be familiar with potential Fifth Amendment self-incrimination issues. Referral to a criminal attorney for advice on how to proceed in such circumstances may be required.

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§1.26 B. Advising on Business Matters

An attorney who represents a real estate broker may be responsible for more than real estate matters. There are unique aspects of the real estate brokerage industry that impact general issues such as choice of business entity and the scope and nature of the business relationships. For example, advising a real estate broker to incorporate involves more than concern about personal liability. Estate planning issues are implicated as well. A broker's stock-in-trade is usually listings. Listings are agency agreements in which the broker is the agent of the owner of the property. An agency agreement is terminated by the death of the agent. At the death of a real estate broker, all of the listings cease to exist and with them a substantial portion of the value of the business. If the broker incorporates, the listings are taken in the name of the corporate broker license. If the broker dies or is otherwise disqualified to act as the responsible broker, another broker can be brought in to act as the responsible broker for the corporation, thus maintaining the validity of the listings and the value of the business as an asset of the estate. Likewise, if the broker sells the business, the listings are not assignable. However, if they are in the name of a corporation, the business, including the listings, is transferable by sale of stock. There is no transfer of the asset, only the sale of the stock reflecting ownership in the company, which in turn owns the asset.

Counsel should be also be familiar with insurance issues. These include shopping for and evaluating errors and omissions insurance (see chap 10), workers' compensation insurance, and commercial general liability insurance. An attorney who is advising a real estate broker on business matters should have familiarity with employment law, the Unruh Civil Rights Act (CC §51), and other fair housing issues on a state and federal level, as well as taxation issues. An attorney representing an owner of a real estate brokerage needs to consider the form of the entity, *i.e.,* whether to incorporate or not, the creation of the initial corporate documents including buy/sell agreements, and other related matters.

As discussed above, the incorporation decision is a significant one. An attorney representing a broker in business matters must also be aware of the issues involved in the relationship between the broker and the salespersons. Whether the salespersons are employees or independent contractors can have significant consequences. See §1.3. For discussion of the relationship between brokers and salespersons, see §§8.32-8.42. On the requirement of a written agreement to document the relationship, see §8.40.

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2

Broker Contracts

Todd J. Wenzel

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I. CONTRACT LAW

§2.1 A. Elements of Broker Contracts

Contracts between real estate brokers and principals generally grant limited agency authority to the broker and obligate the principal to compensate the broker if specified conditions are fulfilled. On agency relationships, see §§3.3-3.13.

The types of agreements with which brokers are most often involved include listing agreements (see §§2.20-2.49), buyer-broker agreements (see §2.50), purchase and sale agreements or leasing agreements (see §§2.51-2.56), and options and short sale agreements (see §§2.57-2.66). As with any other contract, these types of agreements require the following elements (CC §1550):

- Parties capable of contracting (see §2.2);
- The parties' consent (see §2.3);
- A lawful object (see §2.4); and
- Sufficient cause or consideration (see §2.5).

However, contracts with real estate brokers are subject to additional requirements:

- A copy of any agreement authorizing or employing a broker must be delivered to the person signing it when the signature is obtained (Bus & P C §10142; see §2.45);
- The broker's right to a commission depends on express authorization in the agreement (see §2.41); and
- Other requisites discussed in connection with the forms for listing agreement provisions (see §§2.27-2.49).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.2 B. Capacity to Contract

§2.2 B. Capacity to Contract

To create an enforceable contract, the parties must be capable of contracting. CC §1550. All persons are capable of contracting except minors, persons of unsound mind, and persons deprived by law of their civil rights. CC §1556. The word "person" includes a corporation as well as a natural person. CC §14.

Under Corp C §§16204 and 16302, a partnership may also contract in the firm's name concerning property. Limited liability companies also have all the powers of a natural person, including the power to make contracts, purchase and sell real property, and transfer or otherwise dispose of their property. Corp C §17003.

PRACTICE TIP: Although a limited liability partnership (LLP) and limited liability corporation (LLC) may own, purchase, and sell property, they cannot be licensed as brokers. Only a natural person or a corporation may receive a broker license. Corp C §§13401, 17375.

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§2.3 C. Mutual Consent

The consent of the parties to a contract must be free, mutual, and communicated by each to the other. CC §1565. Consent that is not free can be rescinded. CC §1566. See California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002) on rescission. Consent is not real or free if it is obtained through duress, menace, fraud, undue influence, or mistake, and if it would not have been given if that cause had not existed. CC §§1567-1568. On remedies for fraud, see chap 11; Real Property Remedies, chap 3. Mutual consent is also lacking if the contract is so ambiguous that the parties' intentions cannot be ascertained. On uncertainty, see Real Property Remedies §4.19.

Mistake may, in rare instances, prevent a contract from coming into existence. For example, if the parties have a different understanding of the subject matter, and if neither is at fault or both are equally at fault, there is no contract. *Barfield v Price* (1871) 40 C 535. Usually, however, mistake does not prevent the formation of a contract but makes it voidable. On reformation, see Real Property Remedies, chap 2.

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§2.4 D. Lawful Object

The object of a contract must be lawful at the time the contract is made. CC §§1550(3), 1596. A contract's object is the performance that the party receiving the consideration agrees to provide. When a contract has but one object and that object is unlawful, the contract is void (CC §1598); but when a contract has several objects, it is void only to the extent that any particular object is unlawful (CC §1599). Unlawfulness is defined as that which is "(1) contrary to an express provision of law; (2) contrary to the policy of express law, though not expressly prohibited; or (3) otherwise contrary to good morals." CC §1667.

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§2.5 E. Consideration

To support a claim in damages for breach or an assertion that the buyer is a bona fide purchaser, an agreement must be based on good (*i.e.,* valuable) consideration. See *Horton v Kyburz* (1959) 53 C2d 59, 346 P2d 399. Any benefit conferred or detriment suffered (or agreed to be conferred or suffered) is good consideration if it is more than nominal. See CC §1605. If the agreement is to be specifically enforced, however, the consideration must also be adequate (*i.e.,* it must be just and reasonable). CC §3391(2). For more on specific performance, see California Real Property Remedies and Damages, chap 5 (2d ed Cal CEB 2002). In both situations, the value or adequacy of the consideration is fixed as of the time the agreement is executed. *O'Connell v Lampe* (1929) 206 C 282, 274 P 336; *Henderson v Fisher* (1965) 236 CA2d 468, 46 CR 173.

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F. Statute of Frauds and Broker Contracts

§2.6 1. Written Agreement Required

The clause of the Statute of Frauds (CC §1624) applicable to brokers and their principals states (CC §1624(a)(3)-(4)):

> (a) The following contracts are invalid, unless they, or some note or memorandum thereof, are in writing and subscribed by the party to be charged or by the party's agent:
> …
> (3) An agreement for the leasing for a longer period than one year, or for the sale of real property, or of an interest therein; such an agreement, if made by an agent of the party sought to be charged, is invalid, unless the authority of the agent is in writing, subscribed by the party sought to be charged.
> (4) An agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate, or to lease real estate for a longer period than one year, or to procure, introduce, or find a purchaser or seller of real estate or a lessee or lessor of real estate where the lease is for a longer period than one year, for compensation or a commission.

The writing need not contain all elements of a binding contract. If the document includes the essential terms of the agreement, but their meaning is unclear, extrinsic evidence may be introduced to clarify the terms and the intent of the parties. *Sterling v Taylor* (2007) 40 C4th 757, 152 P3d 420, 55 CR3d 116.

Despite the somewhat contrary language of CC §1624, courts have uniformly held that noncompliance with the Statute of Frauds renders a contract unenforceable rather than void. An oral contract subject to the statute is effective until its invalidity is urged as a defense to an attempt to enforce it. 1 Witkin, Summary of California Law, *Contracts* §344 (10th ed 2005). Thus, the statute's use is primarily defensive. For example, it cannot be invoked by a buyer to recover payments made under an oral contract to sell land if the seller is ready and able to perform. *Walbridge v Richards* (1931) 212 C 408, 298 P 971; *Thompson v Schurman* (1944) 65 CA2d 432, 437, 150 P2d 509. Moreover, part performance of an oral contract may be sufficient to overcome even defensive use of the Statute of Frauds. CCP §1972. In some cases, a party may be estopped from asserting the Statute of Frauds as a defense. See *Sutton v Warner* (1993) 12 CA4th 415, 15 CR2d 632.

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§2.7 a. Broker Engagement Agreements

Although the agency relationship between a broker and principal can be established without a written contract, a broker cannot recover his or her commission without a writing that satisfies the Statute of Frauds. See §2.15; chap 7. The writing must:

- Establish the broker's authority to act for the principal (see §2.10);
- Identify the property (see §2.11); and
- Be signed by the principal (see §2.12).

Further, without a written agreement, the broker will not be able to recover in quantum meruit the value of any brokerage or other incidental services provided to the client. *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 241 CR 22. On quantum meruit and quasi-contract theories of recovery, see §§2.16, 7.6.

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§2.8 b. Finder Agreements

The words "or any other person" in CC §1624(a)(4) mean that even a finder or an intermediary (see §§7.12, 8.15-8.18) must have a written agreement in order to recover a fee in a real property transaction and cannot assert a breach of contract claim based on an oral agreement. Unlike a broker, however, a finder is free to pursue an ordinary misrepresentation claim or sue on a theory of estoppel. See §§2.17-2.18. Compare CC §1624(a)(4) with *Zalk v General Exploration Co.* (1980) 105 CA3d 786, 164 CR 647, in which a finder was able to enforce an oral agreement because the agreement was for locating a company to be acquired rather than locating real property.

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§2.9 c. Leases and Purchase Agreements

Purchase agreements and leases of more than 1 year in duration must also be in writing to satisfy the Statute of Frauds. The writing, which need not be a formal agreement, may be in the form of a letter or memorandum. It must contain the essential elements of a contract, *i.e.,* the names of the parties and their identification, a description of the property, the price or rent, and the time and manner of payment. *Corona Unified Sch. Dist. v Vejar* (1958) 165 CA2d 561, 332 P2d 294. But see *House of Prayer v Evangelical Assoc. for India* (2003) 113 CA4th 48, 7 CR3d 24 (time for performance is not essential term in every contract; if no time is given, court may imply reasonable time for performance). Nevertheless, it is best to reduce the agreement to a formal document to avoid ambiguities and inadequacies.

Letters of intent present special problems of enforceability as written agreements. See California Real Property Sales Transactions, chap 3 (4th ed Cal CEB 2007).

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2. Contents of Writing

§2.10 a. Employment of Broker

In order for the broker to act or negotiate a sale for the owner, the writing must establish the fact of employment. CC §1624(a)(4). Some courts give a strict interpretation to this requirement, so any memorandum on which a broker intends to rely should use words that typically denote an employment relationship, such as "appoint," "employ," or "authorize." Other language that has been held sufficient to show an employment relationship includes: "you may have the listing with one or two other realtors" (*Rogers v Grua* (1963) 215 CA2d 1, 30 CR 39), "go ahead" (*Spitler v Avery* (1961) 189 CA2d 811, 11 CR 724), and "take it up" (*Bruner v Van's Mkts.* (1951) 103 CA2d 135, 229 P2d 56).

Some older cases dealing with this issue have held that writings that set forth the terms on which the principal is willing to sell or buy, without specific language appointing the broker, do not comply with CC §1624(a)(4). See, *e.g., Franklin v Hansen* (1963) 59 C2d 570, 30 CR 530. In *Seck v Foulks* (1972) 25 CA3d 556, 102 CR 170, however, a court found that the Statute of Frauds was satisfied when the broker jotted down the terms of the sale, including the commission, on the back of his business card and had the seller date and sign it, despite the fact that no specific language of appointment was used.

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§2.11 b. Description of Property

The property that is the subject of the writing must be described with sufficient clarity to permit reasonable identification. See, *e.g., Wolf v Price* (1966) 244 CA2d 165, 52 CR 889. In addition to satisfying the Statute of Frauds, the description must be certain enough to make the agreement specifically enforceable. CC §3390(5).

An exact legal description is not required, but is highly advised. Parol evidence may be admitted to explain the meaning of the written description. A description such as "my house," when the principal owned only one house in the state, has been held sufficient. *Pray v Anthony* (1929) 96 CA 772, 274 P 1024. Courts have not, however, admitted extrinsic evidence to identify the property when a writing contained no description at all. *Proulx v Sacramento Valley Land Co.* (1912) 19 CA 529, 126 P 509. The description may also be incorporated into the writing by reference.

PRACTICE TIP: Making the description an exhibit to the writing allows it to be prepared separately or photocopied from the owner's deed, a title insurance policy, or a preliminary report. This saves time and reduces the chance of error in retyping the description. It is customary (but not strictly necessary) to include the assessor's parcel number.

See California Real Property Sales Transactions §§4.31-4.34 (4th ed Cal CEB 2007) for additional discussion on describing property.

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§2.12 c. Execution

The writing need not be signed by both parties, but it must be executed by or on behalf of "the party to be charged." CC §1624(a). The signature of an authorized agent of a corporation is sufficient to bind the corporation. *Marks v Walter G. McCarty Corp.* (1949) 33 C2d 814, 205 P2d 1025. If the writing is subscribed by a broker, written authority must be subscribed by the principal. CC §1624(a)(3). The broker's authority to sign need not be in writing when the act is purely clerical or ministerial, *e.g.,* when the broker is directed by the principal to sign the document for the principal. *Murphy v Munson* (1949) 95 CA2d 306, 212 P2d 603.

The Statute of Frauds is intended to establish the existence of a contract (but not necessarily all its terms); therefore, the writing can be signed after the services are rendered or even after the sale has closed and title has been transferred. *Estate of Rule* (1944) 25 C2d 1, 152 P2d 1003, disapproved on other grounds in *Parsons v Bristol Dev. Co.* (1965) 62 C2d 861, 44 CR 767. A promissory note for the broker's commission, signed by the seller after closing, satisfied the Statute of Frauds in *Fellom v Adams* (1969) 274 CA2d 855, 79 CR 633.

In commercial or industrial transactions, there may be no memorandum on which the broker can rely to claim commissions due until the parties execute the contract of sale or the escrow instructions. Both escrow instructions (*Beazell v Schrader* (1963) 59 C2d 577, 30 CR 534) and a deposit receipt (*Mitchell v Johnston* (1956) 140 CA2d Supp 982, 298 P2d 170) have been held sufficient as writings, but the broker's rights are then contingent on completion of the sale. If a sale is not completed because of mutual rescission or the buyer's breach (*Paulsen v Leadbetter* (1968) 267 CA2d 148, 72 CR 819), CC §1624(a) requires a showing that the principal and the broker intended the commission to be earned on execution of the agreement. In *Rader Co. v Stone* (1986) 178 CA3d 10, 223 CR 806, a broker in a lease transaction was able to satisfy the subscription requirement because a landlord's agent had signed a "Realtor Registration Form" completed by the broker, which, together with a series of other papers, was held to constitute a written contract to pay a commission.

See §2.14 on requirements for electronic signatures. On broker commissions generally, see chap 7.

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§2.13 d. Amount of Commission Need Not Be Specified

The Statute of Frauds does not require that the writing indicate the amount of the broker's commission or even the broker's entitlement to compensation. *Barcelon v Cortese* (1968) 263 CA2d 517, 69 CR 657. If a writing demonstrates that the principal authorized the broker to act on his or her behalf, other provisions of the agreement, including the commission, may be proved by parol evidence. *Bruner v Van's Mkts.* (1951) 103 CA2d 135, 229 P2d 56. If no evidence exists in writing or from parol evidence on the amount of the commission, the courts will infer an agreement to pay reasonable compensation. *Beazell v Schrader* (1963) 59 C2d 577, 30 CR 534. See also discussion on compensation in §2.15.

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§2.14 3. Electronic Transactions Act

The Uniform Electronic Transactions Act (CC §§1633.1-1633.17) provides that an electronic record ("a record created, generated, sent, communicated, received, or stored by electronic means") or electronic signature will satisfy the legal requirements of a writing or signature. CC §1633.8. The term "electronic signature" should be distinguished from the term "digital signature." A digital signature is a digital code that can be attached to an electronically transmitted message to uniquely identify the sender so that if even one bit in the message changes on its way, the signature will not verify at the other end. The use of digital signatures is permitted in transactions with public entities. Govt C §16.5; 2 Cal Code Regs §§22000-22005.

See also the Federal Electronic Signatures in Global and National Commerce Act (15 USC §§7001-7031), which also validates electronic signatures and records. State law, however, may supersede the federal law if certain conditions are met. 15 USC §7002.

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§2.15 4. No Compensation Without a Writing

The California Supreme Court has extensively analyzed the writing requirement and concluded that, except in very limited situations (*i.e.,* when the broker has performed services that are not broker-related or incidental to broker-related services), a broker cannot recover compensation from his or her principal unless the broker has a writing that satisfies the Statute of Frauds. *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 241 CR 22. Courts have applied the statute to broker-client relationships in virtually all categories of real property transactions, including options (*Pacific S.W. Dev. Corp. v Western Pac. R.R.* (1956) 47 C2d 62, 301 P2d 825), assignments of contracts to purchase real property (*King v Tilden Park Estates* (1958) 156 CA2d 824, 320 P2d 109), and exchanges (*Zimmerman v Bank of America* (1961) 191 CA2d 55, 12 CR 319).

Without a writing, the value of the broker's services cannot be recovered, even if the principal has taken advantage of the services and substantially benefited from them. *Augustine v Trucco* (1954) 124 CA2d 229, 268 P2d 780. Although an agreement between two brokers who cooperate in selling real property need not be in writing (*Holland v Morgan & Peacock Prop. Co.* (1959) 168 CA2d 206, 335 P2d 769), a buyer's broker or cooperating brokers may have an enforceable right to share the commission only if there is an underlying express written agreement, *e.g.,* the listing agreement (see *Enea v Coldwell Banker/Del Monte Realty* (Bankr ND Cal 1998) 225 BR 715). The broker may be able to recover a commission for the sale of personal property (*Marks v Walter G. McCarty Corp.* (1949) 33 C2d 814, 205 P2d 1025) or for various nonbrokerage services without a writing as long as they are separable from real estate brokerage services (*Carey v Cusack* (1966) 245 CA2d 57, 54 CR 244). In *Hughes v Morrison* (1984) 160 CA3d 103, 206 CR 321, brokers were permitted to recover a commission when the original sale agreement was replaced by a new agreement between the same parties for the same property. The court concluded that, because the original broker played a substantial part in the renegotiation, the original commission agreement should apply. When the client clearly has used and benefited from the broker's services, a writing may be found to satisfy the Statute of Frauds even if it is not in the form of a traditional listing or commission agreement. *Torelli v J.P. Enters*. (1997) 52 CA4th 1250, 61 CR2d 76 (see §2.19); *Rader Co. v Stone* (1986) 178 CA3d 10, 223 CR 806 (see §2.12).

The Statute of Frauds, however, does not require that the writing indicate the amount of the broker's commission or even the broker's entitlement to compensation. For discussion, see §2.13. On broker compensation generally, see chap 7.

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5. Theories of Recovery in Absence of a Writing

§2.16 a. Quasi-Contract

A broker cannot recover from the seller or lessor on a quasi-contract theory (*i.e.,* that there is a contract implied by law), regardless of the amount of time, expense, or effort spent or substantial benefit conferred on the client. *Beazell v Schrader* (1963) 59 C2d 577, 30 CR 534. This theory of recovery has been so roundly rejected by the courts that many recent attempts by brokers to recover commissions do not even raise it.

Brokers have, however, been allowed to recover under oral agreements on a quasi-contractual basis for nonbrokerage expenditures such as survey costs, costs of locating suitable sites, subdivision costs, and other indirect selling expenses. *Carey v Cusack* (1966) 245 CA2d 57, 54 CR 244. These nonbrokerage services must be clearly separable from brokerage services. *Carey v Cusack, supra*. See also §7.6 on the theory of quantum meruit.

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§2.17 b. Principal's Fraud or Misrepresentation

To recover for fraud, a claimant must show reasonable reliance on a defendant's misrepresentation. A licensed broker cannot, as a matter of law, establish this required element of reasonable reliance to recover on the principal's oral promise to pay a commission because the broker is presumed to know that an oral commission agreement is unenforceable. *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 241 CR 22. The *Phillippe* court, however, suggested that there may be other promises on which a licensed broker could reasonably rely and thus assert a claim for fraud. As an example, the court cited the broker's reliance on a representation that a written agreement had been executed in *Owens v Foundation for Ocean Research* (1980) 107 CA3d 179, 165 CR 571, overruled on other grounds in *Applied Equip. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 28 CR2d 475. 43 C3d 1270.

In contrast to a broker, a finder may seek recovery based on the principal's alleged misrepresentation, and the fact that an unwritten promise is unenforceable as a contract does not preclude an action for fraud. *Tenzer v Superscope, Inc.* (1985) 39 C3d 18, 216 CR 130. Mere proof that a promise was made but not fulfilled, however, is insufficient to prove fraud. Something more than nonperformance is required to prove an intent not to perform on the promise. 39 C3d 30. The court reserved for another day the question of whether licensed brokers may invoke equitable remedies to avoid the results of the Statute of Frauds. 39 C3d 28 n6. On finders generally, see §§2.8, 7.12, 8.15-8.18.

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§2.18 c. Estoppel

The theory of estoppel generally is not of use to a broker trying to collect a commission in the absence of a written contract. Many principal and broker disputes seem to present a prima facie case for invoking the equitable estoppel doctrine to prevent a reneging principal from raising the defense of the Statute of Frauds. See 13 Witkin, Summary of California Law, *Equity* §191 (10th ed 2005); *Domarad v Fisher & Burke* (1969) 270 CA2d 543, 76 CR 529. Courts are often unwilling to apply this theory, however, because it would permit precisely what the Statute of Frauds was designed to prevent: the oral assertion of a promise with no easily available contravention other than denial. *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 241 CR 22; *Pacific S.W. Dev. Corp. v Western Pac. R.R.* (1956) 47 C2d 62, 301 P2d 825. Compare these cases with *Tenzer v Superscope, Inc.* (1985) 39 C3d 18, 216 CR 130 (see §2.17), in which the supreme court held that a finder, who need not be a licensed real estate broker, was entitled to invoke the doctrine of estoppel to overcome the Statute of Frauds.

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§2.19 6. Exceptions

The courts have recognized a few exceptions to the Statute of Frauds requirement that agreements authorizing or employing brokers must be in writing:

- An agreement between a finder and a broker, providing for a fee to the finder for introducing the broker to prospective sellers or buyers, need not be in writing because no buyer or seller is a party to the agreement. *Grant v Marinell* (1980) 112 CA3d 617, 169 CR 414.
- Commission-sharing agreements between brokers are not subject to the Statute of Frauds. *Iusi v Chase* (1959) 169 CA2d 83, 337 P2d 79.
- An agreement between two brokers who cooperate in selling or leasing real property need not be in writing. *Holland v Morgan & Peacock Prop. Co.* (1959) 168 CA2d 206, 335 P2d 769. The cooperating broker's share can be recovered from the listing broker if the listing broker has a written contract with the seller or lessor, or if the entire commission has already been paid to the listing broker. *Iusi v Chase, supra*.
- A broker who is acting as a member of a joint venture is a principal, and the broker's authority to bind the coventurers in a real property transaction need not be in writing. *Foote v Posey* (1958) 164 CA2d 210, 330 P2d 651.
- An implied covenant of good faith may permit the broker to recover a commission even when the listing agreement has expired. For instance, in *Torelli v J.P. Enters.* (1997) 52 CA4th 1250, 61 CR2d 76, the buyer's offer included a commission to be split between Torelli and the buyer's broker. The seller's counteroffer did not change the commission terms. The counteroffer expired unaccepted. Later, the buyer's broker drafted an offer deleting Torelli's commission and reduced the purchase price by the amount of the commission. The court held that a seller cannot agree to sell the property to the buyer on substantially the same terms as those in a counteroffer without paying the broker the contemplated commission; to do so violates the implied covenant of good faith. The broker's right to a commission—predicated on finding a buyer for the seller—is not necessarily defeated just because the buyer and seller do not sign the precise piece of paper embodying the commission agreement, as long as a sufficient writing exists. 52 CA4th at 1257.

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§2.20 II. LISTING AGREEMENTS

A listing agreement is an engagement contract between the broker and the seller or lessor. The parties may negotiate any terms that are lawful (*Blank v Borden* (1974) 11 C3d 963, 115 CR 31); however, there are a few standard forms that are widely used throughout California. In residential transactions, the California Association of Realtors® (CAR) and smaller private companies like Professional Publishing issue a number of standardized engagement forms. Local real estate associations may also produce forms for use in areas with unique features, customs, and local laws.

PRACTICE TIP: Although there are a number of real estate trade associations, CAR is the largest by far and CAR forms are widely used throughout the state. See §1.8. Residential real estate brokers and salespersons who are not CAR members may turn to forms published by other associations or companies which may be available for a fee

Commercial brokers generally rely on their clients and their clients' attorneys to provide the necessary documentation and to implement transactions. But the larger commercial brokerages tend to have their own standard engagement forms. In southern California, forms from the AIR Commercial Real Estate Association (AIREA) are widely used and may be downloaded from its website. See the Directory for AIREA's website information.

The most commonly used types of listing agreements or provisions include:

- Exclusive right-to sell agreement (see §§2.21-2.22);
- Exclusive agency agreement (see §2.23);
- Open listing agreement (see §2.24);
- One party listing agreement (see §2.25); and
- Net listing provisions (see §2.26)

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A. Types of Listing Agreements

1. Exclusive Right-to-Sell and Right-to-Lease Agreements

§2.21 a. General Characteristics

An exclusive right-to-sell listing agreement gives the listing broker the right to a commission if the property is sold during the listing period by anyone, including the seller. *Lowe v Loyd* (1949) 93 CA2d 684, 209 P2d 851. The leasing equivalent of an exclusive right-to-sell listing may be called an "exclusive right to represent seller in sale or lease listing agreement," but the same rules generally apply. The broker need not be the procuring cause (*i.e.,* the cause or instrument leading to the accomplishment of the prime object of the agreement) and need not even have contacted the buyer. *Berzon v U.L.C. Corp.* (1969) 274 CA2d 690, 79 CR 277. For discussion of procuring cause, see §§7.16-7.20.

Listing agreements are strictly construed against the broker. Courts will not find an exclusive listing agreement unless it is expressly so designated. *E.A. Strout W. Realty v Gregoire* (1950) 101 CA2d 512, 225 P2d 585. An exclusive right-to-sell or right-to-lease agreement must contain a definite termination date. If it does not, the broker will be subject to disciplinary action by the Real Estate Commissioner if the broker seeks compensation under the agreement. Bus & P C §10176(f); chap 9. Provisions in many exclusive right-to-sell and right-to-lease agreements entitle the broker to the full commission if the client withdraws the property from the market (*Baumgartner v Meek* (1954) 126 CA2d 505, 272 P2d 552) or does something to the property that makes it unmarketable or substantially reduces its marketability (*Alderson v Houston* (1908) 154 C 1, 96 P 884). The validity of such a commission-on-withdrawal clause was upheld in *Blank v Borden* (1974) 11 C3d 963, 115 CR 31. See §7.21.

Many exclusive right-to-sell or right-to-lease listing agreements also contain a "safety" or "protection" clause that entitles the broker to the commission if the property is sold or leased within a stated period after the listing expires to a party identified during the term of the listing. On safety clauses, see §§2.43, 7.24.

For additional insight into negotiating and drafting listing agreements, see the Checklist in App C.

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§2.22 b. Specific Characteristics

An exclusive right-to-sell or right-to-lease listing agreement should contain the following elements:

- **Authority to sell or lease.** This provision identifies the parties to the agreement, the subject property, and the term of the listing. It may also include warranties of the principal's legal ownership of the property and the absence of any clouds on title and may address the scope of the employment, *e.g.,* whether the transaction sought is a sale or lease.
- **List of inclusions and exclusions.** This provision lists permanent improvements, fixtures, or personal property that will or will not be included in the transaction.
- **Compensation rights**, including:
- **Purchaser or lessee actually procured.** This provision states that the broker is owed a commission if any "ready, willing, and able" buyer or tenant is procured (see §2.24) by the broker or any other person, even if the transaction does not close (see §7.20).
- **Protection or safety clause.** This clause is also sometimes called a "sunset" provision and provides that a commission is owed to the broker if the principal sells or leases the property within a given period of time after the end of the listing period (or cancellation of the listing) to a buyer or tenant introduced by the broker or any cooperating broker (see §§2.43, 7.24).
- **Withdrawal of property from market.** If the property owner cancels the listing, a commission may still be owed under the agreement under specific instances, such as when an offer has been presented and the owner fails to respond or if the property is under contract at the time of withdrawal (see §7.21).
- **Duties of principal and broker.** Typical duties require the broker to exercise reasonable efforts and due diligence to market the property, order reports and disclosures, and advertise and provide information on the property in various media, including a multiple listing service (MLS) or private subscription service (see §§1.11-1.12). The principal usually must agree to consider all reasonable offers presented by the broker, make the property available for showing at reasonable times, and provide the broker with all the property information requested (see chaps 3, 5).
- **Multiple Listing Service or other subscription listing service.** Both commercial and residential listing agreements generally require that the property be advertised in the local MLS or subscription service for the area unless the principal signs a form instructing the broker to withhold the listing from the MLS (see chap 1).
- **Agency.** Listing agreements for residential property contain a brief description of agency and dual agency and note that if the property consists of less than four residential units the owner must receive a "Disclosure Regarding Agency Relationships" form prior to executing the listing. Commercial listing agreements generally describe the agency relationship, but omit mention of the statutory form (see chap 3).
- **Excluded persons.** Less common in residential agreements than in commercial agreements, the listing may include a list of persons and entities that the broker has cultivated while marketing the property. If a new broker is employed during the sunset period of the listing, a transaction with any of these "excluded persons" may result in commissions owed to the original listing broker (see Practice Tip in §7.24).
- **Dispute resolution.** Standard residential exclusive right-to-sell listing agreements generally provide for voluntary mediation of broker and principal disputes. Arbitration of disputes is mandatory unless both parties opt out. Standard commercial forms may or may not include a mediation provision, but generally require arbitration of disputes (see chap 6, §§7.21-7.24).

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§2.23 2. Exclusive Agency Agreement

An exclusive agency listing agreement provides that the broker is the only agent authorized to procure offers for the property and is entitled to a commission even if another broker completes the transaction. *Fleming v Dolfin* (1931) 214 C 269, 4 P2d 776; *Carlsen v Zane* (1968) 261 CA2d 399, 67 CR 747. If the owner independently procures a buyer or tenant, however, the broker is not entitled to the commission. *Faith v Meisetschlager* (1919) 45 CA 7, 187 P 61. Compare *Coldwell Banker & Co. v Pepper Tree Office Ctr. Assocs.* (1980) 106 CA3d 272, 165 CR 51, disapproved on other grounds in *Barrett v Bank of America* (1986) 183 CA3d 1362, 1371, 229 CR 16, in which the broker was denied a commission under an exclusive agency listing despite the absence of a finding that the owner was the procuring cause. Most brokers will not accept a listing when the owner reserves the right to market the property on its own or with other exclusions to the broker's exclusive right to sell or lease.

If the broker presents an offer from a ready, willing, and able buyer before a purchase agreement is executed by a buyer independently procured by the seller, the broker is entitled to the commission. *Houston v Williams* (1921) 53 CA 267, 200 P 55. Conversely, if the seller procures a buyer and enters into a purchase agreement before the broker procures a buyer, the broker's right to the commission is lost. *California Land Sec. Co. v Ritchie* (1919) 40 CA 246, 180 P 625. Sale of the property by the owner automatically terminates an exclusive agency listing, even if the broker is not notified. *E.A. Strout W. Realty v Gregoire* (1950) 101 CA2d 512, 225 P2d 585. If the owner sells to a prospective buyer who had already been contacted by the listing broker, the broker must show that he or she was the procuring cause. *Nelson v Mayer* (1954) 122 CA2d 438, 265 P2d 52. For discussion of procuring cause, see §§7.16-7.20.

As with an exclusive right-to-sell agreement, courts will not find the existence of an exclusive agency in the absence of clear and specific language. *Summers v Freeman* (1954) 128 CA2d 828, 276 P2d 131. An exclusive agency listing must also contain a definite termination date. Bus & P C §10176(f). For additional insight into negotiating and drafting listing agreements, see the Checklist in App C.

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§2.24 3. Open Listing Agreement

An open (or general) listing requires the broker to be the procuring cause (see §§7.16-7.20) of a buyer or tenant who is ready, willing, and able to complete the transaction on the terms of the listing. An owner can employ a number of brokers to list the same property under open listing agreements, and the first broker to procure a buyer or tenant earns the commission. *Marks v Rowley* (1951) 102 CA2d 619, 228 P2d 29. If the owner sells or leases the property without a broker's assistance, all open listings are terminated, and no commission is owed. *Edens v Stoddard* (1954) 126 CA2d 56, 271 P2d 610. Unlike either of the exclusive listings, an open listing agreement need not contain a definite termination date. Bus & P C §10176(f); *Summers v Freeman* (1954) 128 CA2d 828, 276 P2d 131. An open listing without a specified duration may be revoked by the owner at any time before the broker produces a buyer or tenant, regardless of the efforts the broker may have made before termination. *Tetrick v Sloan* (1959) 170 CA2d 540, 339 P2d 613; *Heffernan v Merrill Estate Co.* (1946) 77 CA2d 106, 174 P2d 710. The only limitation on the owner's right to terminate is that the revocation must be made in good faith. *Tetrick v Sloan, supra*.

PRACTICE TIP: Because an open listing is not exclusive, it is difficult for any one broker to be the procuring cause of the transaction, and is often rejected for that reason. If accepted, an open listing may result in below average efforts by the broker due to the perceived difficulty of earning a commission.

For additional insight into negotiating and drafting listing agreements, see the Checklist in App C.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.25 4. One Party Listing Agreement

§2.25 4. One Party Listing Agreement

Under a one party listing agreement (sometimes called a single party compensation or a "limited listing" agreement), the broker receives a commission if the broker's client specifically named in the agreement buys or leases the property. The property owner is still free to market the property through many brokers. This agreement is typically used when a broker with a specific potential buyer wants written assurance that the owner will pay a commission if his or her client completes the transaction.

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§2.26 5. Net Listing Provisions

A net listing provision may be added to any of the listing agreements discussed in §§2.21-2.25. Under a net listing provision, the broker's commission is earned in any manner the parties agree on (*e.g.,* any one of the listing agreements mentioned in §2.20), but the amount of the commission is the amount by which the actual sale price exceeds a stated net price to the seller. See *Smith v Zak* (1971) 20 CA3d 785, 98 CR 242. If the property is sold for the specified net sum or a lesser amount, the broker does not earn a commission. *Haigler v Donnelly* (1941) 18 C2d 674, 117 P2d 331. Although legal, a net listing provision provides an obvious opportunity for abuse by brokers, and its use will be scrutinized closely by the Real Estate Commissioner under the authority of Bus & P C §10176(g).

Both brokers and owners should be cautious about using net listing arrangements. A broker should explain the nature and effect of a net listing to the principal and should make sure that the net sale or lease price is set by the owner. Any facts tending to indicate that the broker influenced the price may subject the broker to liability for secret profits (see §§3.35-3.37, 3.72-3.74) and disciplinary action by the Real Estate Commissioner (see chap 9).

A broker must ordinarily disclose to the seller any amounts he or she will receive as a result of the transaction and any interest, direct or indirect, the broker has in the purchase or lease of the property. See §§3.30-3.37. There is some authority for easing these disclosure requirements when the transaction is pursuant to a net listing (*Pascal v Cotton* (1962) 205 CA2d 597, 23 CR 357), but the continuing vitality of this exception is open to question and, in any event, it is strictly limited to transactions in which the net price was set by the seller without any influence from the broker. *Sierra Pac. Indus. v Carter* (1980) 104 CA3d 579, 163 CR 764. Courts have held the broker to a strict duty to disclose when the broker has influenced the setting of the net price. *Sierra Pac. Indus. v Carter, supra*. For additional insight into negotiating and drafting listing agreements, see the Checklist in App C.

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§2.27 B. Listing Agreement Provisions

The listing agreement may be prepared in any format acceptable to the principal and the broker. A number of standardized listing agreement forms are reproduced in California Real Property Sales Transactions, chap 2 (4th ed Cal CEB 2007). Most standard listing agreements tend to favor brokers, and the property owner's counsel should make any changes or include any additional provisions on an addendum or rider attached to the listing agreement. See App C for a review checklist. Alternatively, counsel may prefer to draft the listing agreement either in the form of a letter agreement employing the broker or in a formally prepared and executed employment contract.

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§2.28 1. Drafting Listing Agreements or Amending Standard Forms

Circumstances will dictate the format to use in a given transaction. Brokers (especially residential brokers) usually prefer their own forms and more readily accept riders to those forms. Using a rider presents some risk of contradiction between the agreement and the rider, and both should be carefully reviewed for consistency. The form agreement should include a notation that it is subject to the attached rider. The principal and the broker should initial the notation and sign the addendum.

The form provisions and comments in §§2.29-2.49 are intended to enable the principal's attorney to draft a complete listing agreement, letter agreement, or rider to a standard form agreement. Some of the provisions are found in standard listing agreements; others are generally omitted from standard agreements but should be added by addendum or separate agreement when needed by the parties. Many of the provisions are not essential to every listing agreement, but they could be useful to cover a situation in a particular transaction.

The principal's attorney, whether using a standard form listing agreement or an attorney-drafted form, should carefully review or draft each provision, paying special attention to the provision specifying when the commission is earned and the other provisions discussed in §§2.29-2.49.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.29 2. Form: Engagement of Broker; Term of Listing

§2.29 2. Form: Engagement of Broker; Term of Listing

[*Add one of the following alternatives*]

[*Alternative 1: Letter agreement*]

_ _[*Date*]_ _

_ _[*Name and address of broker*]_ _

Dear _ _[*name*]_ _:

_ _[*I/We*]_ _ (Owner) employ you as broker (Broker)

[*Alternative 2: Employment contract*]

_ _[*Date*]_ _

_ _[*I/We*]_ _ (Owner) employ _ _[*name of broker*]_ _ as broker (Broker)

[*Continue*]

for the period beginning _ _[*date*]_ _, and ending at midnight on _ _[*date*]_ _ (Listing Period), for the sale of _ _[*my/our*]_ _ _ _[*specify, e.g., fee interest/undivided interest/leasehold interest/fee interest subject to leasehold*]_ _ in the real property in the City of _ _[*name*]_ _, County of _ _[*name*]_ _, described as follows: _ _[*describe property by address, legal description, assessor's parcel number, or other appropriate means*]_ _ (Property).

Comment: The need to use language indicating the broker's employment is discussed in §2.10. Most standard agreements specify in their title or opening provisions the type of listing agreement under which the broker is employed (open, exclusive agency, exclusive right-to-sell or right-to-lease, or one party listing; see §§2.21-2.26). Since these specifications actually define the conditions under which the commission is earned, they should also be included in the provision on the broker's commission. See the form provision in §2.41.

The event triggering the broker's right to a commission must occur during the term of the listing or during an agreed-on extension. This event is usually the formation of a contract between the principals that ultimately leads to a completed transaction. Close of escrow, which may dictate *when* the commission is due or may be a condition to payment of the commission, may occur *after* the term has ended. Although listing agreements are commonly granted for a specific number of days or months, a specific termination date is recommended for clarity.

An exclusive agency, exclusive right-to-sell listing agreement, or exclusive right-to-lease listing agreement must contain a definite termination date for the listing period. See §§2.21-2.23. A broker is subject to discipline under Bus & P C §10176(f) for attempting to collect compensation under any of these exclusive listings if it does not have a termination date. The broker who has performed fully under an exclusive listing agreement without a termination date may, however, be able to recover the commission if the principal has benefited from those services. See *Schaffter v Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 752, 83 CR3d 19; *Babcock v Houston* (1973) 33 CA3d 858, 109 CR 454. If the broker has not performed, the principal can rescind the agreement and the broker cannot enforce it. *Nichols v Boswell-Alliance Constr. Corp.* (1960) 181 CA2d 584, 5 CR 546.

The termination date need not be a calendar date, but it must be determinable from the listing agreement itself without reference to some external event. *Dale v Palmer* (1951) 106 CA2d 663, 235 P2d 650. Listing agreements that provide for the listing to continue until revoked by the principal, but in no event later than a definite calendar date, have been upheld. See *Lowe v Loyd* (1949) 93 CA2d 684, 209 P2d 851. A listing that purported to renew automatically after a period of time, unless actively terminated by the principal, would not be enforceable. *Dale v Palmer, supra*.

The Statute of Frauds does not require that the listing agreement contain an exact legal description of the property if the description adequately identifies the property. CC §1624(a); see §2.11. Whether a street address, legal description, or assessor's parcel number is used, accuracy is vital. The purchase agreement or lease will probably describe the

property as it is shown in the listing agreement, and the buyer or tenant may have a defense against performing if the description in the purchase agreement is not correct. See California Real Property Remedies and Damages §4.19 (2d ed Cal CEB 2002) on the uncertainty of a legal description as a defense to the enforcement of the agreement.

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§2.30 3. Form: Transaction Price

[*Add one of the following alternatives*]

[*Alternative 1: Minimum total sale price*]

The minimum price for sale of the Property is $_ _[*amount*]_ _ paid as follows: _ _[*specify, e.g., all cash to owner/in installments as follows: _ _[specify installments*]_ _*/(other consideration)*]_ _.

[*Alternative 2: Net sale price to owner*]

The price of the Property may not be less than $_ _[*amount*]_ _ net to Owner after deduction of all expenses and costs of sale payable by the Owner, except _ _[*specify expenses owner will bear*]_ _.

[*Alternative 3: Lease of property*]

A lease or other tenancy of the Property for the following rent and terms: _ _[*describe proposed leasing terms*]_ _ and such other additional standard leasing terms reasonably similar to terms contained in _ _[*e.g., forms previously provided by broker or owner*]_ _ or such other rent and terms agreeable to Owner.

Comment: In a sale transaction, unless the seller requires the transaction to be structured as an installment sale or an exchange, the listing agreement generally need not specify the payment terms in any greater detail than "cash to seller." If the seller wishes the transaction to be an installment sale under IRC §453, the listing agreement should specify the maximum downpayment the seller will accept, the amounts of future installments, their payment dates, and the interest rate. For discussion of installment sales, see California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007). On exchange transactions, see generally, Real Property Exchanges (3d ed Cal CEB 2002).

If the seller is willing to accept some other arrangement for all or part of the purchase price, such as a buyer's promissory note (usually referred to as seller financing) or the buyer's assumption of an existing loan, the listing agreement should specify that the price may be paid by alternative methods. This expands the circumstances under which a broker may earn a commission even if the seller refuses to sell. See discussion on recalcitrant sellers in §§5.7, 7.21.

Occasionally, the principal may want to specify details of payment of rent or the purchase price in the listing agreement, and the form can be modified for that purpose.

In most circumstances, Alternative 1 can be used in an exchange without modification if the seller intends the disposition of the property to be the first leg of a tax-deferred exchange (except in the unlikely event such exchange is intended to be direct (*i.e.,* in exchange for the buyer's property) or simultaneous). Because cash is typically generated from the buyer of the taxpayer's property, the broker's commission can usually be paid from the leg of the transaction that generates the cash. See generally Real Prop Exchanges, chap 1.

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4. Deposit

§2.31 a. Form: Authority to Accept Deposits

[*If applicable, add one or both of the following options*]

[*Option 1: Authority to accept deposit as owner's and buyer's/lessee's agent*]

You are authorized on Owner's behalf to accept and hold _ _[*buyer's/lessee's*]**_ _ deposit. On Owner's acceptance of _ _**[*buyer's/lessee's*]**_ _ offer, you are instructed to _ _**[*e.g., deliver the deposit to Owner/place deposit in escrow*]**_ _.**

[*Option 2: Authority to accept deposit only as buyer's/lessee's agent*]

You are authorized to accept _ _[*buyer's/lessee's*]**_ _ deposit only as _ _**[*buyer's/lessee's*]**_ _agent until Owner's acceptance. The deposit is to be considered accepted only when Owner accepts _ _**[*buyer's/lessee's*]**_ _ offer.**

Comment: Generally, escrow agents—not brokers—hold the deposit. This provision, therefore, generally would not be necessary. If the parties do elect to have the broker hold the deposit, however, the listing agreement must address the broker's authorization to do so. This type of provision clarifies for whose benefit the broker holds the deposit. The issue of for whose benefit the broker holds the deposit is affected by the type of agency relationship that the broker and the principal confirm before execution of the listing. See discussion of agency in §§3.3-3.13. An express authorization to accept the deposit for the principal renders the broker the principal's agent in holding the deposit, which shifts the risk of loss of the deposit to the principal. *Hicks v Wilson* (1925) 197 C 269, 240 P 289; *Warshauer v Bauer Constr. Co.* (1960) 179 CA2d 44, 3 CR 570. Without express authorization, the broker holds the deposit as the buyer's or lessee's agent and the buyer or lessee retains the risk of loss. *Clark v Patterson* (1931) 213 C 4, 300 P 967.

If the property owner and the broker agree that the broker will be a dual agent (see §§3.22-3.29), the clause in Option 2 above should be used to limit the owner's exposure regarding the deposit. This provision will protect the owner from the broker's loss or misappropriation of the deposit.

In most localities, by custom and practice, escrow agents rather than brokers hold the deposit. Parties, however, may disagree on who should hold the deposit: an escrow company, the broker, or the principal. An escrow holder may be unsatisfactory because in a dispute it will almost invariably refuse to release the deposit to either party unless all parties sign written release instructions, preferring to interplead the funds in the litigation. Custody of the deposit by the broker or the property owner exposes the buyer or property owner to the risk of loss or misappropriation by the other. Brokers are often reluctant to hold funds because of the complex rules on broker trust accounts. See Bus & P C §10145; 10 Cal Code Regs §§2830.1-2836, 2950-2951. On the broker's duty to account for funds held, see §§3.52-3.55.

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§2.32 b. Form: Handling Deposits

_ _[*Buyer's/Lessee's*]_ _ **deposit must be made only** _ _[*e.g., in cash or cashier's check or a combination*]_ _**. All checks must be made to the order of** _ _[*e.g., Owner/name of escrow holder*]_ _**, and all deposits must be delivered by Broker to** _ _[*e.g., Owner/escrow holder*]_ _ **by the next business day following receipt.**

Comment: Lawyers frequently require that payments be made in cash or by cashier's check because payment on personal checks, even certified checks, can be stopped. See California Real Property Sales Transactions §4.37 (4th ed Cal CEB 2007). If payment on a check is stopped, both parties may be unsure of their rights regarding the property until the dispute over the check is resolved, and the effect may be to remove the property from the market for a considerable period.

This provision requires immediate delivery of any deposit, which is in the best interest of both the principal and broker. It minimizes the chances for loss or misappropriation by the broker and reduces the time in which the buyer or lessee might regret making an offer and decide to stop payment. The broker is required to place the deposit into a neutral escrow depository or broker's trust account no later than 3 business days after receipt. Bus & P C §10145; 10 Cal Code Regs §2832. The buyer/lessee retains title to the deposit and is entitled to its return until the property owner unconditionally accepts the offer. *Norris v San Mateo County Title Co.* (1951) 37 C2d 269, 231 P2d 493.

When the deposit is deemed paid can depend on the method of payment and intent of the parties. If both the buyer/lessee and the property owner intend a check to be held as the deposit without being cashed, the broker's receipt of the check will be treated as payment of the deposit. *Beazell v Kane* (1954) 127 CA2d 593, 274 P2d 224. If it is not expressly agreed that the check is to be held without being cashed, the check does not constitute payment of the deposit until it is honored by the drawee bank. *Mendiondo v Greitman* (1949) 93 CA2d 765, 209 P2d 817. Whatever methods of payment and custody of the deposit are used, the deposit never becomes the property of the broker. The broker holds the deposit as agent, escrow holder, and trustee for the respective parties. *Savage v Mayer* (1949) 33 C2d 548, 203 P2d 9; *Holloway v Thiele* (1953) 116 CA2d 68, 253 P2d 131.

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§2.33 5. Form: Designating Escrow Holder

Escrow will be opened with _ _[*name and address of escrow holder*]_ _, and must close no sooner than _ _[*date*]_ _, and no later than _ _[*date*]_ _. Broker will deliver any deposits Broker holds under the terms of this listing agreement to the escrow holder on execution by both _ _[*buyers/lessees*]_ _ and Owner of a _ _[*purchase and sale agreement/lease agreement*]_ _.

Comment: The principal may wish to designate a particular escrow holder in the listing agreement. The principal's right to select the escrow holder is constrained by CC §2995, which bars a developer from requiring use of an escrow holder in which it has a financial interest, and by the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617), which prohibits most property owners from conditioning the sale on the use of a particular title company (12 USC §2608).

Whether or not an escrow holder is named, the principal may wish to set out the closing date to prevent closing before possession can be delivered in order to ensure that closing occurs by a particular date or to specify a closing date in a particular tax year. For more on RESPA, see §§1.22, 3.37, 8.16.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.34 6. Form: Delivery of Possession

§2.34 6. Form: Delivery of Possession

_ _[B*uyer/Lessee*]_ _**may have possession of the Property** _ _[*e.g., at close of escrow/no sooner than* _ _[*date*]_ _]_ _**.**

Comment: If the date of delivery of possession is important to the principal, it should be a condition of the listing agreement. Close of escrow is usually given as the time for delivering possession, but an owner-occupant may need more time to move. Unless given additional time to vacate, an owner who is unable to deliver possession at the close of escrow may be in violation of the purchase or lease agreement.

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§2.35 7. Form: Broker's Duties

By accepting this listing, broker agrees to exercise due diligence to procure a _ _[*buyer/lessee*]_ _ and promptly and diligently to do the following: _ _[*describe broker's duties*]_ _.

Comment: Preprinted listing agreements rarely spell out the broker's duties. Promotion of a particular property may require services beyond those ordinarily performed by the broker selected. If the principal has specific requirements in mind for the broker's performance, the listing agreement should specify the services to be provided so that the principal can revoke the listing if the broker fails to perform. The principal may, for example, want the agreement to specify marketing services such as advertising (names of newspapers, frequency of appearance of ads, emphasis of special features), signs (size, design, location, wording), photographs, putting the property on the multiple listing service, and restrictions on showing the premises.

The broker's failure to exercise due diligence in performing its duties may enable the principal to revoke the listing. *Coleman v Mora* (1968) 263 CA2d 137, 69 CR 166. Whether the broker has performed with due diligence is a question of fact that depends on the circumstances of each case (*Whitney Inv. Co. v Westview Dev. Co.* (1969) 273 CA2d 594, 78 CR 302), and there are no precise standards for ascertaining whether the broker's duty has been breached. If the principal has listed the services expected of the broker in as much detail as possible, it will be easier to establish a breach if it occurs. The broker's failure to advertise and offer the property to the public in a nondiscriminatory fashion may breach the duty to exercise due diligence by failing to reach a market that would otherwise be available. *Crowell v Issacs* (1965) 235 CA2d 755, 45 CR 566.

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§2.36 8. Form: Broker Cooperation; Submitting Listing to MLS

[*If applicable, add one of the following alternatives*]

[*Alternative 1: Residential listing*]

Broker _ _[*may/will*]**_ _ refer the listing to the _ _**[*name*]**_ _ multiple listing service and is authorized to cooperate with and compensate any of its members in securing a purchaser.**

[*Alternative 2: Commercial listing—add one of the following options*]

[*Option 1: No cooperation required for a period*]

Broker _ _[*may/will*]**_ __cooperate with other brokers in the marketing of the property _ _**[*from the outset/after the first _ _*[*number*]*_ _ days*]**_ _ of the listing period _ _**[*and share its commission equally with any broker procuring a buyer*]**_ _.**

[*Option 2: Use of MLS or other subscription service*]

Broker _ _[*may/will*]**_ _ refer the listing to the _ _**[*specify name of local multiple listing service or commercial subscription service*]**_ _ and is authorized to cooperate with and compensate any of its members in securing a purchaser.**

Comment: It could be argued that reference to the multiple listing service (MLS; see §§1.11-1.14) is authorized when that conforms with local practice, even if the listing agreement is silent. The broker may want to attempt to market the property without the services of a cooperating broker to avoid splitting the commission, but may also want to retain the right to submit the listing to the MLS, if necessary. The provision on using an MLS can be either permissive or mandatory.

Some localities have an MLS that will accept commercial listings as well as residential, but they are not generally used for commercial transactions. If used, the listing should address whether the listing broker is required to cooperate (*i.e.,* share its commission) with outside brokers. Principals often will insist on cooperation and a 50/50 commission split. There are, however, situations in which the principal agrees to some other arrangement (*e.g.,* no cooperation required during first week or two of listing); and in some markets, the listing agreement may customarily provide only for the listing broker's compensation and the buyer's/lessee's broker must obtain compensation from its own client. In any event, both broker and principal would be served by a clear written expression of their understanding.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.37 9. Broker's Compensation

§2.37 9. Broker's Compensation

The many issues that arise in regard to broker compensation are discussed in detail in chap 7. The discussion and forms in §§2.38-2.44 are intended to assist counsel in drafting or reviewing the compensation provisions in a listing agreement.

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§2.38 a. Conditioned on Closing

No matter which type of listing is used, the principal should try to negotiate for payment of the commission only if the transaction is consummated. On the differences among types of listings, see §§2.21-2.26. Specific language that conditions payment on the closing actually occurring is preferable to the more common clauses providing that the commission is "payable" on or at close of escrow. Otherwise, the principal may be liable for the commission if the broker produces a buyer or lessee who makes an unconditional offer accepted by the principal, whether or not procured under the listing terms and regardless of whether the transaction is consummated. See §§7.16-7.20.

When payment of the commission is conditioned on closing, the principal cannot avoid payment by unreasonably preventing the closing and will be liable for the payment if the failure to close arose from the principal's lack of good faith. *Stromer v Browning* (1966) 65 C2d 421, 55 CR 18; *Seck v Foulks* (1972) 25 CA3d 556, 102 CR 170. On the principal's duties owed to the broker, see §§5.1-5.6. Nevertheless, the broker should attempt to negotiate inclusion of explicit language to this effect at the end of the commission-on-closing clause (*e.g.,* commission is earned if the closing is prevented by the principal's default).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.39 b. Not Conditioned on Closing

§2.39 b. Not Conditioned on Closing

If the commission is not to be conditioned on closing, the principal may wish to provide that, in the event of the buyer's or lessee's breach, the commission will be limited to half of any damages the principal recovers, not to exceed the agreed commission amount. (Such language is used in, for example, the CAR Form RPA-CA: Residential Purchase Agreement and Joint Escrow Instructions. CAR forms are available without additional charge to CAR members on the organization's website and for a fee by other purchasers. See Directory for CAR's website information.) The purchase agreement or lease may contain such a provision even if the listing agreement does not, in which event the purchase agreement or lease controls (provided that the broker is a party to it), despite the commission provision in the listing agreement. This contract term is not always favorable to the broker. If the amount retained or recovered by the principal is nominal, the broker's recovery may be an inconsequential amount, regardless of any other theory of recovery the broker may have had. *Chapman v Gilmore* (1963) 221 CA2d 506, 34 CR 515.

PRACTICE TIP: From a practical standpoint, whether the payment of the broker's commission is or is not conditioned on the closing may be of no consequence, except as to whom a claim could be asserted against in the event of breach. If the buyer or lessee breaches the contract, the broker may have a claim as a third party beneficiary against the buyer/lessee for the lost commission. If the principal terminates the contract before closing, the broker may have a claim against the principal for breach of the implied covenant of good faith and fair dealing.

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§2.40 c. Payment From Deposits

Frequently, the only amount really at issue as damages is the deposit, and the property owner's right to retain the deposit is governed by statutes on liquidated damages. See CC §§1671-1681. If the purchase agreement or lease contains a valid liquidated damages provision and either the listing or the lease or purchase agreement provides that the broker may recover half of any funds recovered by the property owner, then the broker is entitled to half of the deposit.

An interesting question arises when the property owner elects to return a deposit to which the owner is or may be entitled. Does the provision entitling the broker to half of any funds recovered entitle the broker to a commission equal to half of the deposit? In *Kritt v Athens Hills Dev. Co.* (1952) 109 CA2d 642, 241 P2d 606, the listing agreement provided that the commission should be one-half of any deposit retained, but it did not obligate the property owner to retain the deposit. It was held that the owner had no obligation to retain deposits to which it was otherwise entitled, and the broker recovered nothing for sales on which deposits were returned.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.41 d. Form: Entitlement to Commission

§2.41 d. Form: Entitlement to Commission

Owner agrees to pay Broker as a commission

[*Add one of the following alternatives*]

[*Alternative 1: Simple percentage of sale price*]

_ _[*number*]_ _ percent of the first $_ _[*amount*]_ _ of the gross selling price plus _ _[*number*]_ _ percent of the gross selling price in excess of $_ _[*amount*]_ _, if, during the listing period or any extension of it,

[*Alternative 2: Flat fee regardless of sale price*]

the total sum of $_ _[*amount*]_ _ regardless of the selling price _ _[*or the type or value of any property accepted in exchange for the property*]_ _, if, during the listing period or any extension of it,

[*Alternative 3: Balance over net price sale price to owner*]

the balance of the selling price in excess of $_ _[*amount*]_ _ net to Owner after payment of all other costs in escrow except the following, which will be paid by Owner out of Owner's net price: _ _[*list expenses to be paid by owner*]_ _, if, during the listing period or any extension of it,

[*Alternative 4: Lease of property*]

the amount of $_ _[*amount*]_ _ or in accordance with the commission schedule attached hereto as Exhibit __.

[*Continue*]

[*Add one of the following alternative circumstances under which the commission is earned*]

[*Alternative 1: Exclusive right-to-sell or right-to lease listing*]

anyone (including Owner) procures a _ _[*buyer/lessee*]_ _ on the terms stated in this listing agreement or any other terms acceptable to Owner.

[*Alternative 2: Exclusive agency listing*]

any broker procures a _ _[*buyer/lessee*]_ _ on the terms stated in this listing agreement or any other terms acceptable to Owner.

[*Alternative 3: Open listing*]

Broker procures a _ _[*buyer/lessee*]_ _ on the terms stated in this listing agreement or any other terms acceptable to Owner.

[*Alternative 4: One party listing*]

Broker procures _ _[specify *name of specific buyer/lessee for which broker will be paid*]**_ _ on the terms stated in this listing agreement or any other terms acceptable to Owner.**

[*Continue*]

[*If applicable, add one or more of the following options*]

[*Option 1: Commission conditioned on closing or owner's default*]

Payment of the commission is conditioned on close of escrow, but it will be deemed earned even if escrow fails to close if that failure arose from Owner's default or lack of good faith.

[*Option 2: Commission on buyer's/lessee's default*]

If _ _[*buyer/lessee*]_ defaults, the commission will be payable only if and when Owner collects damages from the _ _[*buyer/lessee*]_ , by suit or otherwise, and in an amount not to exceed half the damages recovered after

first deducting Owner's actual out-of-pocket expenses incurred in connection with the transaction (*e.g.,* title, escrow, and inspections and reports prepared at Owner's expense), and any expenses of collection, including but not limited to attorney fees.

[*Option 3: Withdrawal clause*]

A commission of _ _ percent of $_ _[*amount*]**_ _ will be payable if Owner withdraws the Property from a transaction or the market, or otherwise sells, encumbers, leases, or renders it unmarketable during the listing period.**

[*Continue*]

[*Add if a printed or form agreement for sale of residential property is used; set words below in not less than 10-point bold type to comply with Bus & P C §10147.5*]

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.

Comment: The commission amount is usually a percentage of the sales price or total rent or, sometimes, a flat fee. When the amount is a percentage, a sliding scale may be used if the percentage decreases (or, rarely, increases) over a certain sales price. Sometimes commission agreements provide for different percentages to be payable, depending on whether the listing broker sells or leases the property or whether a cooperating broker procures the buyer or lessee.

The language in the last paragraph of the form is required by Bus & P C §10147.5. It must be included in any printed or form agreement for the sale of a mobile home or residential real property containing four or fewer residential units. Section 10147.5 also provides that the amount or rate of compensation may not be printed in the agreement. See also chap 7.

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§2.42 e. Form: Excluded Parties

Broker will not be entitled to a commission for any sale, lease, exchange, or other transfer to any of the following persons: _ _[*names*]_ _.

Comment: A property owner who signs a listing agreement with a particular broker may already have brought the property to the attention of one or more prospective parties or have an obligation to another broker under a safety clause. See §2.43. This provision enables the owner to eliminate any claim by the present broker for a commission on a sale to such a buyer. Under an exclusive right-to-sell listing (see §2.21), this provision is essential to protect the owner in the event of a transaction with a party with whom the owner or previous broker had negotiated. It is also useful in an open listing (see §2.24) or an exclusive agency listing (see §2.23) to avoid disputes about who procured a particular buyer or lessee. It would be unnecessary with a one party listing (see §2.25). Many brokers will not accept a listing containing such an exclusion, or will do so only if the exclusion is limited to a brief period of time. See also Practice Tip in §7.24.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.43 f. Form: Transaction After Termination of Listing Agreement (Safety or Protection Clause)

§2.43 f. Form: Transaction After Termination of Listing Agreement (Safety or Protection Clause)

If, within _ _[*number*]_ _ days after termination of the Listing Period or any extension of it, Owner agrees to _ _[*sell/lease/transfer/option/exchange*]_ _ the Property _ _[*to/with*]_ _ anyone with whom broker negotiated concerning the Property during the Listing Period or any extension of it, Broker will be entitled to a commission in the amount and on the terms specified in the listing agreement. Owner has no obligation to pay Broker any commission under this provision unless, no later than _ _[*number*]_ _ days after expiration of the Listing Period or any extension of it, Broker provides to Owner a written list of all parties with whom Broker has negotiated for a possible transaction.

[*If applicable, add the following option*]

[*Option: Termination on broker's failure to perform*]

This provision will not apply if Owner terminates this agreement because of Broker's failure to perform or breach of duty, or if, during the period specified in this provision, a transaction involving the property is procured by any other licensed real estate broker under a valid listing agreement.

Comment: A "safety" clause (sometimes called "protection" or "sunset" clause) entitles the broker to a commission if the property is sold within a stated period (the "sunset period," generally 30 to 60 days) after the listing expires to a buyer identified during the listing term. This type of clause is often contained in exclusive right-to-sell or right-to-lease listing agreements. Under this safety clause, the broker must actually have negotiated with the excluded party regarding the property (*Simank Realty, Inc. v DeMarco* (1970) 6 CA3d 610, 86 CR 212); however, the clause could also be drafted to encompass any person who physically entered and was shown the property during the listing period or for whom the broker or any cooperating broker submitted a signed, written offer to acquire, lease, exchange, or obtain an option on the property.

The broker need not be the procuring cause of the eventual transaction (*Leonard v Fallas* (1959) 51 C2d 649, 335 P2d 665; *Delbon v Brazil* (1955) 134 CA2d 461, 285 P2d 710), unless the agreement calls for that level of involvement (*E.A. Strout W. Realty Agency, Inc. v Lewis* (1967) 255 CA2d 254, 62 CR 918). This clause requires the broker to notify the owner in writing of parties with whom the broker has negotiated and only requires the owner to agree to a sale within the protection period. The more common, but ambiguous language, "if the property is *sold* during the term," should be interpreted the same way. The escrow closing date may determine when the commission is payable, but it should not be relevant to the question of whether it has been earned. See additional discussion of safety clauses in §7.24.

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§2.44 10. Form: Printed Form Subordinate to Drafted Provisions

The rider, containing _ _[*pages/provisions*]_ _ numbered _ _[*number*]_ _ through _ _[*number*]_ _, executed concurrently with this agreement and appended to it, constitutes an integral part of this agreement and supersedes inconsistent provisions in it.

Comment: Brokers often prefer to use standard listing agreement forms even when they intend to alter them substantially; these altered terms are set out in a specially drafted rider. See §§2.27-2.28. To make it clear that the printed form is part of a broader agreement, the rider should refer to the printed form.

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§2.45 11. Form: Acknowledgment of Receipt; Broker's Acceptance

[*Add one of the following alternatives*]

[*Alternative 1: Listing agreement*]

Owner acknowledges receipt of a copy of this listing agreement.

[*Alternative 2: Letter agreement mailed to broker*]

Please sign and return the enclosed copy of this letter as evidence of your agreement to its terms.

Comment: These provisions are designed to protect the broker, who is required to give a copy of the agreement to the person signing it (Bus & P C §10142) and is subject to discipline for failure to do so (Bus & P C §10177). Failure to deliver a copy, however, will not affect the broker's right to a commission under a valid listing agreement. *Summers v Freeman* (1954) 128 CA2d 828, 276 P2d 131.

Effective January 1, 2010, Bus & P C §10177 was amended to include additional grounds to subject a real estate licensee to discipline. These now include violations of certain federal acts or regulations, including the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617); the Truth in Lending Act (TILA) (15 USC §§1601-1693r); the Home Ownership Equity Protection Act (15 USC §1639); or any regulation promulgated under any of these federal acts. Bus & P C §10177(q). The statute was also amended to include failures to comply with Civ C §§2920-2944.7, related to mortgage liens. Bus & P C §10177(r). Notably, Civ C §2923.1 pertains to the fiduciary role of mortgage brokers and the obligation that mortgage brokers place the economic interest of the borrower ahead of their own economic interest, and states that any violation of a broker's fiduciary duties is a violation of the California Residential Mortgage Lending Act (Fin C §§50000-50706), under which mortgage brokers are licensed. These amendments were passed in response to the mortgage crisis of the late 2000s and to impose tighter controls to avoid the potential for loan modification and foreclosure rescue scams. For additional discussion of broker disciplinary actions, see §§9.9-9.11.

If the agreement takes the form of a letter to the broker, acknowledgment by the property owner is unnecessary, and the second alternative should be used to show the broker's assent to the terms of the listing agreement.

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§2.46 12. Alternative Dispute Resolution

Alternative Dispute Resolution (ADR) provisions, generally mediation and arbitration clauses, are commonly found in standardized listing agreement forms as well as in individually drafted forms. See, *e.g.,* paragraphs 19A-B of the CAR Exclusive Authorization and Right to Sell listing agreement, available to CAR members on the organization's website. See Directory for CAR's website information. ADR of broker and principal disputes is discussed in detail in chap 6. The discussion in §§2.47-2.48 is intended to assist counsel in drafting or reviewing the ADR provisions in a listing agreement.

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§2.47 a. Mediation

Mediation clauses allow the parties to agree to mediate any dispute between them arising out of the applicable transaction before any court action or arbitration. Typically, a mediation clause will permit the parties to select a mutually agreeable mediator and if the parties cannot agree on a mediator, the superior court will appoint one. Some mediation clauses provide that if the clause is initialed by both parties and a party refuses to participate in mediation, then that party is not entitled to recover prevailing party attorney fees should that party later prevail at arbitration or trial. Such a provision is enforceable. See *Johnson v Siegel* (2000) 84 CA4th 1087, 1100, 101 CR2d 412.

For an example of a mediation clause, see §6.22.

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§2.48 b. Arbitration

As with all contracts that convey real property, or that contemplate a future real property sale, a listing agreement that provides for binding arbitration must set forth the arbitration clause in specific statutory language, and in a particular type size and style. CCP §1298. The arbitration clause also must be separately initialed by the parties. The statutory language informs the parties that, by selecting arbitration, they are waiving certain rights, including the right to a jury trial. These requirements have resulted in litigation over the enforceability of arbitration clauses that did not include the statutory language, or were not in the proper typeface, or were not separately initialed by both parties. Following the United States Supreme Court's decision in *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 134 L Ed 2d 902, 116 S Ct 1652, CCP §1298 is probably invalid under the supremacy clause as an unreasonable restraint on arbitration in contravention of the federal Arbitration Act (9 USC §§1-16), at least in any transaction involving any aspect of interstate commerce (*e.g.,* any transaction in which financing is contemplated). *Hedges v Carrigan* (2004) 117 CA4th 578, 11 CR3d 787. See discussion in §6.27.

When the statute is enforceable, however, failure to follow its requirements will, at a minimum, invalidate the clause and may invalidate the entire contract. As long as the supremacy clause remains on the books, the careful drafter should continue to observe its technical requirements, even though a straightforward arbitration clause (in normal typeface and without separate initials) should be enforceable. The parties can alter the language of the notice to change, *e.g.,* the method of arbitration or the right to discovery. The parties may also want to specify the number of arbitrators (American Arbitration Association Real Estate Industry Arbitration Rule 19 provides for one arbitrator unless the contract provides for more), the place in which the arbitration will be held, and the time period within which the hearing shall be scheduled.

For an example of an arbitration clause, see §6.34.

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§2.49 13. Execution; Acknowledgment of Receipt

A broker's listing agreement must be executed by the party to be charged. CC §1624(a). The issue of proper execution typically arises in the context of the broker's attempt to recover a commission, and usually the primary question is whether the party executing the listing agreement was actually the owner of the property. Sometimes a principal of the entity that owns the property executes the listing without properly indicating his or her title or authority. At the very least, the person signing the listing will be bound; but the broker should attempt to ensure that the actual property owner is bound as well. Sound practice calls for both the owner and the broker to sign the agreement. If a letter agreement is used, the broker should be required to sign and return a copy to the owner. See §2.45. For a discussion of signature requirements in business contracts, see Drafting Business Contracts: Principles, Techniques & Forms §§18.1-18.33 (Cal CEB 1994).

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§2.50 III. BUYER-BROKER AND LESSEE-BROKER AGREEMENTS

In residential transactions, it is less common for brokers to earn their commissions from the buyer rather than the seller. In commercial transactions it is not unusual for each party to pay its own broker commission, depending on the local market custom and kind of transaction. Generally, however, even when the broker is employed by the buyer or lessee, it is often understood that the buyer's or lessee's broker must look to the property owner to be paid a commission. In many buyer-broker and lessee-broker agreements, the principal is a substantial commercial client interested in locating sites for new ventures, and the broker and the principal have worked together over time and have developed a relationship of mutual trust. For these reasons, their agreement is often not reduced to writing until a purchase agreement or long-term lease is executed. In this less formal atmosphere, it is important that the terms of the broker's employment are clearly expressed and understood by both the principal and the broker. Oral agreements should be put in writing as soon as possible, even if only in the form of a letter, to avoid disputes and misunderstandings.

The property seeker may still be liable to pay the broker commission even if the property owner releases it from liability for defaulting under the transaction agreement and failing to close escrow. *Schaffter v Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 752, 83 CR3d 19.

The various listing agreement provisions set forth in §§2.29-2.45 can be readily adapted for a buyer-broker or buyer-lessee agreement, as appropriate, regardless of whether a letter or an employment contract format is used. Provisions that might be desired by the property seeker or the broker include employment of the broker and term of the agency (see §2.29); characteristics of the property sought; conditions under which the commission will be earned and by whom it will be paid (see §2.41); a safety clause (see §2.43); and the broker's duties (see §2.35).

In response to the opinion in *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 73 CR2d 784 (buyer-broker has fiduciary duty to client; see chap 3), CAR revised its form buyer-broker agreement. There are now three standard forms: the Buyer Broker Agreement—Nonexclusive/Not for Compensation (BRNN), the Buyer Representation Agreement—Exclusive (BRE), and the Buyer Broker Agreement—Non-Exclusive (BRNE). The CAR forms are available to CAR members on the organization's website. See Directory for CAR's website information. In general, the agreements do the following:

- Delineate the scope of the tasks and duties to be performed by the buyer and the broker;
- Consent to the broker's potential dual agency; and
- Limit the amount of time a buyer has to bring a legal claim against the broker to the same 2-year period specified in CC §2079 (see §11.32).

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IV. LEASES AND PURCHASE AGREEMENTS

§2.51 A. General Characteristics

The elements of an enforceable purchase and sale agreement or a lease are the same as for other real property contracts. See the discussion of the elements of contracts in §§2.1-2.5. As with listing agreements, agreements for the sale of real property or a lease of more than 1 year must meet the Statute of Frauds requirement that the agreement, or a memorandum of it, must be in writing and signed by the party to be bound. CC §1624(a). A buyer's agreement "to pay an indebtedness secured by a mortgage or deed of trust on the property" must also be in writing. CC §1624(a)(6). To obtain specific performance, the agreement must be sufficiently certain (CC §3390(5)), which requires designating the parties, the purchase price or rent, the method of payment, and the description of the property. See the discussion of the Statute of Frauds in §§2.6-2.19.

Brokers and attorneys for brokers should be intimately familiar with the provisions of a standard lease or purchase and sale agreement. Purchase and sale agreements for all types of real property are covered in detail in California Real Property Sales Transactions, chaps 4-6 (4th ed Cal CEB 2007). Leases of various types are covered in detail in Retail Leasing: Drafting and Negotiating the Lease (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease (Cal CEB 1996); and Ground Lease Practice (2d ed Cal CEB 2009).

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§2.52 B. Use of Printed Forms

As with listing agreements, there are a number of sources that provide preprinted leases and purchase agreements that require the person completing them to only fill information into the designated spaces. Counsel should carefully review such forms provided by brokers, title companies, escrow agents, and stationery stores before using them. Other common sources include CAR, private companies such as Professional Publishing, and local real estate associations. Commercial brokers may also provide their own standard forms or use those provided by professional organizations such as the AIR Commercial Real Estate Association.

The advantage of using these forms is that a printed form has a certain authority, some clients accept them readily, and the work needed to amend a form (and resulting cost to the client) may be less than that required to prepare an entire agreement. Many such forms, however, contain provisions that may be objectionable, such as a provision that title is to be taken by a buyer "subject to covenants, conditions, and restrictions of record" or "subject to any conditions or facts an accurate survey would reveal." If printed forms are used, they should be read carefully to ascertain the propriety and adequacy of their provisions for a particular transaction and their compatibility with the addendums, and to ensure that the agreement as a whole is consistent and clear. Lawyers who are familiar with a printed form should not assume they know what it says; laser printers can be used to produce a document that looks familiar but has actually been modified.

PRACTICE TIP: One benefit of using these forms is that they tend to be comprehensive, thereby minimizing problems due to missing terms. Another benefit is that their provisions have been legally analyzed and are presumably up-to-date, a benefit that is of particular use in residential transactions because attorneys are rarely involved. These forms also guide both broker and principal through essential elements and expectations of the transaction. The forms have the additional benefit of helping to dispel the parties' suspicion toward their use—as well as the other principal—since standard forms appear neutral, favoring neither party. Given the nature of standard forms, unusual situations or special circumstances need to be addressed by addendum.

For complex multi-unit condominium transactions, sales of apartment complexes, or commercial lease transactions, custom crafted agreements drafted by experienced real estate attorneys are more appropriate. Most of the provisions derive from boilerplate language, but can be modified to suit the property in question or the parties' needs.

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§2.53 C. Addressing Broker's Commission

Although the broker is instrumental in negotiating and documenting a lease or a purchase and sale agreement, the broker is not a party to that agreement, but is instead a third party beneficiary of the contract. The property owner and buyer or lessee enter into the agreement, and when its object is achieved, the broker's commission becomes due and payable. On broker commissions generally, see chap 7.

Following is a typical clause providing for payment of the broker's commission:

Broker's Commission; Indemnity. Under separate agreement, [Seller or Lessor] must pay _ _[*name*]_ _ (Broker) for its services as broker in this transaction. Neither party has had any contact or dealings regarding the Property, or any communication in connection with the subject matter of this transaction, through any licensed real estate broker or person, other than the Broker, who can claim a commission or finder's fee as a procuring cause of the transaction contemplated in this Agreement. If any other broker or finder perfects a claim for a commission or finder's fee based on any contract, dealings, or communication with a party (Indemnifying Party), then the Indemnifying Party must indemnify, defend, and hold the other party (Nonindemnifying Party) harmless from all costs and expenses (including reasonable attorney fees and costs of defense) incurred by the Nonindemnifying Party in connection with such claim.

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D. Exculpatory Clauses

§2.54 1. No Exculpation From Intentional Misrepresentation

A property owner and broker cannot avoid liability for intentional torts by including exculpatory language in the lease or purchase agreement. In *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 55 CR3d 59, the court was concerned with the effect that an express exculpatory clause in favor of the brokers would have on their affirmative misrepresentation that a residential lot could be split. The clause expressly advised the buyer of his right to conduct inspections, including the right to investigate matters affecting the value or desirability of the property, such as ordinances affecting future development and zoning of the property. The clause went on to strongly advise the buyer to investigate the conditions. In overruling the claim that the clause precluded justifiable reliance, the court noted that, as a matter of public policy, a contract cannot exempt anyone from responsibility for his or her fraud or willful injury to persons or property. See §§3.80, 11.24, 11.68.

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§2.55 2. Effect of Exculpatory "As Is" Provision

An "as is" or similar exculpatory provision will *not* immunize a property owner from liability for failure to disclose known hidden defects (*Lingsch v Savage* (1963) 213 CA2d 729, 29 CR 201; see *Shapiro v Hu* (1986) 188 CA3d 324, 233 CR 470; *Katz v Department of Real Estate* (1979) 96 CA3d 895, 158 CR 766), or from liability for the broker's fraudulent acts of which the owner has knowledge (*Herzog v Capital Co.* (1945) 27 C2d 349, 164 P2d 8; *Lingsch v Savage, supra*). Similarly, an "as is" sale does not shield a broker from liability, although the broker is not liable for foundation defects discoverable only by extraordinary efforts beyond the diligent inspection standard. *Wilson v Century 21 Great Western Realty* (1993) 15 CA4th 298, 18 CR2d 779. An innocent principal, however, is protected by an exculpatory provision from liability for damages for the broker's affirmative acts of misconduct. The injured party's only remedy is rescission. *Speck v Wylie* (1934) 1 C2d 625, 36 P2d 618.

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§2.56 3. Liability of Innocent Principal for Broker's Nondisclosure

An unanswered question is whether an exculpatory provision will protect an innocent principal from liability for damages for a broker's failure to disclose defects. See *Lingsch v Savage* (1963) 213 CA2d 729, 29 CR 201. Because the broker's knowledge of defects is imputed to the principal (see §5.17), and because an exculpatory clause will not protect a principal who knowingly fails to disclose defects, it could be argued that the rule of *Speck v Wylie* (1934) 1 C2d 625, 36 P2d 618, that the injured party's only remedy is rescission, is limited to misrepresentations and would not apply to the broker's nondisclosure of defects. See *Herzog v Capital Co.* (1945) 27 C2d 349, 164 P2d 8.

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V. OPTIONS AND SHORT SALES

§2.57 A. Options

A number of California lawyers advocate options that enable buyers to tie up property while investigating it without being bound to buy it. One alternative permits the seller to retain the deposit as the price for the option if it is not exercised, thus avoiding problems of liquidated damages. For detailed discussion of options, see California Real Property Sales Transactions, chap 8 (4th ed Cal CEB 2007). On requirements for liquidated damages provisions, see Real Property Sales §4.142.

Brokers may assist with the negotiation and documentation of an option, and compensation for the broker's services would be earned at the time the option is entered into and at the time of the sale if the option is exercised.

In commercial lease transactions, the lease may contain a clause that allows the lessee an option to extend the lease term for a period of years. The broker in such a transaction should ensure that the lease contains provision for payment of an additional commission in such event. This language might state:

In addition to payments owed under section _ _[*e.g., section relating to payment of broker commissions*]**_ _, and unless Lessor and Broker agree otherwise in writing, Lessor agrees that (a) if Lessee or any affiliate of Lessee exercises any option with regard to the Premises or any other premises in the Project or (b) if Lessee remains in possession of the Premises with Lessor's permission after the expiration of the Lease Term; Lessor will pay Broker a commission fee based on Broker's schedule of commissions in effect as of the effective the date of this Lease.**

WARNING: In 2010, the California Supreme Court held that a real property purchase agreement that contained a "free look" provision would actually be an option contract because the buyer was not obligated to take any further action during a 3-year investigation period. The provision reviewed by the court is standard language in many forms used in California residential property sales transactions. See *Steiner v Thexton* (2010) 48 C4th 411, 106 CR3d 252. Brokers and their counsel should be careful to ensure, if an option to purchase is not the intent of the parties, that the sales agreement provides for adequate legal consideration or affirmative obligations by the buyer.

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B. Short Sales

§2.58 1. What Is a Short Sale?

During real estate downturns, brokers may be asked to participate in so called "short sales" of distressed property. The common understanding of a short sale is "a sale in which the lender agrees to accept less than a full payoff of its loan balance." Goodman, Short Sales and Deeds in Lieu After the Mortgage Forgiveness Debt Relief Act of 2007 (2008) (available online; see Directory). It is often an alternative to foreclosure of the property.

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§2.59 2. How a Short Sale Works

Most lenders require certain financial data about the property and the borrower-property owner when considering a short sale. First, the lender will verify the true and accurate value of the property. Documentation demonstrating the property's value will assist the lender in determining whether it will recover more by proceeding with a short sale than through foreclosure proceedings.

The property owner (*i.e.,* the borrower) should be prepared to provide the lender with detailed financial statements evidencing the borrower's insolvency. Usually, this is in the form of a "hardship letter" to the lender. Additionally, some lenders will not commit to a short sale unless there is a valid and firm purchase offer from a qualified buyer and a knowledgeable broker who can negotiate the deal.

Assuming that acceptable financial data is supplied to the lender by the borrower or the borrower's broker, a deal may be negotiated. Unless the lender desires to purchase the property itself, an independent third party usually purchases the property straight from the lender. Sometimes the short sale may be initiated by the third party, or its broker, who may learn that the property is in default from one or more property default notification companies, and approach the lender on a short sale option.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.60 3. Additional Broker Duties in Short Sales

§2.60 3. Additional Broker Duties in Short Sales

Short sales represent a sizable share of the market in real estate downturns, so brokers must be aware of relevant issues and duties. The listing broker should:

- Be aware of and use appropriate forms, *e.g.,* CAR Short Sale Listing Addendum (CAR form SSL) and Short Sale Addendum (CAR form SSA);
- Contact and work closely with the property owner's lender and possibly assist the owner in compiling data to forward to the lender;
- Inform the owner of alternatives to the short sale, such as loan modifications or workouts, deeds in lieu of foreclosure, or forbearance agreements that may be available from the lender;
- Have the owner agree in writing to disclose the potential short sale in the MLS marketing;
- Advise the owner to seek tax advice, *e.g.,* regarding forgiveness of indebtedness;
- Be aware that lenders often ask brokers to reduce their commissions as a condition of the lender's approval of the short sale; and
- Advise the owner that the property may be lost to foreclosure even if the short sale is moving forward.

A buyer's broker should advise the buyer:

- That the consent of the property owner's lender is needed to proceed with the sale;
- That the lender may approve a sale to another buyer;
- That the process is usually slower than other sales;
- That although the buyer may incur expenses (*e.g.,* for structural and pest inspections), the seller's lender may not approve the sale; and
- As an extra precaution, make all short sale disclosures in writing.

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4. Benefits and Drawbacks of Short Sales

§2.61 a. Benefits to Borrower

A successful short sale enables a property owner to avoid foreclosure proceedings and stay in the property until the transaction is completed. A foreclosure is considered a major credit infraction that can severely damage the owner's credit for years. A short sale may have little or no effect on the owner's credit, depending on whether the lender reports the short sale to credit reporting bureaus as loan losses.

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§2.62 b. Benefits to Broker

Brokers are generally paid an industry standard commission directly from the proceeds of the property sale. If the property is sold for less than the loan amount, the commission may be less than the industry standard. However, if a broker becomes a short sale "specialist," the increase in business during downturns may make up for the loss.

Some brokers recoup the difference in commission (or even receive a higher-than-usual commission in a "hot" short sale market) by arranging to have the additional amount paid by the buyer rather than the seller.

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§2.63 c. Benefits to Lender

A short sale enables a lender to recover a certain amount for the property, and generally, lenders risk losing more money if the property is sold at a foreclosure auction. In addition, if the lender rejects a short sale and proceeds to foreclosure, unless the lender obtains a "full credit bid," the lender may have to purchase the property itself to avoid losing the collateral. In that event, the lender becomes the owner of the property, which most institutional lenders want to avoid. Therefore, a short sale has appeal to lenders as well as borrowers. On trustee sales and full credit bids, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009).

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§2.64 d. Drawbacks to Borrower

A short sale may result in taxable income to the borrower if the home was refinanced. The difference between the property's value and the balance on the mortgage is considered a forgiveness of debt and this amount may be considered taxable income in certain circumstances. The tax consequence may be forgiven if the borrower can prove financial insolvency.

The Mortgage Forgiveness Debt Relief Act of 2007 (Pub L 110-142, 121 Stat 1803) was enacted on December 20, 2007. Generally, the Act allows exclusion of income realized as a result of debt reduction through mortgage restructuring, or mortgage debt forgiven in connection with a foreclosure, on the taxpayer's principal residence. See IRS, *The Mortgage Forgiveness Debt Relief Act and Debt Cancellation*, available online (see Directory for URL). Under the Act, taxpayers may exclude debt forgiven on their principal residence if the balance of their loan did not exceed $2 million. IRC §§108(h)(2), 163(h)(3)(B)(ii). The limit is $1 million for a married person filing a separate return. IRC §§108(h)(2), 163(h)(3)(B)(ii). The new law as originally enacted applies to debt forgiven in calendar years 2007, 2008, or 2009. Pub L 110-142, §2(a), (d), 121 Stat 1803. A 2008 amendment to the Act, applicable to discharges of indebtedness occurring on or after January 1, 2010, extends applicability of the Act through 2012. Pub L 110-343, Div A, Title III, §303(a), 122 Stat 3807.

The debt must have been used to buy, build, or substantially improve the taxpayer's principal residence and must have been secured by that residence. IRC §§108(h)(2), 163(h)(3)(B)(i). Debt used to refinance qualifying debt is also eligible for the exclusion, but only up to the amount of the old mortgage principal, just before the refinancing. IRC §§108(h)(2), 163(h)(3)(B)(i).

CAUTION: Brokers should not attempt to advise their principals on tax matters. Instead, brokers should advise principals to consult with a tax accountant regarding these and any other tax matters. See §3.68.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/2 Broker Contracts/§2.65 e. Drawbacks to Broker

§2.65 e. Drawbacks to Broker

The lender may seek to reduce the broker's commission by modifying a pre-existing listing agreement or multiple listing service (MLS) offering. If there is no listing agreement or MLS marketing in place, the lender may insist on reducing the commission prior to negotiating the short sale. See §2.62 on strategies to recoup lost short sale commissions.

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§2.66 f. Drawbacks to Lender

To a lender, the main drawback of a short sale is that the lender waives the right to seek a deficiency judgment, which would otherwise be available for a non-purchase-money loan if the lender utilized judicial foreclosure proceedings to cure the borrower's default. See CCP §§580b, 726(b). However, even if a deficiency judgment is awarded as part of a judicial foreclosure proceeding, the lender may not be able to collect the judgment because of the borrower's likely financial inability to pay the debt.

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Agency: Broker Fiduciary and Statutory Duties

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§3.1 I. SOURCE OF DUTIES

Real estate brokers are subject to two broad sets of duties: those imposed by regulatory statutes, including the general law of agency (see §§3.2-3.13); and those arising from the common law (see §§3.17-3.20). See also *Carleton v Tortosa* (1993) 14 CA4th 745, 755, 17 CR2d 734. In addition, by joining a national or regional association of brokers, some brokers are subject to a set of private codes and standards. See §§3.14-3.16.

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§3.2 A. Statutory Duties

Various laws govern California brokers and real estate brokerage practice. The general principles and rules of agency are found in CC §§2295-2357. The primary source of real estate broker duties is Bus & P C §§10000-11505 (Real Estate Law) and the specific rules for disclosure of material facts in transactions involving residences are set forth in CC §§1102-1102.17 (for clients) and CC §§2079-2079.24 (for brokers). Broker licensing provisions are mainly found in Bus & P C §§10130-10149 and detailed regulations are set forth in 10 Cal Code Regs §§2705-2781 and 2830.1-3109. On regulation and discipline of brokers, see chaps 8-9. Private contract law fills in the remainder of the set of rights, duties, and powers of the broker. See *Carleton v Tortosa* (1993) 14 CA4th 745, 755, 17 CR2d 734.

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§3.3 B. Law of Agency

Agency between broker and principal may occur without a listing agreement; it can be implied from the interactions between the parties. For example, in *Hale v Wolfsen* (1969) 276 CA2d 285, 290, 81 CR 23, the court found that Hale was the agent of the buyer because Hale had signed on as a cooperating broker, agreed to split a commission with the original broker, prepared a proposed exchange agreement, carried on correspondence, and was named in the final deposit receipt. The court found an implied agency between Hale and the buyer, even though Hale was also the agent for the seller.

Not every interaction between a real estate broker and a property owner, buyer, or tenant creates an agency relationship. "An agent is one who represents another… in dealings with third persons." CC §2295. Representation will not result from every interaction. For example, an agency is not usually established when a seller's broker at a residential open house communicates with prospective buyers or, in a commercial setting, when brokers communicate regularly with property owners and investors about the state of the market. Frequently, there is no agency relationship created unless the broker is retained to represent the principal in marketing to, or negotiating with, third parties. Brokers nevertheless still have obligations to parties with whom they do not have an agency relationship. See §§3.71-3.87.

Brokers are obligated to "make a full and accurate disclosure of the terms of a [transaction] and to act always in the utmost good faith toward their principals." *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392. In the absence of a fiduciary relationship, a broker still has the duty to refrain from giving misinformation, but the affirmative duty to disclose all information and to explain and counsel a principal is lacking. For example, in the unreported case of *Stetler v Greenpoint Mortgage Funding Inc.* (ED Cal, Jan. 23, 2008) 2008 US Dist Lexis 4880, a borrower sued a mortgage broker whom, it alleged, had received undisclosed kickback payments from the lender. The court granted the mortgage broker summary judgment, holding that the broker did not owe a fiduciary duty to the borrower when the written agreement between them provided that the broker was an independent contractor, not the borrower's agent and also disclosed that the lender could compensate the broker. If the broker *had* been the borrower's agent, the details of any payments from the lender would have had to be disclosed. See §§3.30, 3.35.

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§3.4 1. Agency Defined

Under CC §2295, an agent is one who represents another, the principal, in dealings with third persons. Agency is the relation that results when the principal acts to authorize the agent to "conduct one or more transactions with one or more third persons and to exercise a degree of discretion in effecting the purpose of the principal." *Wallace v Sinclair* (1952) 114 CA2d 220, 229, 250 P2d 154.

An agent who is authorized for a particular act or transaction is called a special agent; all other agents are general agents. CC §2297. In the real estate area, a broker is generally a "special agent" charged to complete a particular transaction.

The existence of an agency relationship and the extent of the authority of the agent are questions of fact for the jury, unless the evidence is susceptible of but one inference. *California Viking Sprinkler Co. v Pacific Indem. Co.* (1963) 213 CA2d 844, 850, 29 CR 194; *Metropolitan Life Ins. Co. v State Bd. of Equalization* (1982) 32 C3d 649, 658, 186 CR 578. The burden of proving agency and its scope rests on the party claiming the agency existed. *California Viking Sprinkler Co. v Pacific Indem. Co., supra*.

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§3.5 2. "Finder" Distinguished

Occasionally, a person who does not hold a real estate license seeks compensation for services rendered under a contract with a principal in connection with a transaction. This is allowed under California law, as long as the services rendered are nothing more than finding and introducing a prospective buyer or lessee to the property owner. See *Zappas v King Williams Press, Inc.* (1970) 10 CA3d 768, 772, 89 CR 307. The finder is not in a fiduciary relationship with either principal. However, if the services include *any* negotiations for or on behalf of any of the parties to a transaction, or the purported "finder" obtained authority to do more than merely introduce the parties, the "finder" becomes an "agent" and a California real estate license is required. *Batson v Strehlow* (1968) 68 C2d 662, 669, 68 CR 589.

A finder's duties are limited by contract to finding and procuring a buyer or lessee "able, willing and ready to accept [the] client's terms or to effect a transaction with [the] client in any terms satisfactory to both." The finder is not in a fiduciary relationship with the principal. A broker may perform the duties of a finder, but in addition "is employed to use discretionary authority for the benefit of his employer and to act for his best interests." *Batson v Strehlow, supra*. See also §§7.15, 8.15-8.18.

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3. Formation of Agency Relationship in Real Property Transactions

§3.6 a. Widely Used Standardized Forms

Practically speaking, the issue of proper formation of the agency relationship in real estate transactions rarely presents itself. The California Association of Realtors® (CAR) and certain other nationwide companies produce listing and broker-buyer form agreements that are in widespread use in California on the residential side. Commercial brokers generally provide their own forms to their principals. See §§1.6-1.10. The prevalence of standard forms also tends to minimize formation issues regarding broker-salesperson agreements, which must be in writing under the licensing statutes. 10 Cal Code Regs §2726. On the relationship between broker and salespersons, see §§8.32-8.42.

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§3.7 b. Statute of Frauds

While the agency agreement may be formed orally, a written agreement is necessary for a broker to obtain a commission. *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 1257, 241 CR 22. An agreement to pay a commission that does not satisfy the Statute of Frauds (CC §1624) may nevertheless be enforceable if ratified by the principal. See *Friddle v Epstein* (1993) 16 CA4th 1649, 1656, 21 CR2d 85. See also *Beazell v Schrader* (1963) 59 C2d 577, 580, 30 CR 534 (escrow instructions providing for payment of commission to broker sufficient to satisfy Statute of Frauds).

But estoppel will not save a commission agreement that fails to satisfy the Statute of Frauds. This is because the licensed broker or salesperson is deemed to be aware of the law in this regard and thus incapable of satisfying the necessary element for proving estoppel, justifiable reliance. See *Phillippe v Shapell,* 43 C3d at 1259. See discussion of estoppel in §11.70.

For more on the Statute of Frauds and broker compensation, see discussions in §§2.6-2.19, 7.14-7.15.

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§3.8 c. Statutory Disclosure Requirement

Finally, in addition to the requirement of a written agreement, a mandatory agency disclosure (see CC §2079.16) must be provided by a broker or salesperson to his or her principal for the purchase or sale (or lease for a period of greater than 1 year) of real property consisting of one to four dwelling units or a manufactured home. CC §§2079-2079.1, 2079.14. CAR provides a standard form that mirrors the statutory requirements. CAR forms are available only to CAR members. For more information, visit the CAR website at the address listed in the Directory. Failure to provide this disclosure renders the broker's right to compensation voidable. *Huijers v DeMarrais* (1992) 11 CA4th 676, 685, 14 CR2d 232.

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§3.9 4. Scope of Authority

The extent of the agency is measured by the authority conferred on the agent, actually or ostensibly, and the agent's power is sufficient to do everything that is necessary, proper, or usual to accomplish the principal's purpose. *Wallace v Sinclair* (1952) 114 CA2d 220, 229, 250 P2d 154, citing CC §§2315-2320, 2330.

- *Actual authority* is such as a principal either (1) intentionally confers upon the agent or (2) intentionally, or by want of ordinary care, allows the agent to believe himself to possess. CC §2316.
- *Ostensible authority* is such as a principal intentionally or by want of ordinary care, causes or allows a third person to believe the agent to possess. CC §2317. See also discussion in §5.21.

Typically, the authority of residential and commercial brokers representing a property owner is set forth in the listing agreement. For brokers representing the buyer or tenant, the scope of authority is most often established by oral agreement and by the broker's efforts in undertaking the additional, necessary steps usually performed for such engagements in the ordinary course of business. See CC §2319.

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§3.10 5. Ratification of Authority

Ratification is *after-the-fact* approval or authorization by a principal of an agent's acts or omissions that were outside of the agent's scope of authority. *Anderson v Fay Improvement Co.* (1955) 134 CA2d 738, 748, 286 P2d 513. Ratification may occur "only in the manner that would have been necessary to confer an original authority for the act ratified, or where an oral authorization would suffice, *by accepting or retaining the benefit of the act, with notice thereof*." (Emphasis added.) CC §2310. The principal's after-the-fact approval or authorization may be express or implied by conduct. See *Behniwal v Mix* (2005) 133 CA4th 1027, 1040, 35 CR3d 320 (sellers ratified broker's forgery of their signatures on contract documents by signing disclosures); *Gates v Bank of America* (1953) 120 CA2d 571, 576, 261 P2d 545.

Commencing a lawsuit based on the validity of an agent's unauthorized act also constitutes ratification. *Price v McConnell* (1960) 184 CA2d 660, 665, 7 CR 695, cited with approval by *Navrides v Zurich Ins. Co.* (1971) 5 C3d 698, 704, 97 CR 309.

Delay by the principal after learning of an agent's unauthorized conduct tends to prove implied approval. When an agent exceeds his or her authority, it is the principal's duty to promptly repudiate. See *Gaine v Austin* (1943) 58 CA2d 250, 260, 136 P2d 584.

If a principal ratifies part of an indivisible transaction, he or she is deemed to ratify the whole transaction. CC §2311. A principal "cannot split the agency transaction into separate parts, and take the benefits without the burden." *Gift v Ahrnke* (1951) 107 CA2d 614, 623, 237 P2d 706.

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§3.11 6. When Duty Terminates

An agency terminates, as to every person who has notice of (CC §2355)

- The expiration of its term;
- The extinction of its subject;
- The death of the agent;
- The agent's renunciation of the agency; or
- The incapacity of the agent to act as agent.

Unless the agent's power is coupled with an interest in the agency (see §3.12), an agency will also terminate (CC §2356(a))

- If the principal revokes it;
- If the principal becomes too incapacitated to contract; or
- If the principal dies.

Typically, under CC §2355(b), the transfer of the subject matter of an agency—the sale of the property—terminates the agency. See *McColgan v Bank of Cal.* (1929) 208 C 329, 334, 281 P 381. In most real estate transactions, the agency will terminate at the close of escrow, when the property changes hands and the commission is paid. See, *e.g.*, *Menzel v Salka* (1960) 179 CA2d 612, 624, 4 CR 78. Otherwise, an agency relationship generally may be terminated by the principal at any time except after the agent performs by selling the property or in the event of an exclusive listing for a specific term. See *Tetrick v Sloan* (1959) 170 CA2d 540, 546, 339 P2d 613.

A bona fide transaction entered into with an agent by any person acting without actual knowledge of the revocation, death, or incapacity of the principal is binding upon the principal, his or her heirs, devisees, legatees, and other successors in interest. CC §2356(b).

Typically, a broker and principal will enter into a real estate listing, and the broker's authority will be fixed by the terms of the listing. See Bus & P C §10131. Once the broker negotiates a binding contract of sale or lease to the principal's satisfaction, the broker has completed his or her services. See *McPherson v Real Estate Commissioner* (1958) 162 CA2d 751, 754, 329 P2d 12 (principal did not object to resale at higher price).

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§3.12 a. Duty Does Not Terminate When Agency Is Coupled With Interest

An agency is revocable unless it is coupled with an interest. CC §2356(a). The requirements for the creation of an agency coupled with an interest are (*Lombardo v Santa Monica YMCA* (1985) 169 CA3d 529, 541, 215 CR 224):

- The agency is held for the benefit of the agent rather than the principal;
- The agency is created to secure the performance of a duty to the agent or to protect a title in the agent; and
- The agency is created at the same time the duty or title is created or is created for consideration.

"For a power to be coupled with an interest so as to be irrevocable there must be a specific, present and coexisting interest in the subject of the power or agency." *Jay v Dollarhide* (1970) 3 CA3d 1001, 1023, 84 CR 538, disapproved on other grounds in *Morris v Thogmartin* (1973) 29 C3d 922, 105 CR 919. The agent must have an "interest in the subject of the power, as distinguished from an interest in the proceeds of the power" for the agency to become irrevocable. *Todd v Superior Court* (1919) 181 C 406, 414, 184 P 684. If an agent becomes a party to the transaction (*e.g.*, an agency coupled with an interest), the fiduciary relationship will likely continue past the entry into a binding contract. See *Lane Mortgage Co. v Crenshaw* (1928) 93 C 411, 426, 269 P 672 (exclusive agency for management of building coupled with free rent in building is irrevocable power coupled with interest).

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§3.13 b. Some Duties Survive Closing

Although selling the property generally terminates the agency relationship, a broker's fiduciary duties include certain postclosing obligations related to the sale. *Menzel v Salka* (1960) 179 CA2d 612, 623, 4 CR 78 (broker knew sellers continued to rely on him as their agent). Even after the expiration of the agency, the broker may not disclose or take advantage of confidential information acquired from the client. Restatement (Third) of Agency §8.05, Comment c (2006). The fiduciary duty of a real estate broker to his or her principal, "precludes the agent from obtaining any advantage over the principal in any transaction had by virtue of his agency." *Roberts v Lomanto* (2003) 112 CA4th 1553, 1563, 5 CR3d 866. In *Lomanto*, a broker (who was both the leasing and listing broker of the property) offered to purchase her principal's shopping center after the expiration date on the listing agreement had passed. The broker later assigned her purchase rights to a third party. The principal consented to the assignment without knowing that the broker would receive a $1.2 million assignment fee (effectively raising the price of the property from $11 million to $12.2 million). The broker also received a $110,000 commission from the principal on the sale of the property. The court held that the broker breached her ongoing fiduciary duty to her principal as his leasing broker, which duties were also recited in the purchase contract. The *Lomanto* decision essentially lengthens the fiduciary duty of a broker who participates in the sales transaction in any way outside of the traditional broker role.

> [A] real estate licensee, *while acting in his or her capacity as such*, must not receive any benefit from the transaction of his or her agency other than that which is known and accepted by the principal. The agent will not be permitted to retain *anything* that might otherwise derive from participation in the transaction unless the agent *fully* discloses the nature *and amount* of the benefit and receives the approval of the principal. *It is totally immaterial that the transaction is otherwise fair to the principal, or that the principal receives exactly the price wanted for the property*. *Lomanto,* 112 CA4th at 1563. [Emphasis added.]

PRACTICE TIP: When questioned by their principal as to what information should be disclosed to a potential buyer, brokers often tell the principal to err on the side of disclosure. *Lomanto* tells us that brokers would do well to follow their own advice, particularly when the broker participates in the sale in any form beyond acting as a broker; that is, the broker must disclose everything to his or her principal to the standard of a trustee to his beneficiary.

In *Lomanto*, the broker had ongoing agency duties (as the leasing broker) outside the purchase transaction. However, the case of *Stephens, Partain & Cunningham v Hollis* (1987) 196 CA3d 948, 242 CR 251, seems to suggest that after the agency relationship has terminated, a broker can take a position that conflicts with that of its former principal (loan broker permitted to act as foreclosing trustee on deed of trust given when broker initially arranged for loan). On the duty of confidentiality, see §3.51.

Termination of a transaction does not terminate the broker's statutory duties. Real estate brokers must retain documents in connection with transactions for which a license is required for 3 years. These documents are subject to audit by the Real Estate Commissioner. Bus & P C §10148. Documents may be retained using electronic image storing media, if requirements regarding the manner of storage and accessibility are met. 10 Cal Code Regs §§2729, 2729.5. In addition, the Real Estate Law (Bus & P C §§10000-10580) imposes at least two additional postclosing duties on brokers. A broker must:

- Inform both seller and buyer in writing of the sale price within 1 month after the transaction closes (Bus & P C §10141); and
- Record or deliver to the beneficiary any deed of trust executed in the transaction (Bus & P C §10141.5).

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§3.14 C. Private Codes of Ethics

The National Association of Realtors® (NAR) publishes a Code of Ethics and Standards of Practice, a copy of which may be found in App A. Similarly, the California Association of Realtors® (CAR) promulgates a California Code of Ethics and Arbitration Manual. The CAR Manual may be found on the CAR website listed in the Directory. See also §§1.6-1.8.

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§3.15 1. Judicial Notice of Private Association Standards

When evaluating the standard of conduct for brokers, California courts have taken judicial notice of a private association's standards. California Evidence Code §452(h) authorizes courts to take judicial notice of relevant criteria, including rules and ethical codes promulgated by private professional associations. *Nguyen v Scott* (1988) 206 CA3d 725, 737 n2, 253 CR 800; *Easton v Strassburger* (1984) 152 CA3d 90, 101 n5, 199 CR 383. See *Norman I. Krug Real Estate Invs. v Praszker* (1994) 22 CA4th 1814, 28 CR2d 498. These standards apply to the brokers who are members of such private associations. Residential brokers are often members of NAR. Commercial brokers may or may not be members of an association such as the AIR Commercial Real Estate Association, or may voluntarily adhere to certain standards. Even when the standards do apply, they may not completely define a particular broker's duties, but will be considered by the court in the context of the standards, custom, and practices in the real estate community. See *Stevenson Real Estate Servs., Inc. v CB Richard Ellis Real Estate Servs, Inc.* (2006) 138 CA4th 1215, 1223, 42 CR3d 235. An attorney seeking to prove the standard of care at trial will need to look closely at the individual broker's memberships and whether the association standards definitively apply to the broker in question under the specific facts of the case. When applicable, such standards may, but not necessarily will, supplement the standard of care set forth in case law, the Real Estate Law, and as defined by custom and practice in the particular industry.

In addition, the standards, if shown to be relevant to the issues in the case, may be applied through expert testimony to brokers generally in that community, even if they are not subject to the standards themselves. In other words, an expert witness might testify that a subgroup of the community, who are gifted or advanced in their particular community, apply a particular standard and accordingly it is appropriate to apply that standard to all brokers in the community. See chap 13 on standard of care witnesses.

WARNING: Judicial notice of documents must be presented to and considered by the trial court or it may not be raised in a future appeal. There is an exception to this rule if "the request for judicial notice is unopposed and the matters to be judicially noticed are not reasonably open to dispute." *Carleton v Tortosa* (1993) 14 CA4th 745, 753 n1, 17 CR2d 734.

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§3.16 2. Private Standards as Basis for Legal Action

The rules and standards of a private association may give grounds for an actionable claim. The dispute in *Stevenson Real Estate Servs., Inc. v CB Richard Ellis Real Estate Servs. Inc.* (2006) 138 CA4th 1215, 42 CR3d 235, involved an alleged violation of the Rules of Professional Conduct of the American Industrial Real Estate Association. Broker A sued broker B for interference with a prospective economic advantage because Broker B had essentially stolen Broker A's client (with whom it had no written contract) and cut Broker A out of the deal. Broker A based its complaint on a violation of the trade association rules that prohibited an "associate" from inserting himself or herself "into a transaction or potential transaction initiated by another associate" and "using tactics calculated to interfere with the first associate's relationship with the client." The court held that such rules can constitute a standard and may be independently actionable (even if only via arbitration within the association). Moreover, the court noted that Broker B could not simply claim that it was not an associate of the trade association, and thus not subject to its rules. The rules must be introduced as evidence so that the trial court, through judicial notice procedures, could make its own determination.

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II. FIDUCIARY DUTIES

§3.17 A. Basis in Common Law

A broker's fiduciary duties arise because of the agency relationship between the broker and the principal. Fiduciary duties exist at common law and are not necessarily overridden by a statute imposing a duty of care. *Batson v Strehlow* (1968) 68 C2d 662, 68 CR 589; *Ward v Taggart* (1959) 51 C2d 736, 336 P2d 534. "Under the common law, unchanged by *Easton* [*Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383, and CC §2079], a broker's fiduciary duty to his client requires the highest good faith and undivided service and loyalty." *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25, 73 CR2d 784. Individual fiduciary duties are discussed in §§3.20-3.87.

A mortgage broker (statutorily defined as a licensed real estate broker who provides mortgage brokerage services) is a fiduciary of its borrower-client. Any violation of the broker's fiduciary duties is a violation of the California Residential Mortgage Lending Act (CRMLA) (Fin C §§50000-50706) and incurs requisite civil penalties and liability. The mortgage broker's fiduciary duty to its client includes a duty to place the economic interest of the client ahead of the economic interest of the broker. CC §2923.1. See also additional discussion of CRMLA in §8.24.

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§3.18 B. Broker Duties Analogous to Trustee Duties

A broker's duties are similar to those owed by a trustee to the beneficiary of a trust. See Prob C §§16002-16004 (duties of loyalty, impartiality, and avoidance of conflict); *Batson v Strehlow* (1968) 68 C2d 662, 674, 68 CR 589. See also Prob C §16463(c), which requires full disclosure and the principal's consent when a trustee has "an interest in the transaction adverse to the interest of the beneficiary."

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§3.19 C. Duty Arises When Agency Created

A broker's fiduciary duties arise when an agency relationship is created. At times, however, lesser fiduciary duties may be owed to a prospective principal. For example, a broker owes a duty of fair and honest dealing when advising prospective borrowers about loan terms, even before the execution of any loan agreement. See *Realty Projects, Inc. v Smith* (1973) 32 CA3d 204, 210, 108 CR 71. A broker also has a duty to preserve the confidentiality of information obtained from the property owner even before execution of the listing agreement. *Beeler v West Am. Fin. Co.* (1962) 201 CA2d 702, 20 CR 190.

Although a written agreement is required for a broker to recover a commission, the agency relationship can be created with little or no formality and is not subject to the Statute of Frauds (CC §1624). *Gann v Williams Bros. Realty* (1991) 231 CA3d 1698, 1705, 283 CR 128. "The creation of an agency relationship is not dependent upon the existence of a written agreement. The relationship may be implied based on conduct and circumstances, as well as by ratification." *Scholastic Book Clubs, Inc. v State Bd. of Equalization* (1989) 207 CA3d 734, 737, 255 CR 77. Whether an agency exists depends on the intent of the parties. *Nichols v Arthur Murray, Inc.* (1967) 248 CA2d 610, 612, 56 CR 728.

"The existence of an agency relationship is usually a question of fact." *Violette v Shoup* (1993) 16 CA4th 611, 619, 20 CR2d 358. Some courts have stated that "[t]he essential element of an agency relationship is the right of control, not the dispensing of" a benefit. *St. Paul Ins. Co. v Industrial Underwriters Ins. Co.* (1989) 214 CA3d 117, 123, 262 CR 490. Other courts cite control as an "important factor." See *Nichols,* 248 CA2d at 613. A recent appellate opinion, however, rejects the idea of a bright line test, whether it concerns "control" or any other factor. In *Borders Online, LLC v State Bd. of Equalization* (2005) 129 CA4th 1179, 29 CR3d 176, 183, the court discusses four major factors that might show agency:

- The agent has power to alter legal relationships of the principal;
- The agent acts as the fiduciary of the principal;
- The principal can control the agent; and
- The agent consents to act as the principal's agent.

Although the *Borders Online* court acknowledged that courts may consider these factors, it denied that a bright line test exists or that a court is bound by these factors. 129 CA4th at 1190.

PRACTICE TIP: Even though courts will look to all the facts to decide if an agency is established, brokers and their principals should document the nature of the relationship at the earliest opportunity. If an agency agreement is contemplated, it is advisable to put it in writing. If a broker's duties and role are intended in the transaction, a writing protects the client by clarifying that there is a fiduciary relationship. Likewise, if some other, nonbroker relationship is intended, the duties, roles, and intents of each party should be documented.

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§3.20 D. Standard of Care

The broker must exercise reasonable skill and care for the benefit of the principal. Principals have the right to rely upon the statements and recommendations made to them by their broker. This is especially true when the principal is inexperienced and relies on the broker's superior knowledge. *Schoenberg v Benner* (1967) 251 CA2d 154, 162, 59 CR 359. For more on the standard of care, see §3.48.

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§3.21 III. CONFLICT OF INTEREST DUTIES

The broker's fiduciary duties to the client include a duty of utmost loyalty, trust, and confidence. This duty requires the broker to avoid any conflict of interest and to put the principal's interests ahead of the broker's. These common law fiduciary duties are not diminished by the specific duties listed in CC §2079 (duty to inspect, duty to disclose material facts), but rather are supplemented by them. *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25, 73 CR2d 784.

When, however, (1) a conflict of interest is fully disclosed and the principal's informed consent is obtained and (2) the broker remains absolutely loyal to both buyer and seller, a dual agency relationship may exist. See §§3.23-3.24 for a discussion of the requirement of written consent and disclosure for residential transactions and a discussion recommending written disclosure and consent in all types of transactions.

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§3.22 A. Dual Agency, a Matter of Utmost Care

A broker or salesperson may not act as an agent for more than one party to a transaction without full disclosure to and consent of all parties. Bus & P C §10176(d). While the property owner usually pays the broker's commission, that fact alone does not prevent a broker from being the agent of the buyer or tenant as a dual agent. *Wolf v Price* (1966) 244 CA2d 165, 173, 52 CR 889. Disclosure must be made, and consent obtained, if an agent intends to represent both parties to the transaction. *Ohanesian v Watson* (1953) 118 CA2d 386, 389, 257 P2d 1022. Dual agency should be disclosed at the earliest practical time, and it is highly recommended that the clients' consent be obtained in writing. Should a dispute arise in this context, it is always easier for a broker to point to a clearly written disclosure and executed consent than to parse through verbal communications, documents, and the actions of the parties to prove whether the broker was or was not an agent for a party at a particular time.

A dual agency may exist, even though the principals are represented by different salespersons in different offices, if the salespersons are licensed under the same broker. CC §2079.13(d). In such cases, the dual agency exists at the broker level.

PRACTICE TIP: Many clients, especially in commercial transactions, find that dual agency can result in more direct negotiations and communication of information concerning the property. Dual agency can reduce the potential for misunderstanding and adversarial posturing that may threaten the making and closing of a deal. Nevertheless, the clients' informed consent to the dual agency is critical in all transactions, and the broker must be alert to the possibility of continuing conflicts as the transaction progresses.

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§3.23 1. Dual Agency in Residential Transactions

In a residential transaction, adequate disclosure is accomplished with the execution of the statutory agency disclosure form. The required written disclosure must be included either in the purchase and sale agreement or in a separate writing executed or acknowledged before or in conjunction with the execution of the purchase and sale agreement. If the listing broker's confirmation is a separate writing, it must be executed or acknowledged by the seller and the listing broker. CC §2079.17(b). If the listing broker's confirmation is a separate writing, it must be signed by the seller, the buyer, and the listing broker. CC §2079.17(a). See CC §§2079.13-2079.17 on requirements for disclosure and consent of agency relationships in residential transactions.

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§3.24 2. Dual Agency in Commercial Transactions

No case has held that disclosure and consent must be in writing in a commercial transaction. However, to prevent any dispute regarding the existence or nature of the dual agency, it is highly recommended that the broker disclose and obtain written consent. Written confirmation of the dual agency typically is included in the purchase and sale agreement or lease but should be disclosed prior to the agreement and consented to in writing at the first opportunity (long before the transaction agreement). For instance, a broker may obtain consent to the dual representation in a letter of intent, provided that the letter of intent comprises the first occasion to do so.

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§3.25 3. Failure to Disclose Dual Agency

A broker may be denied a commission for failing to disclose that a dual agency existed. See *L. Byron Culver & Assocs. v Jaoudi Indus. & Trading Corp.* (1991) 1 CA4th 300, 305, 1 CR2d 680. In *Huijers v DeMarrais* (1992) 11 CA4th 676, 684, 14 CR2d 232, the court held that a listing broker who gave the statutory agency disclosure to the seller when the purchase contract was signed should have done so *before* the parties entered into the listing agreement under former CC §§2374-2375.5, repealed by Stats 1995, ch 428, §2. Due to the untimely disclosure, the seller owed no commission. *Huijers*, 11 CA4th at 686.

Dual agency is sometimes criticized on the grounds that the conflict between the interests of the principals are so fundamental that a single broker cannot possibly serve both parties and fulfill the agency obligations of undivided loyalty and full disclosure. Although these observations correctly point to the risks inherent in such representation, courts have only limited dual agency, not prohibited it. *L. Byron Culver & Assocs.,* 1 CA4th at 304. See Bernhardt, *Making the Broker Pay When the Deal Goes Bad*, 29 CEB Real Prop L Rep 240 (Mar. 2006). Others think these objections take an overly academic view of the real estate marketplace, especially in commercial transactions in which many clients are professional real estate investors who use their brokers primarily to assist them in marketing or finding property, but who generally rely on their own expertise (and/or that of their attorneys or other professional advisors) to negotiate and evaluate a transaction.

It should be underscored that obtaining an initial, knowing waiver of a potential conflict of interest does not extinguish the broker's fiduciary duties to each principal. If an actual and abiding conflict of interest arises during a dual agency transaction, it must be disclosed. If the parties do not consent to the conflict, or if the existence of the conflict creates an inability to continue in the transaction without breaching a fiduciary duty to one of the clients, the broker must withdraw from the transaction.

WARNING: Except when dealing with the issue of price, a broker must withdraw from a dual agency transaction if one of the clients demands that information material to the transaction remain secret and such secrecy precludes full and adequate disclosure to and consent by the other party. CC §2079.21. See, *e.g*., *Alhino v Starr* (1980) 112 CA3d 158, 172, 169 CR 136. Under such circumstances, depending on the written contract between the broker and client, the objecting party may be liable for a commission.

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§3.26 B. Unintended Dual Agency

Normally, a broker is the agent of the party who first employs the broker (*Stephens v Ahrens* (1919) 179 C 743, 746, 178 P 863), but a dual agency representing both buyer and seller or tenant and landlord is not prohibited. One of the most common scenarios is a real estate transaction involving two principals and only one broker, who was originally retained by the seller but who also works with the buyer to complete the sale. In this situation, there is often a common misunderstanding that the broker represents both parties. Agency election remains subject to the agreement of the parties and the broker; in the absence of an express agreement, however, an agency relationship can be implied from the parties' conduct, *i.e.,* the broker's acceptance of duties from and responsibilities to the noncontracted party. An unintended dual agency was found in the following circumstances:

- A seller's broker negotiated a loan on behalf of the buyers (*Montoya v McLeod* (1985) 176 CA3d 57, 64, 221 CR 353);
- A buyer's broker transmitted escrow instructions on behalf of the sellers (*Whiteman v Leonard Realty Co.* (1961) 189 CA2d 373, 11 CR 211);
- A seller's broker agreed to convey the buyer's counteroffer to the seller (*Wright v Lowe* (1956) 140 CA2d 891, 296 P2d 34);
- A buyer's broker approached property owners on behalf of his clients and subsequently entered into a listing agreement for the sale of the property (*Wolf v Price* (1966) 244 CA2d 165, 173, 52 CR 889).

The payment of compensation, or the obligation to pay it, to a broker by the seller or the buyer does not necessarily determine a particular agency relationship. CC §2079.19. In the absence of other factors, however, payment of a commission is strong evidence of an agency relationship between the broker and the party paying the fee. See *Standard Realty & Dev. Co. v Ferrera* (1957) 151 CA2d 514, 311 P2d 855.

PRACTICE TIP: Because dual agency can be implied (or argued to exist) from such facts, it is good practice for the broker to document the fact that it is the agent of only one of the parties. Further, to the extent the broker provides assistance to a nonclient during the course of representing the broker's actual client, *i.e.,* furnishing a report or providing comparables, it is further recommended that the broker document that the assistance is provided as a courtesy and that the broker still represents only that broker's client. See also §3.28.

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§3.27 1. No Commission Necessary to Prove Existence of Agency

An unintended agency can be the source of disputes and potential breaches of fiduciary duty, especially if the duties of the broker to its original client and the other parties is not carefully created and maintained in writing. Problems may arise, for example, when a broker, who was originally retained by the property owner, takes affirmative actions to assist the buyer or tenant in order to advance the transaction and the broker's receipt of his or her commission. Such actions on the part of the broker may appear innocuous to the broker at the time. For instance, a buyer may simply request copies of certain title documents or reports, and then raise questions concerning such documents. By simply explaining the structure or purpose of reports or documents to the buyer, the broker may be raising the issue of unintended agency. Such assistance by the broker may engender the belief by the buyer that the broker is acting on the buyer's behalf or lead to a misunderstanding that the broker represents both parties. The problem of unintended agency is compounded if the broker has undertaken an act or series of acts for the unsophisticated or first-time buyer. See *Montoya v McLeod* (1985) 176 CA3d 57, 64, 221 CR 353; *Wright v Lowe* (1956) 140 CA2d 891, 897, 296 P2d 34. See, *e.g.,* CC §2079.19.

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§3.28 2. How to Avoid an Unintended Agency

An agency relationship may arise without any express agreement between the parties. A broker should protect itself and the parties by making sure that agency relationships are disclosed to, and confirmed by, all parties in writing (as is required in residential transactions; see §3.23). To prevent an unrepresented party from claiming an agency, a broker should:

- Decline to undertake substantive activities for the unrepresented principal, including acts that the broker may perform for its own principal, *e.g.,* analytic or valuation tasks, which are particularly susceptible to being misconstrued;
- In those situations in which the broker feels it necessary to provide information to a third party or prospective buyer or tenant, initially disclose and, depending on the circumstances, continue to disclose thereafter that the providing of information is merely a courtesy and that by so doing the broker is not undertaking the representation of the unrepresented principal; and
- Whether a residential or a commercial transaction, make repeated written reminders of the lack of an agency relationship on the one hand, and repeated written confirmations of the relationship on the other.

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§3.29 C. Multiple Clients

A traditional dual agency (one broker representing both parties to a transaction) is not the only situation in which a broker may represent multiple clients with conflicting interests in the same property or transaction. Occasionally, a broker may represent more than one potential buyer for the same property with one or more salespersons under that broker presenting offers to purchase the property. In that situation, the broker or salesperson would be considered a dual agent; however, in contrast to the more common buyer-seller or landlord-tenant dual agency, there would presumably be no conflict under usual custom and practice unless the competing buyers were represented by the same salesperson. In that case, disclosure and client consent to the multiple agency is required in residential transactions and recommended in commercial transactions. See CC §2079.13(d), 2079.16; *Montoya v McLeod* (1985) 176 CA3d 57, 63, 221 CR 353.

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§3.30 D. Self-Dealing

A conflict of interest exists any time a broker or a third party in a close relationship to the broker stands to profit personally from a transaction. As with any other conflict, full and timely disclosure of the facts, and the client's informed consent, are required to avoid a breach of fiduciary duty. See Bus & P C §§10176(g), 10177(o); *Savage v Mayer* (1949) 33 C2d 548, 203 P2d 9. In *Nguyen v Scott* (1988) 206 CA3d 725, 736, 253 CR 800, the court stated:

> A broker's failure to disclose that he is himself bidding on property also works an unfairness on other prospective purchasers. [Citations.] Not only is the broker likely to have an advantage over other bidders because of his knowledge of their offers and the owner's desires, but his contacts with other purchasers may easily lead them to rely on his assistance and forego their own efforts to negotiate for the property. Article 12 of the Code of Ethics of the National Association of Realtors provides: "The REALTOR shall not undertake to provide professional services concerning a property or its value where he has a present or contemplated interest unless such interest is specifically disclosed to all affected parties."

Under 10 Cal Code Regs §2904, loan fees paid by the buyer to the broker must be disclosed to both parties before closing, even if such fees are only anticipatory.

See also §3.35 (duty to avoid secret profits) and §3.46 (duty to be honest and truthful).

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§3.31 1. Broker's Purchase of Client's Property

If a broker purchases the client's property (directly or through a related party) without adequate disclosure and consent, it will be presumed that the client entered the transaction without sufficient consideration and under undue influence, and the broker bears the burden of proving the fairness of the transaction. *Batson v Strehlow* (1968) 68 C2d 662, 665, 68 CR 589. See *Smith v Zak* (1971) 20 CA3d 785, 98 CR 242 (citing former CC §2235, repealed by Stats 1986, ch 820, §7).

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§3.32 a. Significant and Meaningful Disclosure and Consent Required

A broker may purchase the client's property if *all* material facts related to the purchase, including any anticipated profit, are disclosed to the client. *Donnellan v Rocks* (1972) 22 CA3d 925, 928, 99 CR 692. Without the required disclosure, the fact that the broker paid a fair price for the property, or that it could not have been sold for a greater price, will not be a defense to liability for nondisclosure. *Bate v Marsteller* (1959) 175 CA2d 573, 580, 346 P2d 903.

If the acts of an agent are questioned by the principal, and the fiduciary relationship has been established, the burden is on the agent to prove that he or she acted with the utmost good faith toward the principal and that he or she made a full disclosure prior to the transaction of all the facts relating to the transaction under attack. *Timmsen v Forest E. Olson, Inc*. (1970) 6 CA3d 860, 871, 86 CR 359.

Any fact that might conceivably be material to a transaction must be disclosed by the purchasing broker. For example, the broker's failure to disclose a sale of the listed property to the state for taxes, and the broker's subsequent acquisition of the property, are sufficient to state a cause of action for breach of the broker's fiduciary duty. See *Skopp v Weaver* (1976) 16 C3d 432, 128 CR 19.

The broker's duty to disclose all facts relating to the best price obtainable (see §3.59) poses an acute problem for a broker who purchases the client's property for resale. Resale at a substantial profit belies a broker's attempt to demonstrate that full disclosure was made. See, *e.g., Smith v Zak* (1971) 20 CA3d 785, 98 CR 242. See also *Roberts v Lomanto* (2003) 112 CA4th 1553, 1563, 5 CR3d 866 (involving broker's option to purchase client's property).

PRACTICE TIP: A broker who intends to purchase a client's property must carefully document all disclosures and obtain the client's written acknowledgment and consent. In addition, the broker should insist that the client select an independent broker and attorney, of the client's choice, to represent the client in an arm's-length transaction, which should be fully documented.

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§3.33 b. Indirect Sales: Parties Related to Broker

The duty to disclose the broker's purchase of the listed property extends to purchases by the broker's relatives and employees and to entities in which the broker has an interest. For example, in *Batson v Strehlow* (1968) 68 C2d 662, 68 CR 589, a broker's disclosure to the seller that he was president of the purchasing corporation was held inadequate because he did not also disclose that he and his wife were its sole shareholders and had paid the entire price themselves. The broker concealed that he was dealing for himself as principal and attempted to earn a commission as well. See *Smith v Zak* (1971) 20 CA3d 785, 98 CR 242 (buyer was broker's salesperson); *Loughlin v Idora Realty Co.* (1968) 259 CA2d 619, 66 CR 747 (buyer was broker's mother-in-law). See also *Warren v Merrill* (2006) 143 CA4th 96, 49 CR3d 122, in which a broker placed her daughter's name on the title to the property in an elaborate financing scheme and then refused to transfer the property to the buyer. Although *Warren* did not involve a lack of disclosure, it presents a cautionary tale regarding the tangled legal and emotional web that can result when a broker involves a related person in the transaction.

A broker must always disclose to the seller any relationship with a buyer corporation or partnership, even if the broker is only a limited partner or minority shareholder. See *Smith v Zak, supra*.

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§3.34 2. Broker's Interest in Property Sold to Client

The buyer's broker must fully disclose all benefits the broker will receive from the transaction. A broker must disclose any interest it has in the property being acquired by the client, as well as any interest held by someone related to the broker. The same disclosure obligations and other considerations apply as when a broker purchases the client's property. See *Kroeker v Hurlbert* (1940) 38 CA2d 261, 101 P2d 101. If the broker fails to disclose an interest in the overall transaction or in property that is purchased by the client, the broker must disgorge any profits realized. See *Crogan v Metz* (1956) 47 C2d 398, 303 P2d 1029.

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§3.35 E. Secret Profits

A broker is liable to the principal for any secret profits, gratuities, or other benefits obtained in a transaction. See *Roberts v Lomanto* (2003) 112 CA4th 1553, 5 CR3d 866; *Menzel v Salka* (1960) 179 CA2d 612, 4 CR 78. The broker may not retain any benefit derived from the transaction unless the nature and amount of the benefit have been fully disclosed to the principal. It is immaterial that the transaction is otherwise fair to the principal, or that the principal receives exactly the desired price for the property, or that he or she pays no more for it than intended. *Menzel v Salka, supra*.

The broker must disgorge all secret profits regardless of whether the principal suffered any actual damages. *Savage v Mayer* (1949) 33 C2d 548, 203 P2d 9. The principal may recover from the broker and from all others who knowingly shared in the secret profits. *Crogan v Metz* (1956) 47 C2d 398, 303 P2d 1029. A fiduciary is liable for secret profits that the fiduciary permits to flow to a third party, even if the fiduciary personally does not share in them. See *St. James Armenian Church v Kurkjian* (1975) 47 CA3d 547, 121 CR 214. Realizing undisclosed profits as part of a transaction may subject a broker to discipline by the Real Estate Commissioner. Bus & P C §10176(g). See §9.10.

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§3.36 1. Exception for Net Listings

A narrow exception to the requirement of full disclosure of the broker's interest in, and profit from, the sale may arise when the property is sold under a net listing (in which the client agrees to accept a specific price for the property and the broker's compensation is any amount received in excess of the specified figure). See §2.26 on net listing commissions.

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§3.37 2. Kickbacks, Referral Fees, and Inducements

Kickbacks, referral fees, and other unearned fees from title companies, escrow holders, and other third parties are prohibited under Bus & P C §10177.4 and the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617), whether disclosed by the broker or not. 12 USC §2607(a)-(b). Violation of RESPA's ban on kickbacks could subject a broker to criminal penalties as well as civil liability for three times the amount of the referral fee. 12 USC §2607(d). For further discussion of RESPA, see §§1.22, 8.16; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 12 (4th ed Cal CEB 2009).

In addition, Ins C §12404(c) prohibits a number of activities by title companies, whether performed directly or indirectly, as "per se inducements for the placement or referral of title insurance business," including expenditures for advertising or for food, beverages, or entertainment. On kickbacks, referral fees, and other unearned fees from a title company, see California Title Insurance Practice §§1.13-1.14 (2d ed Cal CEB 1997).

On broker's secret profits and third parties, see §3.72.

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IV. ADDITIONAL DUTIES OWED TO PRINCIPAL

§3.38 A. Duty to Investigate

The broker has a duty to find and disclose reasonably obtainable material information. As a fiduciary, the broker must place himself in the position of the principal and ask himself: What information is required to intelligently engage in this transaction? *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25, 73 CR2d 784.

The fiduciary duty to investigate includes the duty to convey accurate information. The broker should either independently confirm the accuracy of the information the broker gives to the principal, or ensure that the principal is informed that the information has not been verified and/or comes from a third party source. See *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 561, 29 CR2d 463. In *Salahutdin*, the broker knew that the size of the property and its ability to be subdivided were important to the principal's decision to purchase, but the broker nevertheless misrepresented both size and subdivisibility, having failed to obtain a property survey or otherwise independently confirm statements on the multiple listing sheet.

Compare this fiduciary duty to investigate owed to a broker's principal with the statutory duty to investigate owed by a listing broker to any prospective purchaser under CC §2079, discussed in §3.42. See also the discussion on limitations on broker duties set forth in §§3.67-3.70.

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B. Duty to Disclose

§3.39 1. Imposed by Common Law and Statute

A property owner has both a common law and statutory duty of disclosure. *Calemine v Samuelson* (2009) 171 CA4th 153, 161, 89 CR3d 495. A fact is material and must be disclosed if it is one that the broker should realize would be likely to affect the principal's willingness to enter into or complete the transaction. The test of materiality is objective: would a reasonable person in the principal's position have acted differently, had he or she known the true facts? For example, in *Roberts v Lomanto* (2003) 112 CA4th 1553, 1567, 5 CR3d 866, the court found that a broker had breached her fiduciary duty by not disclosing the amount of a $1.2 million assignment fee. The fee was material in that the $1.2 million presumably would have been paid to the principal, had it not been allocated by the buyer to pay the assignment fee.

Under CC §2079 (see §3.42), a broker has specifically defined statutory disclosure duties for residential properties (with a 2-year limitations period), but the statute does not preempt the duties provided under the common law. *Michel v Moore & Assocs.* (2007) 156 CA4th 756, 763, 67 CR3d 797. In *Michel*, the court of appeal stated that, even if the broker were *competent* in her visual inspection of the property, a claim for negligent nondisclosure may exist in a situation in which the broker failed to disclose to the buyer, facts about a pre-listing property inspection, conducted by another salesperson in the broker's employ. A broker's failure to share material information with the principal is constructive fraud. *Michel v Moore & Assoc*, *supra*. See CC §1573. See also discussion in §§11.28, 11.57, 11.64.

Generally, the duty to disclose is limited to material facts. Once disclosed, there is no duty to provide details that would "merely serve to elaborate on the disclosed facts." *Calemine v Samuelson*, *supra*. However, the common law may require disclosure of the existence of any litigation involving those facts. Thus, in *Calemine*, the appellate court held that even though the property owner had properly disclosed information regarding water intrusion on the subject condominium, a triable issue of fact remained as to whether he should also have disclosed the existence of two prior law suits brought by his homeowners association (HOA) related to the water intrusion. 171 CA4th at 166. See also *Pagano v Krohn* (1997) 60 CA4th 1, 70 CR2d 1 (seller's disclosure duty was met when buyer received letter from HOA describing water intrusion and subsequent litigation); *Assilzadeh v California Fed Bank* (2000) 82 CA4th 399, 98 CR2d 176 (owner satisfied statutory duty by disclosing existence of prior defect litigation, even if details of litigation were not disclosed). Note, however, that if the broker or property owner has no knowledge of prior litigation, there is no duty to call the HOA to inquire if any construction defect problems exist or if the association has filed any lawsuits alleging construction defects. *Padgett v Phariss* (1997) 54 CA4th 1270, 63 CR2d 373.

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§3.40 a. Materiality

A fact is material and must be disclosed if it is one that the broker should realize would be likely to affect the principal's willingness to enter into or complete the transaction or that might influence the price the principal is willing to pay or receive. *Rattray v Scudder* (1946) 28 C2d 214, 169 P2d 371; *Calemine v Samuelson* (2009) 171 CA4th 153, 161, 89 CR3d 495; *Fisher v Losey* (1947) 78 CA2d 121, 177 P2d 334. The test of materiality is objective: would a reasonable person in the principal's position have acted differently, had he or she known the true facts? In *Roberts v Lomanto* (2003) 112 CA4th 1553, 5 CR3d 866, the court found that a broker who had agreed to purchase her principal's property breached a fiduciary duty by not disclosing the amount of a $1.2 million assignment fee she received when she assigned her purchase right. The amount of the fee was material in that the $1.2 million presumably would have been paid to the principal as part of the purchase price, had it not been allocated by the buyer to pay the assignment fee. In *Michel v Moore & Assocs*. (2007) 156 CA4th 756, 67 CR3d 797, the court held that even if the broker performed a competent visual inspection of the property, a claim for negligent nondisclosure may exist because the broker failed to disclose to the principal negative facts found by another salesperson of her brokerage firm in an earlier inspection of the property. This failure to share material information with the principal was constructive rather than intentional fraud. 156 CA4th at 763. See CC §1573.

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§3.41 b. Verifying Disclosures

The broker's duty of disclosure does not include a duty to verify the truth or explain the legal or practical implications of disclosed facts. See *Pagano v Krohn* (1997) 60 CA4th 1, 70 CR2d 1. For a similar decision holding that a listing broker does not have such a duty, see *Sweat v Hollister* (1995) 37 CA4th 603, 43 CR2d 399, disapproved on other grounds in *Santisas v Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830 (discussion of legal ramifications of disclosed facts not required).

A buyer's or tenant's broker has no duty to verify the accuracy of the property owner's disclosures or those of the listing broker. It is incumbent on potential purchasers or tenants, therefore, to investigate and make their own informed decisions. However, a client has the right to rely upon the statements of the broker. In presenting the client with information obtained from the property owner or other third parties, the broker should inform the client of the source of the information and the fact that it has not been verified. Liability may arise if the client reasonably believes that the information was obtained from the broker's own investigation. See *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463.

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§3.42 2. Statutory Disclosure Requirements for Residential Property

A listing broker owes statutory inspection and disclosure duties to the prospective purchaser of residential property. The duties, pertaining only to real property comprising one to four dwelling units or a manufactured home, are set forth in detail in CC §§2079-2079.24. Section 2079, which arose out of and followed the court of appeal's articulation of the common law duty in *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383, requires a reasonably competent and diligent visual inspection of the property by the broker and disclosure to a prospective purchaser of all facts materially affecting the value or desirability of the property that the investigation reveals. These statutory duties apply only to the listing broker, any cooperating broker selling the property, and any salespersons working under them.

The duty to inspect imposed by CC §2079 is *not* a fiduciary duty; it is owed by the broker to the opposite principal. The fiduciary duty owed by the broker to his or her own principals is naturally more extensive. See *Michel v Moore & Assocs.* (2007) 156 CA4th 756, 762, 67 CR3d 797; *Wilson v Century 21 Great Western Realty* (1993) 15 CA4th 298, 307, 18 CR2d 779.

The legislature enacted these disclosure statutes to protect unsophisticated buyers and owners of residential property from those with greater knowledge and bargaining power. Parties to commercial transactions are presumed to be more experienced and sophisticated in real estate matters and thus not in need of statutory protection. *Smith v Rickard* (1988) 205 CA3d 1354, 1361, 254 CR 633. This presumption does not mean that the broader duties of the common law may be overlooked, nor that a lower standard of care is owed to parties to commercial transactions; nor does it excuse brokers from their obligation to carefully assess specific real estate needs of their principals, whatever the transaction.

NOTE: Under CC §2079 only a "reasonably competent and diligent visual inspection" is required. A neighbor's comments about possible problems, for instance, do not necessarily constitute notice and do not automatically create any additional duty to inspect, although many brokers would err on the side of disclosing and investigating such comments. Nor does the CC §2079 inspection "include or involve an inspection of areas that are reasonably and normally inaccessible to such an inspection" (CC §2079.3). *Wilson v Century 21 Great Western Realty, supra*. Nevertheless, a broker should always consider whether a higher duty is owed under the common law. See §3.39. The scope of the statutory duty to disclose is evolving, as new case law is published which interprets the statutory and common law duties. For instance, do a neighbor's comments about possible problems necessarily constitute notice, triggering a duty to inspect? Is a broker or salesperson on constructive notice if a salesperson from another office of the same broker has knowledge of a material condition? Brokers should be careful to consider whether the scope of their inspections is adequate. See, *e.g., Michel v Moore & Assocs.* (2007) 156 CA4th 756, 67 CR3d 797 (remanding to lower court for determination whether facts elicited by salesperson in same office as listing salesperson could be attributed to broker).

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§3.43 C. Duty of Loyalty and Good Faith

A broker's duty of good faith and loyalty arises out of the common law. A broker assumes the duties, obligations, and high standards of good faith from the start of the fiduciary relationship between the broker and the principal. The duty of loyalty and good faith embraces duties of honesty and full disclosure. *Batson v Strehlow* (1968) 68 C2d 662, 674, 68 CR 589. The good faith standard is high, because the broker and principal relationship is fiduciary. *Montoya v McLeod* (1985) 176 CA3d 57, 64, 221 CR 353 (law charges broker with "same obligation of undivided service and loyalty" that is imposed on trustee in favor of beneficiary). "Undivided service" is the well-settled standard, but what does that mean when the broker acts as a dual agent? The dual agent must demonstrate the utmost in honesty and disclosure, to allay the concerns of the principals as to the broker's loyalty and commitment to service. See §§3.22-3.25.

Loyalty has its limits. A broker has no legal duty to conceal his principal's dishonest acts from persons who will be harmed by them. *Willig v Gold* (1946) 75 CA2d 809, 814, 171 P2d 754. Concealing a principal's dishonest acts is contrary to a broker's duty to be honest and truthful.

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§3.44 D. Duty of Obedience

Real estate brokers owe their principals the obligations of loyalty and obedience. Restatement (Third) of Agency §1.01, Comment (2006). An agent has a duty to act in accordance with the express and implied terms of any contract between the agent and the principal. Restatement §8.07. The broker's duty of obedience is limited, to the extent that the instructions of the principal are lawful and reasonable. Restatement §8.09. Also, a broker's duty of obedience does not supersede the broker's power to resign and terminate the agency relationship. Restatement §3.10.

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§3.45 E. Duty to Be Honest and Truthful

Honesty and truthfulness are prerequisites for an applicant to obtain a real estate license. Bus & P C §§10152-10153. The ongoing duty of brokers to be honest and truthful in their dealings extends to all involved in the transaction, not just the broker's principal. See *Ward v Taggart* (1959) 51 C2d 736, 741, 336 P2d 534. This is a broad duty, found in common law, statute, and the National Association of Realtors® (NAR) Code of Ethics, Article 1 (see App A). A broker or salesperson can be disciplined by the Real Estate Commissioner for "conduct… which constitutes… dishonest dealing." Bus & P C §§10176(i), 10177(j).

There are any number of ways for a broker to breach its duty to be honest and truthful. These include undisclosed self-dealing (*Batson v Strehlow* (1968) 68 C2d 662, 674, 68 CR 589) and failing to convey a purchase offer (*Nguyen v Scott* (1988) 206 CA3d 725, 737, 253 CR 800). In *Hale v Wolfsen* (1969) 276 CA2d 285, 292, 81 CR 23, for instance, a broker untruthfully stated that the property had appreciated "quite a bit" and that rentals were sufficient to meet the loan payments.

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§3.46 1. Honest and Truthful Advertising

A broker must be honest and truthful in its advertising. "Advertising" is "[a]ny written or printed communication, or oral communication made in accordance with a text or outline that has been reduced to written form, which is published for the purpose of inducing persons to purchase or use a product or service." 10 Cal Code Regs §2705. Business and Professions Code §17500 provides that it is unlawful to advertise (including on the Internet) any statement concerning real property or services that is untrue or misleading.

All brokers and salespersons must place their license identification number on all first-point-of-contact marketing materials (including business cards and stationery) and on residential purchase and sale agreements. Bus & PC §10140.6. Effective July 1, 2010, brokers and salespersons who are mortgage loan originators must also include on their first-point-of-contact materials the identifier assigned by the Nationwide Mortgage Licensing System and Registry (NMLS). Bus & PC §10140.6. See §§8.1, 8.24 for more on mortgage brokers and the NMLS. See Directory for the NMLS website. If a broker wants to be licensed under a fictitious name, the name must not be misleading or constitute false advertising. 10 Cal Code Regs §2731(c)(1). False advertising concerning land can result in criminal penalties and revocation or suspension of a license. Bus & P C §10140; chaps 8-9.

In California, the regulations regarding advertising on the Internet are relevant mainly to circumstances under which a real estate broker license is not required to advertise services. The advertisement must provide for direct contact between prospective parties and a licensed California real estate broker, but little else is said about affirmative duties regarding Internet advertising. See 10 Cal Code Regs §2770.

PRACTICE TIP: Because the Internet is not geographically limited, the real estate broker or broker's counsel should be careful to review any restrictions on advertising in other jurisdictions where the broker is not licensed before posting advertising on the Internet.

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§3.47 2. Puffery Versus Fraud

Puffery is distinguishable from actionable misrepresentation. The NAR Code of Ethics, Article 2 (see App A) provides that its members must avoid exaggeration, misrepresentation, or concealment of pertinent facts relating to the property or the transaction. A listing broker has the incentive, however, to use language that will put the property in the best, most saleable light, and may even have an obligation to its client to do so. "Puffery" consists of generalized, vague, and unspecific assertions, upon which a reasonable consumer would not rely. Puffery is characterized by general rather than specific assertions. For example, a collection agency's statement that "we're the low-cost commercial collection experts" is puffery, not false advertising, because a reasonable consumer would not interpret the claim as a factual statement on which he or she could rely. See *Cook, Perkiss and Liehe, Inc. v Northern Cal. Collection Serv., Inc.* (1990) 911 F2d 242, 246. A lamp maker that claims its product is "far brighter than any lamp ever before offered" is puffing, but "statements such as 35,000 candlepower and 10-hour life, could give rise to a legal liability if they were not true. These exceed the traditional bounds of puffing." *Smith-Victor Corp. v Sylvania Elec. Products, Inc.* (1965) 242 F Supp 302, 308.

PRACTICE TIP: There is no bright line test for whether a statement strays from puffery into misrepresentation. If specific facts are stated, however, they must be accurate. For example, a broker who is unsure about the insulation upgrades of the home he is selling should avoid misquoting the insulation rating, perhaps describing the home as "the coziest you've ever seen!"

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F. Duty of Reasonable Care

§3.48 1. Standard of Care

A broker must exercise reasonable skill and care in the performance of services for the benefit of the client (*Schoenberg v Romike Props.* (1967) 251 CA2d 154, 59 CR 359) and is liable for any damages the client suffers because of unreasonable delay or negligence (see *Wilson v Hisey* (1957) 147 CA2d 433, 305 P2d 686). The standard of care is that which would be followed by a competent broker under similar circumstances. In a residential transaction, the standard of care is that of a "reasonably prudent broker," which is measured by the "degree of knowledge through education, experience, and examination required to obtain a license." CC §2079.2. Professional negligence is the failure to exercise the degree of skill or knowledge ordinarily possessed by an average member of the profession. The applicable standard is not one of perfection, however, and the broker is not a guarantor of the transaction's success. A breach of the duty of care is established not by a mere "failure to be brilliant, but a failure to come up to even a minimum standard of professional competence." *McKnight v Dean* (7th Cir 2001) 270 F3d 513, 518 (legal malpractice).

In litigation against brokers, it is unusual to see a claim for professional negligence (breach of the duty of care) without accompanying allegations of fraud and breach of fiduciary duty. Thus, reported cases in which breach of the broker's duty of care is addressed are somewhat difficult to analyze because they generally also include and discuss issues of intentional misrepresentation or failure to disclose as well as negligence, and the actual grounds of liability can be difficult to pinpoint. See, *e.g., Ford v Cournale* (1973) 36 CA3d 172, 111 CR 334. Courts have held brokers to a duty to advise the client correctly and to investigate certain details of the property and the transaction, especially when the principal is unskilled and is relying on the broker's expertise. In the typical residential transaction, in which the client is often an unsophisticated consumer relying on the broker for professional expertise in real estate matters, such reliance generally can be presumed. In the context of commercial transactions, in which the client's knowledge and experience may equal or exceed the broker's, industry custom and practice is a helpful guideline for the scope of the broker's duty and the client's reasonable reliance.

At trial, the appropriate standard of care would be attested to by a standard of care expert witness. See chap 13.

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§3.49 2. Dealing With Clients Not Proficient in English

If a broker engages in business and negotiates primarily in Spanish, Chinese, Tagalog, Vietnamese, or Korean, the broker must deliver a copy of the contract translated into the language in which the contract was negotiated. CC §1632. The statute applies to dwelling leases longer than a month, certain loans, and foreclosure consulting contracts. The statute notes that these languages are the top five languages spoken in California, after English.

The statute does not address the situation in which the broker negotiates primarily in English, but the principal speaks another language. Also, while a broker may be required to provide the non-English-speaking buyer with a translation of the loan documents, there is no statutory requirement that the purchase contract be similarly translated. A party to a transaction who does not receive the necessary translations under CC §1632 may rescind the contract or transaction.

NOTE: A broker's basic fiduciary duty under the common law includes the duty of good faith and fair dealing, so that the broker upholds the highest and best interests of the principal. Ideally, if the broker has reason to believe that language is a barrier to understanding, the broker should take steps to ensure that the principal has the opportunity to read and understand the contract documents in his or her own language.

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§3.50 G. Duty to Perform With Diligence

The property owner can revoke an exclusive listing if the broker fails to diligently carry out the terms of the agency. *Coleman v Mora* (1968) 263 CA2d 137, 69 CR 166. The broker's lack of diligence will constitute a defense to his or her action for payment of a commission if the owner revokes the listing before accepting an offer procured by anyone other than the broker. In *Coleman,* the court held that the principal may revoke a listing agreement for any of the reasons for which contracts may generally be revoked (see CC §1689 for grounds for rescission), including failure to perform. The broker's breach alone does not terminate the listing agreement, however, and to avoid liability for the commission, the owner should clearly exercise the right to revoke before the property is sold. See *Whitney Inv. Co. v Westview Dev. Co.* (1969) 273 CA2d 594, 78 CR 302.

Whether the broker has performed with diligence is a question of fact to be decided in light of the circumstances of each case. *Whitney Inv. Co. v Westview Dev. Co., supra*. A property owner must be careful in exercising the right to revoke because if the listing is terminated without adequate cause, the broker may be entitled to the commission without any further performance, especially if the listing agreement contains a withdrawal-from-market clause (see §7.21). *Blank v Borden* (1974) 11 C3d 963, 115 CR 31.

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§3.51 H. Duty of Confidentiality

Part of a broker's duty of undivided allegiance, good faith, and loyalty is to keep the principal's confidences, and to use the principal's information to the principal's advantage. A broker who knows something about the property has the duty to use that knowledge to the principal's best advantage. For instance, in *Beeler v City Title Ins. Co.* (1962) 201 CA2d 702, 704, 20 CR 190, a broker who knew that a property owner's secured note could be substantially discounted in the event of a sale wrongfully arranged for a third party to buy the note, to the detriment of the principal in the subsequent foreclosure.

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§3.52 I. Duty to Account

A broker has a duty to account for all funds held on the principal's behalf. The broker may not commingle the money or property of others with his or her own money or property. Bus & P C §10176(e); *Brown v Gordon* (1966) 240 CA2d 659, 49 CR 901. The broker holds the principal's funds as a trustee, and is bound to dispose of them in accordance with the principal's instructions. *Holloway v Thiele* (1953) 116 CA2d 68, 71, 253 P2d 131.

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§3.53 1. Broker Trust Account

The broker may be called on to receive and hold the buyer's deposit as agent for the buyer, as agent for the seller or tenant, or as escrow holder under written instructions in the offer or contract. Brokers are often reluctant to hold funds because the rules on broker trust accounts are complex. See Bus & P C §10145; 10 Cal Code Regs §§2830.1-2849.31. If a broker accepts funds from a principal in connection with a transaction, those funds must either go directly to a neutral escrow depository, to the broker's principal, or into the broker's trust fund account. Funds in a trust account must stay there until disbursed in accordance with instructions from the person entitled to the funds. Bus & P C §10145(a)(1). Regulations require the broker to deposit the funds to an escrow or trust account or deliver them to the owner within 3 days of receipt. 10 Cal Code Regs §2832(a). Under Bus & P C §10146, a broker must provide quarterly and final accountings to the principal of any advance fees that the broker holds for the principal.

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§3.54 2. Presumption of Misappropriation

"Any real estate broker who… collects an advance fee from any other person, hereinafter referred to as the 'principal,' shall deposit any such amount… in a trust account." Such funds are trust funds and not the funds of the broker. Bus & P C §10146. When advance fees paid by the principal are not handled in accordance with §10146, it is presumed that the broker has violated Pen C §§506 and 506a, and that the funds have been misappropriated. Section 10146 provides further that the principal may also recover treble damages and reasonable attorney fees in recovering funds misapplied by the broker.

In *Burch v Argus Props., Inc.* (1979) 92 CA3d 128, 154 CR 485, the court stated that the principal need not plead or prove bad faith or malfeasance in order to recover damages, only that the broker breached the statutory duty to account. Charging a nonrefundable advance fee, when the commission was never earned, was a prima facie violation of the statute. 92 CA3d at 131.

On advance fees generally, see §§8.2, 8.20.

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§3.55 3. Duty to Account for File

Real estate brokers must retain documents in connection with transactions for which a license is required for 3 years. These documents are subject to audit by the Real Estate Commissioner. Bus & P C §10148. There is no direct duty owed to the principal to retain documents, but the principal is a beneficiary of the statute.

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§3.56 J. Duty to Supervise Salesperson

Real estate brokers have a statutory duty to reasonably supervise their salespersons. Bus & P C §10177(h); 10 Cal Code Regs §2725. Reasonable supervision includes the establishment and implementation of policies, rules, procedures, and systems to review, oversee, inspect, and manage transactions requiring a real estate license; and other tasks related to real estate transactions, including document maintenance, handling trust funds, advertising, prohibitions on discrimination, and reporting of license activities. See 10 Cal Code Regs §2725. The form and extent of the supervisory scheme must take into consideration the number of salespersons employed and the number and location of branch offices.

A broker also needs to monitor its salespersons' compliance with its policies, rules, procedures, and systems. Other brokers and salespersons may assist the responsible broker in administering the supervisory scheme, so long as the broker does not relinquish overall responsibility for supervision of the acts of salespersons licensed to the broker. 10 Cal Code Regs §2725.

For a detailed discussion of the relationship between brokers and salespersons, see §§8.32-8.42.

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§3.57 1. Corporate Broker

The corporate officer designated by a corporate broker license has the same duty to supervise the activities of the corporation's salespersons as is undertaken by the licensed corporation. Bus & P C §10159.2; 10 Cal Code Regs §2725. The duties of a corporation's designated broker may be delegable, so long as responsibility for overall supervision is not relinquished. 10 Cal Code Regs §2725. However, this responsibility does not carry with it liability in a third party civil action; it simply brings the broker under the disciplinary scheme. A corporate officer's civil liability to a principal may not be based solely on a failure to supervise. See *In re Grabau* (ND Cal 1993) 151 BR 227, 232.

PRACTICE TIP: Although a limited liability partnership (LLP) and limited liability corporation (LLC) may own, purchase, and sell property, they cannot be licensed as brokers. Only a natural person or a corporation may receive a broker license. Corp C §§13401, 17375.

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§3.58 2. Respondeat Superior

Practically speaking, a broker cannot evade the duty to supervise by establishing an independent contractor relationship with its salespersons. *Hardin v Gianni (In re King St. Invs.)* (9th Cir BAP 1998) 219 BR 848, 856. "The broker is liable as a matter of law for all damages caused to third persons by the tortious acts of the salesperson committed within the course and scope of employment." *California Real Estate Loans, Inc. v Wallace* (1993) 18 CA4th 1575, 1581, 23 CR2d 462.

Some activities, such as property management, may be performed by unlicensed persons under the supervision of a broker. Bus & P C §10131.01. The duty to supervise such employees may be delegated, but only to another real estate broker or a salesperson with at least 2 years' experience, and only if the salesperson has entered into a written agreement with the broker with respect to the delegation. 10 Cal Code Regs §2724.

For further discussion of a broker's respondeat superior liability, see §11.15.

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K. Advice Concerning Price and Value

§3.59 1. Best Price Obtainable

A listing broker has a fiduciary duty to obtain the best price for the property. *Roberts v Lomanto* (2003) 112 CA4th 1553, 1568, 5 CR3d 866. A broker representing a buyer or tenant, however, has a fiduciary duty to act in the best interest of his or her principal, including a duty to obtain the best, *i.e.,* lowest, price for the property. *Kroeker v Hurlbert* (1940) 38 CA2d 261, 101 P2d 101. This conflicts with the broker's personal interest in obtaining the highest commission possible; however, brokers on both sides of the transaction owe their principals the duty to assist them in arriving at the intersection between each parties' terms: the market price (or rent) for the property.

The Real Estate Commissioner may suspend or revoke the license of a broker who generates an inaccurate opinion of the value of residential real property, when the opinion was requested in connection with a debt forgiveness sale (also called a short sale; see §§2.57-2.66), in order to do either or both of the following:

- Manipulate the lienholder to reject the proposed short sale; or
- Acquire a financial or business advantage (including a listing agreement) directly resulting from the inaccurate opinion. Bus & P C §10176(m).

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§3.60 2. Statements About Price

The NAR Code of Ethics, a copy of which may be found in App A, provides that its members may not deliberately mislead the owner as to the market value of the property in attempting to secure a listing. Standard of Practice 1.3. Similarly, NAR members offering services to buyers or tenants are prohibited from misleading them about the savings or other benefits that might be realized through the use of their services. Standard of Practice 1.4. See discussion in §§3.15-3.16 as to whether rules and codes promulgated by private associations (such as the NAR Code of Ethics) may be used by a court to establish custom and practice.

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§3.61 3. Speculative Purchases and Resales

A broker has the duty to fully inform its principal whenever the broker benefits from the transaction and is liable to the principal for any secret profits or other benefits obtained in the transaction. *Menzel v Salka* (1960) 179 CA2d 612, 622, 4 CR 78. The broker may retain benefits derived from the transaction only if the nature and the amount of the benefit have been fully disclosed to the principal. The duty to inform exists, regardless of whether the transaction is otherwise fair to the principal or whether the principal received or paid the desired price for the property. *Menzel v Salka, supra; Thompson v Stoakes* (1941) 46 CA2d 285, 290, 115 P2d 830.

Unpermitted profits and benefits can take many forms. Examples include:

- A buyer's broker falsely inflated the listing price of a home to his principal, purchased the property himself at a lower figure, charged his principal the larger price, and pocketed the difference. *Thompson v Stoakes, supra.*
- A tenant's broker represented to his principal that the rental value was a fair price, while failing to disclose that he was the true owner of the property. *Sands v Eagle Oil & Refining Co.* (1948) 83 CA2d 312, 188 P2d 782.
- Three brokers colluded to inflate the selling price of property so that they could obtain commissions on a series of exchange transactions. *Crogan v Metz* (1956) 47 C2d 398, 402, 303 P2d 1029.
- A listing broker, aware of the potential condemnation of his principal's property for a freeway exit, failed to advertise the property for sale, purchased the property himself at the reduced price he had recommended to the owner, and subsequently resold it to the state for a large profit. *Smith v Zak* (1971) 20 CA3d 785, 98 CR 242.

The requirement that all benefits be fully disclosed also applies to a buyer's broker. A broker must disgorge any profits realized if he or she fails to disclose his or her interest in property that is purchased by the principal. *Kroeker v Hurlbert* (1940) 38 CA2d 261, 265, 101 P2d 101.

Kickbacks, referral fees, and other unearned fees from title companies, escrow agents, and other third parties are prohibited under Bus & P C §10177.4 and under federal law, whether disclosed by the broker or not. Real Estate Settlement Procedures Act of 1974 (RESPA) §8(a)-(b) (12 USC §2607(a)-(b)). In addition, brokers are subject to discipline by the Real Estate Commissioner for realizing undisclosed profits as part of a transaction. Bus & P C §10176(g). On RESPA, see §§1.22, 3.37, 8.16. On broker discipline and regulation, see chaps 8-9.

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§3.62 4. Communicating Offers to Property Owner

A broker representing a property owner may breach his or her duty of honesty and fair dealing by failing to convey a prospective offer to the owner and by secretly competing with the purchaser or tenant. The listing broker must inform the client of all offers received, regardless of whether they conform to the terms of the listing agreement or whether the broker considers them attractive. Failure to disclose an offer is equivalent to a representation to the owner that no offers were received. *Simone v McKee* (1956) 142 CA2d 307, 298 P2d 667. This duty exists whether the offer is oral or written. *Duin v Security First Nat'l Bank* (1955) 132 CA2d Supp 904, 283 P2d 790. Sound business practice may call for a broker to notify the owner of preliminary negotiations or inquiries even before receipt of a formal offer.

The broker's duty to communicate all offers is owed to the client, and not the other party. Thus, if the owner instructs the broker not to entertain offers below a certain level, the broker has no obligation to the prospective buyer or tenant to inform the owner of any nonconforming offer. See *Nguyen v Scott* (1988) 206 CA3d 725, 736, 253 CR 800, for a well-reasoned analysis of a broker's duty to communicate offers.

The broker also owes a duty of honesty to the other party to the transaction, with whom the broker may secretly be in competition. See §3.45.

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§3.63 5. Investigation of Value

A listing broker will often confer with the seller to determine the listing price for the property. The NAR Code of Ethics (see App A) provides that, when its members prepare opinions of value or price, other than in pursuit of a listing or to assist a potential purchaser in formulating a purchase offer, the opinions must include certain information, including the basis for the opinion, the purpose of the valuation, its intended users, and any present or contemplated interest of the broker in the property or transaction. If it is not an appraisal, the opinion must include a statement to that effect. NAR Code of Ethics, Standard of Practice 11-1.

In general, the broker who renders advice or gives an opinion as to the value of property must do so within the broad duties of honesty and diligence. If the broker has done nothing to verify the accuracy of information used to value the property, that lack of verification should be disclosed to the recipient of the valuation, whether or not the recipient is the broker's principal.

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§3.64 6. Investigation of Title

Brokers may breach their duty of care by failing to investigate, or failing to advise the principal to investigate, matters regarding title. In *Brady v Carman* (1960) 179 CA2d 63, 3 CR 612, a listing broker was held to have defrauded a buyer by providing evasive and misleading answers about the nature of an easement. The court found that liability arose because, after inquiry was made, the broker undertook to answer the buyer's question and was thus obligated to obtain and disclose information about the easement and the burdens it imposed on the land.

A broker who is not going to investigate title in the face of an inquiry by a party should refrain from any response and should recommend that the party obtain a title search. An erroneous statement to a party about title or encumbrances, without seeking to ascertain the true facts or recommending a title search, exposes the broker to claims of negligence or constructive fraud. See *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 73 CR2d 784; *Wilson v Hisey* (1957) 147 CA2d 433, 438, 305 P2d 686.

Although a broker may have no duty to investigate title issues, a broker should refrain from giving factual advice regarding title (or anything else) without a proper investigation. In California, a proper title investigation involves obtaining a preliminary report from a title insurance company. Standard forms of residential purchase contracts contain a provision for the buyer to obtain a preliminary report. Review and approval of the preliminary report and any exceptions is a customary contingency to the buyer's agreement. See generally California Real Property Sales Transactions §§4.57, 4.171 (4th ed Cal CEB 2007).

PRACTICE TIP: Regarding easements and other exceptions to title, the broker should review the preliminary report and alert the principal that such exceptions exist. The broker should also advise the principal to seek the appropriate advice of a third party professional, such as a real estate lawyer or title officer, in connection with exceptions to title. On easements, see California Easements and Boundaries: Law and Litigation (Cal CEB 2008).

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§3.65 L. Verification of Others' Representations

A broker has a fiduciary duty to his or her principal "to refrain from making representations of facts material to the client's decision to buy the property without advising the client that he is merely passing on information received from the seller without verifying its accuracy." *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 562 n3, 29 CR2d 463. If the broker receives information from others, he or she must either verify the truth of the information or disclose to the principal that the information is from a third party or is unverified. Otherwise, the principal has a right to rely on the information it receives from its fiduciary, the broker. If the principal's reliance is reasonable (see §11.45), the broker may be liable to the principal for constructive fraud (see §11.43), unless the broker has either verified the information or disclosed that it is unverified.

In *Salahutdin*, the buyer's broker negligently relied on the assurances of the property owner and the listing broker when he repeated the claim that the parcel was more than an acre and could be subdivided. As a fiduciary, the buyer's broker had a duty to refrain from advising his clients about the size and subdividability of the property in the absence of verified and accurate information. He knew these facts were material to his clients' decision to purchase the property. The court stated (24 CA4th at 563):

> While he was not required to investigate the sellers' representations or the truth of the description contained in the multiple listing service sheet before showing the property to plaintiffs, [he] was at least required to tell plaintiffs that he had not verified the information he was passing on to them; that he was simply relying upon the description provided by the sellers.

PRACTICE TIP: The law regarding duties to investigate or verify information can contain gray areas and can be very fact-based. If the broker knows that certain issues are important to the client, the broker should either investigate *or* advise the client—in writing—to investigate further. A copy of that advice should be maintained in the transaction file. If the broker knows that there is a material issue that requires investigation before the client will be satisfied, the broker and client should consider including a contingency clause in the transaction contract providing that the client's satisfaction as to that issue is a precondition to closing the transaction. See *Morgano v Hank Sybrandy, Inc.* (Aug. 6, 2004 D038854) 2004 Cal App Unpub Lexis 7343) When the critical issue is outside the broker's knowledge, it may be prudent to refer the client to a broker or other professional with the requisite experience.

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§3.66 M. Advice on Real Estate Matters

Brokers must pass an examination prepared and administered by the Department of Real Estate, which tests, among other things, their knowledge of real property law and legal principles. Bus & P C §10153. In addition, they must meet certain educational requirements (Bus & P C §§10153.4-10153.5) and must update their professional knowledge through continuing professional education (Bus & P C §§10170-10171.6). See chap 8.

Naturally, principals rely on their brokers to provide advice on real estate matters. Brokers should not, however, undertake to provide services outside of their field of competence. If specialized professional services are needed outside of the broker's area of competence, whether regarding the type of property or other issues such as taxation or zoning, the broker should engage the assistance of one who is competent on such types of property or services, or disclose to the client that this is not the broker's area of competence. National Association of Realtors® (NAR) Code of Ethics, Article 11 (see App A). However, as illustrated by *Morgano v Hank Sybrandy, Inc.* (Aug. 6, 2004 D038854) 2004 Cal App Unpub Lexis 7343, that disclosure may not be enough to prevent allegations of negligence.

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§3.67 N. No Duty to Advise on Matters Outside of Broker's Expertise

A broker's duty is limited to advice on real estate matters. Even regarding real estate matters, the broker must take care that he or she reasonably conforms to the standards of professionalism and competence. National Association of Realtors® (NAR) Code of Ethics, Article 11 (see App A). Brokers and salespersons who give advice regarding mortgages or provide "mortgage brokerage services," as defined in CC §2923.1, must do so competently, or they may face discipline. Bus & P C §10177(q)-(r).

Listing or other retention agreements should inform the principal that the broker is qualified to advise on real estate, and that the principal should consult an appropriate professional if he or she desires legal or tax advice or some other advice or service specific to the property or transaction. *Carleton v Tortosa* (1993) 14 CA4th 745, 755, 17 CR2d 734. Appropriate language on the broker's scope of services can be included in disclosure documents and in the transactional contract as well. Some standard form purchase contracts state:

A real estate broker is a person qualified to advise on a real estate transaction. If you desire legal or tax advice, consult an appropriate professional.

Some contracts state that brokers

will not provide legal or tax advice; will not provide other advice or information that exceeds the knowledge, education, and experience required to obtain a real estate license; and advise the principal to seek legal, tax, and other desired assistance applicable to this transaction from appropriate professionals.

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§3.68 1. Advice on Tax Considerations

A broker will not be liable for failing to give tax advice if the contractual documents and disclosures between the broker and the client advise the client to obtain tax advice elsewhere. *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734; *Santos v Wing* (1961) 197 CA2d 678, 17 CR 457. Moreover, such an admonition does not violate public policy, because the legislature has decided that clients should get tax advice from professionals other than real estate brokers (CC §2079.16). *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734.

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§3.69 2. Advice on Legal Matters

The NAR Code of Ethics, Article 13 (see App A) advises its members not to engage in activities that constitute the practice of law, and that a party who needs legal advice should be urged to obtain legal counsel. There is no bright line test, however, for the broker to determine when he or she has crossed the line from real estate to legal advice on an aspect of the transaction. Although the courts have yet to rule on the extent of legal competence required of brokers, it seems likely that brokers will incur liability for negligently giving legal advice to their principal or for negligently drafting legal documents. See, *e.g., Biakanja v Irving* (1958) 49 C2d 647, 320 P2d 16, in which a notary public was held liable for negligence in drafting a will. Brokers represent themselves to the public as having particular knowledge and skills in the real estate field and are under a corresponding obligation to exercise greater care and skill than is within the capacity of ordinary citizens. *Richards Realty Co. v Real Estate Comm'r* (1956) 144 CA2d 357, 300 P2d 893.

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§3.70 3. Zoning and Permitting

The general rule is that a broker, in the absence of specific knowledge about the property, is under no duty to undertake an affirmative investigation of the zoning or permitting affecting a property. The rule is rife with exceptions, however, because issues of zoning and permitting are often intertwined with other issues regarding duties of disclosure and investigation. A broker who makes representations regarding the zoning or permitting of property must either disclose that the broker is simply forwarding unverified information or, if a representation will be made, the broker owes a duty to the principal to verify that the information is accurate. In *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 26, 73 CR2d 784, the court stated in dicta that "depending on the circumstances, a broker's fiduciary duty may be much broader than the duty to visually inspect and may include a duty to inspect public records or permits concerning title or use of the property." The court implied that the broker knew or should have known that an addition to the house violated setback requirements, yet did not inquire whether permits or variances had been obtained for the addition or advise the buyer to do so. 63 CA4th at 22. While the broker does not owe the principal a duty to spot issues in this area, once a material issue is apparent, the prudent broker will advise the principal, in writing, to investigate further.

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§3.71 V. DUTIES OWED TO THIRD PARTIES

The broker owes no fiduciary duty to any person other than his or her principal, but the broker has a general duty under the Real Estate Law (Bus & P C §§10000-10580) to deal fairly and honestly with all parties to any real estate transaction. Bus & P C §10176(i); *Norman I. Krug Real Estate Invs. v Praszker* (1990) 220 CA3d 35, 42, 269 CR 228.

As a general rule, any person who performs professional services owes a duty of care to all persons within the area of foreseeable risk. *Norman I. Krug Real Estate Inv. v Praszker, supra; Merrill v Buck* (1962) 58 C2d 552, 562, 25 CR 456. The question of whether such duty is owed in a particular case is based on a series of factors, among which are (*Merrill v Buck, supra*):

- The extent to which the transaction was intended to affect the plaintiff;
- The foreseeability of harm;
- The degree of certainty that the plaintiff would suffer injury;
- The closeness of connection between the defendant's conduct and the injury suffered;
- The moral blame attached to the defendant's conduct; and
- The policy of preventing future harm.

Merrill involved a tenant's action against a real estate broker for personal injuries sustained when the tenant fell down a flight of stairs. The fact that there was no privity of contract between the tenant and the broker or even between the landlord and the broker did not relieve the broker of the duty to warn the tenant of the hidden danger of the basement stairs. The court expressly stated that "[p]rivity of contract was not necessary to establish the existence of a duty to exercise ordinary care not to injure another, but such duty may arise out of a voluntarily assumed relationship if public policy dictates the existence of such a duty." 58 C2d at 561.

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§3.72 A. Secret Profits

A broker can be held liable to a third party for secret profits received through fraud or misrepresentation and can be compelled to disgorge those profits whether or not the third party suffered any actual loss. *Ward v Taggart* (1959) 51 C2d 736, 336 P2d 534. On secret profits and the broker's principal, see §3.35.

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§3.73 1. Public Policy Against Causing Harm to Others

The public policy behind the duty of a broker to be honest and truthful, even to nonclients, is illustrated by *Ward v Taggart* (1959) 51 C2d 736, 336 P2d 534. The case involved a commercial transaction in which a buyer, Ward, hired Thompson, a real estate broker, to find raw land for purchase. Thompson then mentioned his assignment to Taggart, who was also a broker. Taggart lied to Thompson, telling him that he had an exclusive agency relationship with a seller of raw land. Ward offered to buy the raw land from Taggart's client for $4000 per acre. Taggart again lied and told Thompson that the owner had refused the offer and would take nothing less than $5000 per acre and that Ward would have to purchase the property directly from Taggart, who would act as authorized agent for the owner. Ward purchased the property on those terms, discovering later that Taggart had used Ward's escrow funds to purchase the property himself before reselling to Ward. In ruling on the case, the court stated, "Even though Taggart was not plaintiff's agent, the public policy of this state does not permit one to 'take advantage of his own wrong' " and that "[a]s a real estate broker, Taggart had the duty to be honest and truthful in his dealings." 51 C2d at 741.

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§3.74 2. Amount of Secret Profit Not a Factor

A broker will remain a fiduciary after becoming a principal in the transaction, even if the principal-broker did not know at the time of purchase that a larger profit would be made by selling the property to a third party buyer. The "secret profit" must still be disgorged. *Roberts v Lomanto* (2003) 112 CA4th 1553, 5 CR3d 866.

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§3.75 B. Duty Not to Misrepresent or Fail to Disclose Facts; Duty Not to Commit Fraud

A broker's dealings with a third party to the transaction, to whom the broker owes no fiduciary responsibility, are generally measured by the same obligations that the principal owes to the third party, because the broker is the principal's agent. The broker has the same affirmative obligations as the property owner to disclose material facts and not to misrepresent them, whether negligently or intentionally. These obligations are founded in long-standing principles of common law. The obligation to disclose includes matters concerning the value or desirability of the property that the broker knows or reasonably should know. *Lingsch v Savage* (1963) 213 CA2d 729, 29 CR 201. These common law obligations of honesty and fair dealing apply in both commercial and residential transactions, but the residential broker will also need to comply with the statutory duties of disclosure set forth in CC §§2079-2079.11. See discussion in §§3.22-3.26, 3.39-3.42.

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§3.76 1. Materiality of Disclosure

Whether a particular fact regarding the property is sufficiently material to require affirmative disclosure depends on the context of each case. *Saporta v Barbagelata* (1963) 220 CA2d 463, 33 CR 661. For example, the property owner and the broker must disclose the following:

- Known termite and fungus infestation (*Saporta v Barbagelata, supra*);
- That the improvements were built on landfill (*Central Mut. Ins. Co. v Schmidt* (1957) 152 CA2d 671, 313 P2d 132);
- That the improvements were not within property boundaries (*Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551); and
- The correct size of the property (*Cory v Villa Props.* (1986) 180 CA3d 592, 225 CR 628).

See also *Furla v Jon Douglas Co*. (1998) 65 CA4th 1069, 76 CR2d 911 (owner and listing broker who overestimated square footage of residence by more than 20 percent may be liable to buyer). Compare *Blickman Turkus, LP v MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 76 CR3d 325, in which the court found that a broker who represented only the tenant in a commercial lease transaction did not have a duty to inform the landlord after the lease was signed but before the tenant took possession about the tenant's deteriorating financial condition. The court noted that any financial information had been obtained by reason of the broker's fiduciary relationship with the tenant, and that if the possession of such knowledge were enough to trigger a duty to disclose, it would be impossible for intermediaries such as brokers to act for their principals in business transactions. 162 CA4th at 877. The court, however, allowed the landlord leave to amend the pleadings to assert dual agency. 162 CA4th at 887. See also *FSR Brokerage, Inc. v Superior Court* (1995) 35 CA4th 69, 41 CR2d 404 (listing broker who failed to disclose to buyer alleged defects in residential balcony that later collapsed, injuring and killing buyer's guests, had no duty to guests). Compare *Geernaert v Mitchell* (1995) 31 CA4th 601, 37 CR2d 483, in which the buyers were able to state a cause of action against a predecessor of their seller for alleged misrepresentations.

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§3.77 2. Failure to Disclose

A broker may be liable to a person with whom it does not have a confidential relationship for fraud "based on mere nondisclosure and involving no confidential relationship" if (*Lingsch v Savage* (1963) 213 CA2d 729, 738, 29 CR 201):

- The broker fails to disclose facts materially affecting the value or desirability of the property;
- The broker knows the facts and that they are unknown to or beyond the reach of the plaintiff;
- The broker intends to induce action by the plaintiff;
- The plaintiff is induced to act because of the nondisclosure; and
- There are resulting damages.

A broker can avoid such liability by disclosing known material facts about the property to a potential buyer or tenant. For residential property, such disclosure usually means conscientiously filling out the broker's portion of the Real Estate Transfer Disclosure Statement (TDS) and promptly submitting a supplemental disclosure to the buyer, if new facts arise or facts change prior to the close of escrow. See CC §§1102-1102.17.

NOTE: Civil Code §1102.9 provides that the TDS "may" be amended, but does not go so far as to actually require supplemental disclosure. Indeed, CC §1102.5 provides that information that becomes inaccurate subsequent to delivery of the TDS does not result in a violation of the disclosure statutes. Nevertheless, best practice would be to provide supplemental disclosure if new information arises.

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§3.78 3. Statutory Disclosures

Brokers also have disclosure responsibilities mandated as statutory duties by various sections of the Real Estate Law (Bus & P C §§10000-10580) and regulations adopted by the Real Estate Commissioner. See §3.42.

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§3.79 4. Broker and Owner Bear Joint and Several Liability

If no disclosure is made, the broker and the property owner are jointly and severally liable for the full amount of the buyer's or tenant's damages. If a broker is aware of misrepresentations that the owner has made directly to the buyer or tenant, the broker is obligated to correct them; the broker has no duty to conceal fraudulent or dishonest acts of the principal. *Willig v Gold* (1946) 75 CA2d 809, 171 P2d 754. If the broker misrepresents a material fact to the buyer or tenant, the owner will be liable along with the broker under a respondeat superior theory. See §3.58.

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§3.80 5. Exculpatory Contract Clauses

In *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 55 CR3d 59, the court was concerned with the effect that an express exculpatory clause in favor of the brokers would have on their affirmative misrepresentation that a residential lot could be split. The clause expressly advised the buyers of their right to conduct inspections, including the right to investigate matters affecting the value or desirability of the property, such as ordinances affecting future development and zoning. The clause went on to strongly advise the buyers to investigate such conditions. In overruling the claim that the clause precluded justifiable reliance, the court noted that, as a matter of public policy, a contract cannot exempt anyone from responsibility for his or her fraud or willful injury to persons or property.

Exculpatory provisions that involve the public interest are unenforceable. *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 96, 32 CR 33. In *Manderville v PCG&S Group, Inc., supra,* the court did not discuss the factors set forth in *Tunkl*, and left open the question of when and how exculpatory clauses in standard real estate contracts are enforceable. Because real estate is publicly regulated, courts may more closely scrutinize exculpatory clauses in favor of brokers. See *Tunkl*, 60 C2d at 99. While exculpatory clauses will not excuse a broker's misrepresentation, they may be useful in defining for the principal the scope of both the broker's duties and the reasonable expectations of the principal. See also discussions of exculpatory clauses in §§2.54-2.56, 11.24, 11.67.

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§3.81 C. Duty Not to Commit Negligence

A broker who renders service in a negligent manner is generally liable to any third person within the zone of foreseeable risk who is injured by the negligent act. *Merrill v Buck* (1962) 58 C2d 552, 25 CR 456 (landlord's rental agent liable to tenant for failure to disclose dangerous condition); *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383 (listing broker liable to buyer for failure to disclose damaged property). Whether such duty is owed in a particular case is based on several factors, enumerated in §3.71. See also *Blickman Turkus, LP v MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 891, 76 CR3d 325 (court refused to extend broker's "duty to deal honestly and fairly with all parties in a sales transaction" when plaintiff failed to allege that broker could have prevented foreseeable harm; lessee's agent in commercial real estate transaction had no duty to disclose to lessor information about lessee's finances acquired after execution of lease); *FSR Brokerage, Inc. v Superior Court* (1995) 35 CA4th 69, 41 CR2d 404 (when broker failed to disclose to buyer alleged defects in residential balcony that later collapsed, injuring and killing buyer's guests, court held the broker had no duty to guests).

The broker will be held liable to third parties for the negligence of the salespersons in his or her employ. Bus & P C §10177(h); CC §2343(3); *Merrill v Buck, supra*. *Easton v Strassburger, supra,* enunciated the residential listing broker's affirmative duty to conduct a reasonably competent and diligent inspection of the property listed for sale. This duty was later codified and included in a specific disclosure form to be signed by the property owner and the broker. CC §§1102-1102.17. See §3.42.

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§3.82 D. Duty Not to Breach Contract

Third party breach of contract cases against brokers are less common than cases brought on tort theories. Although typically a broker acts on behalf of a disclosed principal, the breach of contract theory does arise in certain instances. A broker may also be held liable to a third party for breach of an agreement that is ancillary to the contract to convey. For example, in *Barr v Rhoades* (1969) 274 CA2d 852, 79 CR 505, the sellers and their brokers were held liable for damages when they breached their agreement with the buyer to secure tenants and financing in connection with the sale of an apartment building.

An agent who knowingly enters into a contract without the authority to do so becomes liable as a principal. CC §2343(2).

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E. Duty to Avoid Discrimination

1. State Laws

§3.83 a. Unruh Civil Rights Act

Brokers who participate in discriminatory practices in the housing market may incur liability under any of a number of fair housing statutes. Brokers have been held to be covered by California's Unruh Civil Rights Act (CC §51) (*Lee v O'Hara* (1962) 57 C2d 476, 20 CR 617; *Vargas v Hampson* (1962) 57 C2d 479, 20 CR 618). The fact that a broker was merely following instructions from the principal is not a defense to an Unruh Civil Rights Act suit (*Wagner v O'Bannon* (1969) 274 CA2d 121, 79 CR 44). A private association of real estate brokers or a multiple listing service might also incur liability under the Unruh Civil Rights Act if it accedes to a property owner's wish to market property in a discriminatory manner. *Wagner v O'Bannon, supra*.

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§3.84 b. Fair Employment and Housing Act

A broker who supplies information on the race, color, sex, religion, ancestry, or national origin of a prospective buyer or tenant, even when requested by the owner, violates the California Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996). 53 Ops Cal Atty Gen 196 (1970). In *Smith v Fair Employment & Hous. Comm'n* (1996) 12 C4th 1143, 51 CR2d 700, the supreme court held that the free exercise clauses (guaranteeing freedom of religion) of the federal and state constitutions could not be relied on by a landlord who refused to rent an apartment to an unmarried couple and thereby discriminated against them on the basis of their marital status in violation of Govt C §§12948, 12955(a), (d) and CC §51.

Under FEHA, the "practice of discrimination because of race, color, religion, sex, marital status, national origin, ancestry, familial status, disability or sexual orientation in housing accommodations is declared to be against public policy." Moreover, the "opportunity to seek, obtain, and hold housing without discrimination" by members of these protected classes is declared to be a civil right. Govt C §12921(b).

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§3.85 c. Unlawful Practices

To deny access to, membership in, or participation in a multiple listing service or other real estate brokerage association or service because of race, color, religion, sex, sexual orientation, marital status, ancestry, disability, familial status, source of income, or national origin is considered an "unlawful practice" and is prohibited by Govt C §12955(j). "Religion" includes all aspects of religious belief, observance, and practice. CC §51(e)(3). These enumerated factors include a perception that the person has any particular characteristic within the listed categories or that the person is associated with a person who has, or is perceived to have, any particular characteristic within the listed categories. CC §51(e)(5).

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§3.86 d. Disciplinary Action

Brokers are also subject to administrative action under the Real Estate Law to revoke the broker's license in cases involving discrimination or other illegal activity. Bus & P C §10177(l); 10 Cal Code Regs §§2780-2781. See also Bus & P C §§125.6, 10170.5(a)(4); 10 Cal Code Regs §2725. Broker discipline is discussed in detail in chap 9.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/3 Agency: Broker Fiduciary and Statutory Duties/§3.87 2. Federal Law

§3.87 2. Federal Law

The Fair Housing Act (FHA) (42 USC §§3601-3631; commonly referred to as Title VIII of the Civil Rights Act of 1968) and the Civil Rights Act of 1866 (42 USC §§1981-1982) prohibit discriminatory practices in the sale or rental of a dwelling and serve as potential bases for imposing liability for damages on brokers who participate in discriminatory practices. The FHA applies to selling, renting, making loans secured by residential property, making appraisals, enforcing age discrimination covenants in common interest developments, and advertising residential properties. See 42 USC §§3604-3605; 24 CFR §§100.50(b), 100.75. The FHA covers discrimination by race, color, sex, national origin, religion, familial status, and disability, with exemptions for the following types of housing:

- Single-family homes for sale or rent by the owner, if specified conditions are met (42 USC §3603(b)(1));
- Most rentals by religious organizations and clubs (42 USC §3607(a));
- Housing with reasonable local, state, or federal restrictions on the maximum number of occupants (42 USC §3607(b)(1)); and
- Qualified housing for seniors (42 USC §3607(b)(1)-(3)).

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4

Broker Liabilities to Principals and Third Parties

Clifford R. Horner

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.1 I. INTRODUCTION

§4.1 I. INTRODUCTION

A broker may face liability to a principal or third party based in contract or tort. Breach of contract claims arising out of listing and commission agreements may arise when a broker has failed to meet the obligations specifically imposed by such an agreement. See §§4.2-4.10. Tort claims, on the other hand, may arise out of a broker's failure to meet obligations imposed by statute and common law. Such claims may be based on fraud (see §§4.11-4.29), negligence (see §§4.30-4.38), breach of fiduciary duty (see §4.39) and other theories (see §§4.40-4.51).

NOTE: A claimant may *concurrently* pursue tort and contract causes of action until the party accepts an actual benefit from one of the theories that would make it unfair to continue to pursue the alternative. See *Perry v Robertson* (1988) 201 CA3d 333, 341, 247 CR 74.

This chapter lays out instances and circumstances in which a broker may face liability. See chap 11 for detailed discussion of litigating claims against brokers.

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§4.2 II. CONTRACTUAL LIABILITY

Because written listing or commission agreements between principals and brokers typically contain few protections for the principal and impose very few express obligations on the broker, breach of contract causes of action are less common than tort causes of action. For a discussion of tort causes of action, see §§4.11-4.51, 11.18-11.71. In *Reichert v General Ins. Co. of Am.* (1968) 68 C2d 822, 830, 69 CR 321, the court noted that in order to succeed with a breach of contract claim, the pleading party must successfully prove the existence of the following four elements:

- The existence of a contract (*e.g.,* the listing agreement) (see §4.3);
- The claimant's performance under the contract or excuse for nonperformance under the contract (see §4.4);
- A contractual breach by the defendant (see §4.5); and
- Resulting damages to the claimant (see §4.6).

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§4.3 A. Existence of a Contract

Under the California Civil Code, there are four essential elements that must be shown to prove the existence of a contract (CC §1550; *Lopez v Charles Schwab & Co., Inc.* (2004) 118 CA4th 1224, 13 CR3d 544):

- The parties are capable of contracting;
- The parties have consented;
- The object of the contract is lawful; and
- There is sufficient cause or consideration.

The Statute of Frauds (CC §1624) requires "[a]n agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate… or to procure, introduce, or find a purchaser or seller of real estate… for compensation or a commission" to be in writing in order to be legally enforceable. However, an oral agreement between two brokers to share in a commission is outside the Statute of Frauds. *Grant v Marinell* (1980) 112 CA3d 617, 169 CR 414.

The terms of the contract may help determine, among other things, any limitations with respect to a claimant's available remedies; whether a liquidated damages clause is included providing that all or a portion of the buyer's or lessee's deposit will serve as the property owner's total compensation (and the basis of the broker's commission) if the buyer or lessee breaches the contract; or whether the dispute is subject to binding arbitration.

On contract law as it applies to real estate brokers, see chap 2. For more on contract formation generally, see California Law of Contracts (Cal CEB 2007).

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§4.4 B. Claimant's Performance or Excuse for Nonperformance

Before a party to a contract may require another party to perform, all conditions precedent must be fulfilled. CC §1439. When liability under the contract depends on the satisfaction or performance of one or more conditions precedent, an allegation that such conditions have been satisfied or performed is an essential part of the cause of action. *Careau & Co. v Security Pac. Bus. Credit, Inc.* (1990) 222 CA3d 1371, 1389, 272 CR 387. If the condition is an event, as distinguished from an act to be performed by the claimant, the claimant must allege specifically that the event has occurred. In *Careau & Co.,* the court stated that a general allegation that all conditions have been duly performed or satisfied will not be sufficient if specific facts alleged by the claimant are inconsistent with the general allegation. However, the claimant's nonperformance may be excused by, among other things, anticipatory breach. CC §1440.

The party asserting nonperformance, whether as a cause of action or an excuse for failure to perform, bears the burden of proving the facts on which the obligation depended. *California Prune & Apricot Growers, Inc. v Baker* (1926) 77 CA 393. If, for example, the terms of a listing agreement state unequivocally that the listing broker is required to use best efforts to advertise and market the property, to succeed on a breach of contract claim against the broker, the principal must prove that the broker did not satisfy this express condition of the contract. Best efforts clauses are rarely found in brokerage contracts because of the heightened effort required on the part of the broker to meet the standard of care and effort required.

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§4.5 C. Contractual Breach by Broker

A breach of contract may be either total or partial, and each is actionable if there are measurable damages resulting from the breach. *Borgonovo v Henderson* (1960) 182 CA2d 220, 231, 6 CR 236. In general, a total breach results from a complete failure to perform all of a party's obligations under a contract; a partial breach results from a failure to perform something less than all of a party's duties. See, *e.g., Linden Partners v Wilshire Linden Assocs.* (1998) 62 CA4th 508, 531, 73 CR2d 708 (incorrect estoppel certificate deposited in commercial real estate escrow). See also Restatement (Second) of Contracts §236 (1981).

Contractual relationships between a principal and a broker, a buyer and a seller, or a lessee and a lessor of real property all involve the law of contracts and of agency, providing an overlapping legal framework within which the real estate transaction at issue is analyzed and regulated. The parties to a brokerage contract are at liberty to adopt provisions making compensation depend on any lawful condition stated, while the law of agency supplies terms regarding contingencies not addressed by the provisions of the contract. *R.J. Kuhl Corp. v Sullivan* (1993) 13 CA4th 1589, 1599, 17 CR2d 425. Therefore, in addition to the general covenant of good faith and fair dealing, so long as the written contract entered into between the parties has a lawful objective, the terms of the contract will be a primary source to determine the parties' obligations and liabilities to each another. A careful review of the terms of the contract will assist the parties in determining whether a breach did in fact occur and whether the parties' liabilities and/or legal remedies are restricted or modified (*e.g.,* by the existence of an arbitration clause).

On agency law, see chap 3. For further discussion of contractual breach, see chap 5; California Real Property Remedies and Damages §§4.28-4.34 (2d ed Cal CEB 2002).

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§4.6 D. Resulting Damages

The basic method to determine the actual monetary harm suffered by the claimant is known as the "benefit-of-the-bargain" measure. Civil Code §3300 provides:

> For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.

Contract damages are generally limited to those within the contemplation of the parties when the contract was entered into, and consequential damages beyond the expectation of the parties are not recoverable. *Erlich v Menezes* (1999) 21 C4th 543, 550, 87 CR2d 886. Damages must also be reasonable, and when an obligation appears to create a right to unconscionable and grossly oppressive damages, no more than reasonable damages can be recovered. CC §3359. For detailed discussion of damages, see §§11.89-11.106.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/ E. Advantages of a Breach of Contract Claim/§4.7 1. Attorney Fees Clause

E. Advantages of a Breach of Contract Claim

§4.7 1. Attorney Fees Clause

Many contracts contain clauses authorizing recovery of attorney fees and costs expended in enforcing the contract by the prevailing party in a breach of contract claim. In an action based on a contract which specifically provides for such fees and costs, courts may award fees to the party who is deemed the prevailing party in the action, "whether he or she is the party specified in the contract or not." CC §1717. Contractual fees have been recovered in the following scenarios:

- **Suit by either party to the contract.** Either party to the contract may recover attorney fees, even if the contractual fee provision only authorizes recovery of fees by a particular party. CC §1717(a). In *Hsu v Abbara* (1995) 9 C4th 863, 39 CR2d 824, the California Supreme Court held that a defendant homeowner who had a "simple, unqualified victory" against a purchaser's claim was entitled to recover reasonable attorney fees incurred in defense of the claim since the contract contained a prevailing party attorney fees clause. 9 C4th at 877. Thus, a defendant who successfully defends against a contract claim is, as a matter of law, the prevailing party on the contract.
- **Successful suit by nonsignatory plaintiff.** Attorney fees may be awarded to a nonsignatory who successfully sues under the contract on a third party beneficiary theory. In *Steve Schmidt & Co. v Berry* (1986) 183 CA3d 1299, 228 CR 689, a buyer's broker successfully sued the seller under a listing agreement between the seller and the listing broker and was awarded attorney fees. The listing broker entered into a commission-sharing agreement with the plaintiff real estate brokerage, which required the brokerage to obtain a ready, willing, and able buyer. The president of the brokerage ultimately accepted the original offer to sell on the exact terms in the listing agreement, but the seller refused to comply. The plaintiff brokerage sued for its share of the commission and attorney fees, which were granted because the court reasoned that the purpose of CC §1717 is to provide a "reciprocal remedy," which applies whether or not the prevailing party was actually named in the contract. 183 CA3d at 1316.
- **Successful defense against nonsignatory plaintiff.** Attorney fees may be awarded to a party to the contract who is sued by a nonsignatory. In *Jones v Drain* (1983) 149 CA3d 484, 196 CR 827, the sellers were awarded attorney fees after successfully defending against a cooperating broker suing for breach of a listing agreement. Notwithstanding the fact that the breach of contract cause of action was completely without merit and that the plaintiff was not a party to the listing agreement, the court of appeal awarded attorney fees to the sellers as prevailing parties under CC §1717.
- **Unenforceable contract.** Attorney fees may be recovered by the prevailing party even if the court determines that the contract is unenforceable. In *Manier v Anaheim Bus. Ctr. Co.* (1984) 161 CA3d 503, 207 CR 508, a would-be buyer brought an unsuccessful action against the seller for specific performance of a purchase agreement. The court held that if the opposing party has also sought attorney fees under CC §1717, the prevailing party is entitled to recover attorney fees whether the contract is upheld, the contract is unenforceable, or the prevailing party is a nonsignatory. But see *Myers Bldg. Indus., Ltd. v Interface Technol., Inc.* (1993) 13 CA4th 949, 17 CR2d 242 and *Leach v Home Sav. & Loan Ass'n* (1986) 185 CA3d 1295, 230 CR 553, both questioning the analysis in *Manier*.
- **Document other than a contract.** An attorney fees clause may be enforced in an action on an instrument that is not technically a "contract," such as a recorded declaration of restrictions or a deed of trust. See *Chase Manhattan Mortgage Corp. v Lessel* (1997) 55 CA4th 10, 64 CR2d 113; *Mackinder v OSCA Dev. Co.* (1984) 151 CA3d 728, 198 CR 864.

NOTE: Counsel should also be familiar with *Leamon v Krajkiewcz* (2003) 107 CA4th 424, 132 CR2d 362, in which a seller prevailed in establishing that a purchase agreement was invalid, but was still subject to a clause in the agreement requiring mediation of any dispute as a condition precedent to a lawsuit, and was thus precluded from

recovery of attorney fees. See also *Hasler v Howard* (2005) 130 CA4th 1168, 30 CR3d 714, in which the applicable attorney fees clause applied only to contract disputes; thus neither the broker or the principal could recover fees in a tort action. Recent changes in standardized broker forms requiring that the party initiating litigation first attempt or offer mediation or be barred from attorney fee recovery at trial or arbitration, along with recent case law upholding such provisions, warrant close scrutiny by counsel. See, *e.g., Frei v Davey* (2004) 124 CA4th 1506, 22 CR3d 429; *Blackburn v Charnley* (2004) 117 CA4th 758, 11 CR3d 885.

For further discussion of attorney fees allowed by contract, see California Attorney Fee Awards, chap 6 (2d ed Cal CEB 1994). See also discussion of attorney fees in broker litigation in §§11.104-11.106.

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§4.8 2. Longer Statute of Limitations

A claimant has a longer period of time in which to bring an action based on a written contract. The statute of limitations to commence an action on a contract, obligation, or liability that is founded on an instrument of writing is 4 years. CCP §337(1). In contrast, an action on a contract, obligation or liability not founded on an instrument of writing must be commenced within 2 years. CCP §339(1). For more discussion of statute of limitations, see §§11.32, 11.63-11.65, 11.81, 11.86.

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§4.9 3. Broader Damages

Depending on whether the cause of action arises out of the breach of a listing agreement or a purchase and sale agreement, contract damages may include the broader, benefit-of-the bargain measure of damages. See §§4.6, 11.90.

If the breach of contract claim arises out of a listing agreement, the basic measure of damages under CC §3300 is the amount that will compensate the claimant for all detriment proximately caused by the broker's breach or the amount that, in the ordinary course of things, would be likely to result. For example, in *Christensen v Slawter* (1959) 173 CA2d 325, 343 P2d 341, the plaintiff buyer recovered damages incurred from a work stoppage caused by a delay in the closing of escrow.

If a claimant pursues a breach of contract claim on a purchase and sale agreement, and the seller has breached the obligation to convey the subject property, the buyer's damages are governed by CC §3306:

> The detriment caused by the breach of an agreement to convey an estate in real property, is deemed to be the price paid, and the expenses properly incurred in examining the title and preparing the necessary papers, the difference between the price agreed to be paid and the value of the estate agreed to be conveyed at the time of the breach, the expenses properly incurred in preparing to enter upon the land, consequential damages according to proof, and interest.

If the buyer breached the obligation to purchase the subject real property, the seller's general contract damages are governed by CC §3307:

> The detriment caused by the breach of an agreement to purchase an estate in real property is deemed to be the excess, if any, of the amount which would have been due to the seller under the contract over the value of the property to him or her, consequential damages according to proof, and interest. CC §3307.

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§4.10 4. Prejudgment Interest

Mandatory prejudgment interest may be awarded on a breach of contract claim, provided that the claim is liquidated. CC §3287(a). Damages are deemed to be liquidated if the amount is "certain, or capable of being made certain by calculation." CC §3287(a).

EXAMPLE: If a broker's commission for selling a home is specified in an exclusive-right-to-sell agreement to be 6 percent of the selling price, the broker's claim for the commission becomes a liquidated claim when the seller accepts a purchase offer at a specific price or when the broker procures a "ready, willing, and able" buyer (see §7.20) ready to complete the purchase in conformance with the terms specified in the listing agreement. At that point, the commission can be calculated by multiplying the sales offer price by 6 percent.

Prejudgment interest is usually calculated at a rate of 10 percent per year, unless the contract specifies a different legal rate of interest, in which case the contract rate will apply. See CC §3289. Further, prejudgment interest can be awarded from the later of the date the claimant was owed payment or the date the defendant received sufficient information (*e.g.,* from invoices) to calculate the approximate amount due the claimant in the event of liability. See *Anselmo v Sebastiani* (1933) 219 C 292, 301, 26 P2d 1. If the claim is not liquidated, the court can grant or deny a claim for prejudgment interest, in its discretion. CC §3287(b).

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§4.11 III. FRAUD

A claimant may pursue an action against a broker for deceptive conduct, or fraud. There are two main types of fraud that can be pursued: actual fraud (see §4.12) and constructive fraud (see §4.28). Before proceeding with a fraud cause of action against a broker, however, it is essential first to determine whether the 3-year statute of limitations, which begins when the claimant first becomes aware or reasonably should have been aware of the facts constituting fraud, has run on the claim and whether damages have occurred. See CCP §338(d); *Jolly v Eli Lilly & Co.* (1988) 44 C3d 1103, 1110; 245 CR 658; §11.63. If the fraud was committed by the claimant's broker (in his or her fiduciary capacity), a lesser degree of diligence on the part of the claimant is required. *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1240, 44 CR2d 352; *Hobart v Hobart Estate Co.* (1945) 26 C2d 412, 439; 159 P2d 958; *Bennett v Hibernia Bank* (1956) 47 C2d 540, 563, 305 P2d 20.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.12 A. Actual Fraud

§4.12 A. Actual Fraud

The five main types of actual fraud are:

- Intentional misrepresentation (see §4.13);
- Deceit, including intentional deceit and negligent misrepresentation (see §4.14);
- Nondisclosure, or concealment (see §4.15);
- Promissory fraud (see §4.16); and
- Other deceptive conduct by the broker (see §4.17).

Assuming the broker has engaged in any one of these five types of fraud, the other elements which must be proved in order to prevail on a cause of action for actual fraud include: (1) that the broker was a party to a contract or acted with the "connivance" of a party; and (2) that the broker either intended to deceive another party to the contract or induced the other party to enter into the contract. CC §1572. See also CC §1709. For further discussion of the elements of fraud, see §§11.37-11.47; California Real Property Remedies and Damages §§3.36-3.60 (2d ed Cal CEB 2002). For discussion of fraud claims and the statute of limitations, see §11.63.

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§4.13 1. Intentional Misrepresentation

A broker commits intentional misrepresentation by suggesting as a fact something that is not true, when the broker does not believe it to be true. CC §§1572(1), 1710(1). To recover damages for deceit, the claimant must show that the broker intended to induce the principal to alter his or her position to his or her detriment or risk. CC §1709. For example, in *Storage Servs. v Oosterbaan* (1989) 214 CA3d 498, 262 CR 689, the seller's broker committed intentional misrepresentation when, in response to the prospective buyer's inquiry as to whether a state agency was interested in buying the subject property, he claimed that the state was not interested, when in fact an authorized agent of the state had repeatedly expressed to the broker an interest in buying the property. See discussion of intentional misrepresentation and broker claims and defenses in §§11.37, 11.76, 11.96.

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§4.14 2. Negligent Misrepresentation

Negligent misrepresentation occurs when the broker makes a positive assertion in a manner which is not warranted by the information in the broker's possession. The broker must have made an affirmative statement, not merely failed to disclose something. See CC §1710(2). In other words, the broker states as a fact something that is not true when the broker has no reasonable grounds or basis for believing it to be true.

EXAMPLE: A broker could be held liable for negligent misrepresentation for erroneously stating to a buyer or lessee that a property consists of a certain number of square feet without making an adequate investigation to determine or verify such measurement.

A broker may also be liable for negligent misrepresentation for suppressing a known material fact about a property. In *Byrum v Brand* (1990) 219 CA3d 926, 268 CR 609, a broker was liable for telling a buyer that the property was in good condition, notwithstanding the broker's knowledge of an engineer's report which outlined certain precautions that should be taken to improve the structure's ability to withstand an earthquake. See also discussion in §11.96.

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§4.15 3. Nondisclosure

Nondisclosure, or concealment, occurs when a broker suppresses a fact which materially affects the desirability of the subject property and which the broker knows is unknown to the other party. Further, the broker must either have a duty to disclose the fact or have given information of other facts which are likely to mislead the other party without the omitted fact. CC §§1572(3), 1710(3). For example, in *Kallgren v Steele* (1955) 131 CA2d 43, 279 P2d 1027, a seller was liable for failing to disclose that the property was built on government land and was maintained under a special use permit from the federal forest service. See discussion of nondisclosure and broker claims and defenses in §11.42.

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§4.16 4. Promissory Fraud

Promissory fraud occurs when a broker makes a promise to another party without any intention of performing. CC §§1572(4), 1710(4). In *Reton v J.D. Millar Realty Co.* (1933) 132 CA 708, 23 P2d 419, the brokers were held liable for fraud for promising the buyer that the brokers would procure a tenant who would pay sufficient rent to cover the buyer's mortgage payments, when in fact the brokers had no intention of actually following through on their promise. See §11.37.

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§4.17 5. Other Deceptive Conduct

Other deceptive conduct, or any other act committed by the broker which is "fitted to deceive," is also considered fraud. CC §1572(5). In *Brady v Carman* (1960) 179 CA2d 63, 3 CR 612, a seller's broker was held liable for fraud as a result of giving evasive and misleading responses to the buyer about a 30-foot utility easement that the buyer had discovered during a due diligence investigation of the subject property. In response to the buyer's questions, the seller's broker assured the prospective buyer that the easement was nothing to be concerned about and that it did not affect or in any way impede the property. In fact, the terms of the easement prevented the installation of a driveway on the portion of the property where the easement was located.

Exculpatory clauses in contracts relieving principals and brokers from liability for intentional misrepresentation or fraud are void as against public policy under CC §1668. See *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 55 CR3d 59. See also discussion in §§2.54-2.56.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.18 B. Advantages of Pleading Actual Fraud

§4.18 B. Advantages of Pleading Actual Fraud

A successful claim of actual fraud can provide several advantages, including:

- Recovery of punitive damages (see §4.19);
- Recovery from the Real Estate Recovery Account (see §4.20);
- Rescission (see §4.21);
- Recovery of commission (see §4.22);
- Avoidance of bankruptcy protection (see §4.23);
- Additional damages (see §4.24).

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§4.19 1. Punitive Damages

If the fraud committed by the broker was intentional, as opposed to a negligent misrepresentation (see §4.14) or constructive fraud (see §§4.28-4.29), the claimant may seek punitive damages. Civil Code §3294(a) provides:

> In an action for the breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.

In *Hartzell v Myall* (1953) 115 CA2d 670, 252 P2d 676, a seller was awarded punitive damages when its real estate broker was held liable for deceptively securing the seller's signature to escrow instructions and a deed. See also §11.103.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.20 2. Real Estate Recovery Account

§4.20 2. Real Estate Recovery Account

The Department of Real Estate (DRE) administers a fund of last resort for persons harmed by a broker through:

- Fraud;
- Misrepresentation;
- Deceit; or
- Conversion of trust funds.

The fund, known as the Real Estate Recovery Account of the Real Estate Fund, provides at least partial recovery of the actual loss when the broker has insufficient assets to pay for the loss. Bus & P C §§10470-10481. The DRE website containing information about the Recovery Account is listed in the Directory.

In order to qualify to receive payment from the Recovery Account the aggrieved party must:

- Obtain a final civil judgment, arbitration award, or criminal restitution award against the broker (Bus & P C §10471(a));
- Show that he or she has conducted a reasonable search of the broker's assets in an effort to collect on the judgment or award and has also made a reasonable effort to collect from all other parties involved in the transaction who may also be liable (Bus & P C §10471(c)(7)); and
- Submit an application to the DRE within 1 year after the judgment or award becomes final, with a copy of the application and required notice also properly served on the broker, who is given an opportunity to respond to the allegations in the application and object to payment of the claim (Bus & P C §§10471(b), 10471.1).

If the aggrieved party is approved to collect from the Recovery Account, he or she will be paid for actual and direct loss, up to the statutory maximum of $50,000 per transaction, with a possible total aggregate maximum of $250,000 per broker. Bus & P C §10474. For additional discussion of the Real Estate Recovery Account, see §§8.46, 9.36.

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§4.21 3. Rescission

If the claimant can successfully prove that the broker's actual fraud caused the claimant to enter into the purchase agreement, the court may permit the agreement itself to be rescinded. CC 1689(b)(1). In *Curran v Heslop* (1953) 115 CA2d 476, 252 P2d 378, the defendant seller knew of a building code violation which was not readily apparent to the plaintiff buyer. The plaintiff showed that had she been made aware of the violation she would not have purchased the property. The court permitted the rescission of the purchase agreement, stating (115 CA2d at 480):

> It is the law that, where material facts are accessible to the vendor only and he knows them not to be within the reach of the diligent attention and observation of the vendee, the vendor is bound to disclose such facts to the vendee, and upon his failure to do so, the vendee may rescind the transaction upon discovering the true state of facts.

Note that a contract may be rescinded against an innocent principal based on the fraud of the principal's broker. *Simmons v California Inst. Tech.* (1949) 34 C2d 264, 273, 209 P2d 581; *Speck v Wylie* (1934) 1 C2d 625, 627, 36 P2d 618. Generally, both principal and broker are deemed to have notice of whatever either has notice of. CC §2332.

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§4.22 4. Recovery of Commission

In the case of intentional fraud conducted by a broker, a principal can be relieved of the obligation to pay a commission and can also recover any commission previously paid after the principal's discovery of the broker's fraudulent act. In *Tackett v Croonquist* (1966) 244 CA2d 572, 53 CR 388, the plaintiff buyer was awarded (in addition to other damages) the commission previously paid to the broker, as a result of the broker's failure to accurately identify the property's acreage and boundary locations. The plaintiff was unable to resell a portion of the property because the misidentified acreage was actually owned by another party. The court found that the broker knew or should have known about the error, that the plaintiff relied on the broker's erroneous representation in purchasing the property, and that the bad faith defeated the broker's right to recover a commission and permitted the principal to recover the commission that had already been paid. 244 CA2d at 577. See also *Roberts v Lomanto* (2003) 112 CA4th 1553, 1563, 5 CR3d 866 (involving broker's sale of her option to purchase client's property), discussed in §3.13.

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§4.23 5. Judgment Not Dischargeable in Bankruptcy

If a broker is held liable for fraud, the court's awarded judgment in favor of the principal cannot be discharged by the broker in a subsequent bankruptcy proceeding. 11 USC §523(a)(2)(A). See *Cowen v Kennedy (In re Kennedy)* (9th Cir 1997) 108 F3d 1015.

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§4.24 6. Additional Damages

If the broker responsible for the fraudulent act was a fiduciary, or if the fraudulent act was performed by another principal to the transaction or their broker, additional damages may be obtained.

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§4.25 a. Fiduciary Fraud

When the fraudulent act was performed by a fiduciary, a verdict for fraud or deceit enables the claimant to recover damages measured by the broader benefit-of-the bargain standard, rather than the narrow out-of-pocket standard. See §§11.89-11.106. In *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, the court stated that CC §§1709 and 3333, read together, apply when a fiduciary (*e.g.,* a broker) commits fraud. In such circumstances, the broader benefit-of-the bargain damages apply. Benefit-of-the-bargain damages are measured by determining the difference between the actual value of that which the claimant received and the value the claimant would have received if the fraudulent representation had been true. CC §3333. In addition, a property owner may be entitled to recover lost appreciation and lost use damages when the listing broker fraudulently induces the sale of the property by failing to disclose a material fact unrelated to the value of the property. See *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 37 CR3d 699; §11.100-11.102.

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§4.26 b. Fraud by Nonfiduciary Party

When the fraudulent act was performed by another principal to the transaction or that principal's broker, a verdict for fraud or deceit generally enables the claimant to recover out-of-pocket damages, or the difference between the value given up and the value received. See CC §3343(a). However, alternative damages may also be available. For example, in *Cory v Villa Props.* (1986) 180 CA3d 592, 225 CR 628, the buyers successfully alleged that the sellers and their brokers misrepresented the size of the property in an advertisement and in the listing. The buyers later conducted their own survey and determined the size had been misrepresented. The court held that because the sellers possessed superior knowledge of the property and asserted such knowledge to the buyers who did not have an equal opportunity to gain such knowledge, the sellers' asserted opinions as to the value of the land were an affirmation of fact on which the buyers reasonably relied and, consequently, actionable fraud. 180 CA3d at 597. Although the court found that the buyers had not suffered any out-of-pocket losses since the value of the property at the time of acquisition was equal to or greater than the price paid by the buyers, the court remanded to the trial court the issue of "additional damages" (*i.e.,* consequential damages) under CC §3343.

Under CC §3343, there are four types of "additional damages" that may be awarded:

- Sums actually and reasonably spent in reliance on the fraud;
- Compensation for any loss of use and enjoyment of the property proximately caused by the fraud;
- If the claimant is a seller, compensation for profits or other gains that might reasonably have been earned by use of the property if seller had retained it; and
- If the claimant is a buyer, compensation for any loss of profits or gains that were reasonably anticipated and would have been earned had the property been as represented, and
- The buyer purchased the property for the purpose of using it or reselling it for a profit;
- The buyer reasonably relied on the fraud in entering into the transaction and in anticipating profits from the subsequent use or sale of the property; and
- The lost profits were proximately caused by the fraud and the buyer's reliance on such fraud.

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§4.27 C. Disadvantages of Pleading Actual Fraud

Actual fraud can be very difficult to prove. Often, the claimant alleges that the broker or other principal to the transaction has deliberately misrepresented facts, which requires the claimant to overcome the difficult task of demonstrating that either party had prior knowledge and voluntarily misrepresented the facts. The claimant must also prove justifiable reliance on the expertise of the broker or the other principal to the transaction. This may also be a difficult task for claimants to overcome if there is evidence that the claimant failed to take appropriate measures at the time of the transaction which would have potentially revealed the alleged fraud or the true underlying facts.

In addition, an unsubstantiated claim of fraud can alienate the trier of fact. Without sufficient evidence to substantiate an allegation of actual fraud, the court may look unfavorably on the party bringing the action. Finally, and most importantly, if fraud is alleged without evidence, the court may impose sanctions pursuant to CCP §128.7. See also §11.39.

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§4.28 D. Constructive Fraud

A claimant should consider pleading constructive fraud against a broker if the broker, without fraudulent intent, breached a fiduciary duty which consequently misled the plaintiff (or someone through whom plaintiff claims) to plaintiff's prejudice and the broker gained an advantage as a result of the breach. See discussion of constructive fraud and broker claims and defenses in §§11.37, 11.43, 11.60, 11.97. Civil Code §1573 defines constructive fraud as:

> 1. In any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him; or,
> 2. in any such act or omission as the law specially declares to be fraudulent, without respect to actual fraud.

In *Schoenberg v Romike Props*. (1967) 251 CA2d 154, 59 CR 359, the broker was held liable for constructive fraud after representing to the seller that the property offered for the buyer's promissory note was ample, when in fact it was worthless. Even though the broker was held to not have any fraudulent intent to deceive the seller, he was held liable for constructive fraud because he breached his fiduciary duty, with the result that the seller was misled and the broker gained his commission. 251 CA2d at 162. A broker may also be held liable for constructive fraud for negligently informing clients that a property fulfills their express requirements without properly examining whether that is true. See *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463.

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§4.29 E. Advantages and Disadvantages of Pleading Constructive Fraud

When pursuing a claim of constructive fraud, it is not necessary to show fraudulent intent to make a successful claim. This avoids a lot of the difficulty of proving fraudulent intent, as is required when pursuing a claim of actual fraud. See §4.27. On the other hand, because constructive fraud does not require proof of fraudulent intent, constructive fraud does not support a prayer for punitive damages or recovery of the commission paid to the broker. See CC §3294.

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§4.30 IV. NEGLIGENCE

A broker owes a duty to all parties to a transaction to use reasonable care, skill, and diligence. See *Smith v Rickard* (1988) 205 CA3d 1354, 1364, 254 CR 633; *Timmsen v Forest E. Olson, Inc.* (1970) 6 CA3d 860, 871, 86 CR 359; §§3.20, 3.48. See also the duties listed in CC §2079.16 (Disclosure Regarding Real Estate Agency Relationship). There are few cases in California that analyze a pure negligence theory against a real estate broker. This is because the cases usually include allegations of breach of fiduciary duty and constructive fraud, as well as breaches of various statutory duties, negligent misrepresentation, or even negligent nondisclosure. See, *e.g., Ford v Cournale* (1973) 36 CA3d 172, 111 CR 334. However, examples of pure negligence include negligent recommendation of an inspector or vendor, and negligence in analyzing whether a fact should have been disclosed (*e.g.,* a repaired problem or something impacting a neighborhood as opposed to the subject home). For further discussion regarding negligence and negligence per se causes of action involving real estate brokers and the strategies to consider in bringing such actions, see chaps 3, 11.

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§4.31 A. Common Negligence Claims

Negligence claims against brokers have been based on the following:

- Failure to investigate. See *Ford v Cournale* (1973) 36 CA3d 172, 111 CR 334; §3.38.
- Careless setting of sales price. See *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 177 CR 882; §3.59.
- Negligent drafting. See *Perry v Robertson* (1988) 201 CA3d 333, 336, 247 CR 74; §11.21.
- Misidentifying property (see *Tackett v Croonquist* (1966) 244 CA2d 572, 53 CR 388) or misrepresenting property (see *Overgaard v Johnson* (1977) 68 CA3d 821, 823, 137 CR 412); §§3.38, 11.21.
- Negligent title, permit, or record search. See *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 73 CR2d 784; *Wilson v Hisey* (1957) 147 CA2d 433, 305 P2d 686; §§3.64, 11.20.
- Improperly advising on tax matters. See *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734; *Santos v Wing* (1961) 197 CA2d 678, 684, 17 CR 457; §§3.67-3.68.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.32 B. Disadvantages of Alleging Negligence Against Broker

§4.32 B. Disadvantages of Alleging Negligence Against Broker

There are two main disadvantages to consider before pursuing a negligence cause of action against a broker: the broker's potential defense of comparative negligence and the possible existence of certain circumstances creating a narrower (or lesser) duty of care than is expected of the broker.

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§4.33 1. Comparative Negligence

With respect to comparative negligence, consider any facts which may lead the broker to argue that the claimant's own negligence was wholly or partially to blame for the alleged problem. See discussion of broker defenses to comparative negligence claims in §11.25. For example, a buyer's broker is not required to verify or check the accuracy of information received from the seller or listing broker as long as the buyer's broker informs his principal that the information has not been verified or checked for accuracy. *Pagano v Krohn* (1997) 60 CA4th 1, 11, 70 CR2d 1.

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§4.34 2. Lesser Duty Owed

With respect to a broker's argument that he or she owed the principal a narrower or lesser duty of care, the broker may argue, for example, that his or her duties were limited by certain express provisions in the listing agreement or deposit receipt. See *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 1499, 55 CR3d 59. See also discussion of broker's defense of contractual disclaimer or exculpatory clause in §11.24.

The broker may also argue that:

- He or she had no duty to alert the claimant to a defect in or at the property because the defect was so obvious (see *McCollum v Friendly Hills Travel Ctr.* (1985) 172 CA3d 83, 217 CR 919);
- The broker's duty was limited based on the claimant's relative sophistication and knowledge of real estate matters (see *Stevens v Hutton* (1945) 71 CA2d 676, 163 P2d 479); or
- The claimant effectively adopted or ratified the broker's act or signature on a particular document either expressly or by implication based on the claimant's conduct (see *Behniwal v Mix* (2005) 133 CA4th 1027, 35 CR3d 320).

See discussion of broker defenses in §§11.24-11.26.

Although the foregoing examples stem from the relatively few published cases involving broker negligence and deal with specific facts that may not apply to a principal's claim(s) against his or her broker, these examples may help counsel determine whether the broker does in fact have a viable defense that lessens or alleviates all of his or her potential liability or exposure.

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§4.35 C. Negligence Claim Against Other Party's Broker

Notwithstanding the absence of any contractual or agency relationship, a broker may also be held liable for the negligent rendering of services to other parties in the transaction, including (1) failing to make certain material disclosures with respect to the property, (2) failing to act honestly and fairly with all parties, and (3) failing to exercise due care to third parties. For discussion of the specific duties owed by brokers to parties who are not their principal, see §§3.71-3.87.

In bringing a negligence claim against another party's broker there is a high probability that the broker will contest the existence of any duty owed to the nonprincipal claimant. To determine whether in fact there was a duty owed, the court will weigh various factors, including:

- The extent to which the transaction was intended to benefit the claimant;
- The foreseeability of the harm;
- The degree of certainty that the claimant would be harmed;
- The moral blame attached to the broker's conduct; and
- The public policy of preventing future harm.

See *Merrill v Buck* (1962) 58 C2d 552, 25 CR 456; *Norman I. Krug Real Estate Invs. v Praszker* (1994) 22 CA4th 1814, 28 CR2d 498. In considering these factors, the most important inquiry in determining whether a duty is owed to third parties may be the foreseeability of the harm suffered by the claimant. This requires a successful showing that a reasonable person would have foreseen an unreasonable risk of harm to the claimant and that the broker failed to disclose such risk and therefore failed to exercise ordinary due care. For example, a listing broker may be found liable for negligence for informing the buyer that the offer had been accepted when it had not. *Earp v Nobmann* (1981) 122 CA3d 270, 175 CR 767, overruled on other grounds in *Silberg v Anderson* (1990) 50 C3d 205, 266 CR 638.

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§4.36 1. Third Party Disclosures

A property owner's broker is held to the same affirmative obligations as the owner to disclose to a buyer or lessee all material facts concerning the value and desirability of the property which are not otherwise readily apparent to the other party. Whether or not a particular fact will be considered material will most certainly depend on the circumstances of the transaction. See discussion of materiality of disclosures to third parties in §§3.75-3.76. There are relatively few published cases dealing specifically with broker negligence towards a nonprincipal; however, claims have been based on the following:

- Incorrect estimation of square footage of the property. See *Furla v Jon Douglas Co*. (1998) 65 CA4th 1069, 76 CR2d 911 (finding triable claim against listing broker and seller who overestimated size of residence).
- Failure to disclose pest and fungus infestation. See *Saporta v Barbagelata* (1963) 220 CA2d 463, 33 CR 661 (finding triable claim against listing broker for passing on seller's misinformation with no further investigation).
- Failure to disclose tenant's poor financial condition to landlord. See *Blickman Turkus, LP v MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 76 CR3d 325 (unsuccessful claim that lessee's broker had duty to inform the landlord after the lease was signed but before the tenant took possession about tenant's deteriorating financial condition).

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§4.37 2. Honest and Fair Actions

A broker must deal honestly and fairly with all parties in a sales transaction, not just his or her principal. See discussion of broker duties to nonprincipals in §§3.71-3.87. In *Nguyen v Scott* (1988) 206 CA3d 725, 253 CR 800, a broker was held liable for breaching this duty by failing to convey a prospective buyer's offer to the seller and instead purchasing the property for himself at a lower price. Further, citing 10 Cal Code Regs §2785(a)(5) in which the term "dishonest dealing" is defined to include "[the] willful failure by a listing broker to present or cause to be presented to the owner of the property any 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," the broker was held to have violated the Code of Ethics of the National Association of Realtors® (NAR). 206 CA3d 736. On the NAR Code of Ethics, see §§1.6-1.7, App A.

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§4.38 3. Failure of Due Care

A broker must exercise due care to third parties (which duty is separate and apart from the duty of care owed to the broker's own client, as further discussed above). The quintessential case on this issue is *Easton v Strassburger* (1984) 152 CA3d 90, 104, 199 CR 383, which was clarified and codified in CC §§2079-2079.24. In *Easton*, the buyer brought a negligence action against the listing real estate broker and others after a massive earth movement on the property significantly reduced the value of the property. Although the evidence at trial did not establish that the listing broker had actual knowledge of the property's past history of slides and soil problems, there was ample evidence suggesting that one or both of the broker's salespersons knew the residence was built on fill and that settlement and erosion problems were commonly associated with such soil. There was also evidence that one salesperson had observed an uneven floor within the house, which the court deemed to be a "red flag" indicator of soil settlement problems. Ultimately, the court held that the duty of disclosure of a real estate broker representing the seller includes the affirmative duty to conduct a reasonably competent and diligent inspection of the property and to disclose to prospective buyers all facts materially affecting the value or desirability of the property that such an investigation would reveal, provided however, that such a duty does not relieve the buyer of protecting himself by exercising reasonable care with respect to the proposed transaction. For detailed discussion of CC §2079 duties, see chap 3. For discussion of broker defenses to CC §2079 claims, see §§11.31-11.34.

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§4.39 V. BREACH OF FIDUCIARY DUTY

A real estate broker owes a principal the same obligation of diligent and faithful service that a trustee owes to the beneficiary of a trust. CC §2322(c); Prob C §§16002, 16004-16005, 16009; *Gray v Fox* (1984) 151 CA3d 482, 489, 198 CR 720; *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 161, 177 CR 882. See §§3.11, 3.18, 11.49. A mortgage broker licensed by the DRE is a fiduciary of its borrower-client, with all the normal duties and obligations imposed upon fiduciaries. See CC §2923.1. The duties of a fiduciary broker to the principal include:

- Undivided loyalty. See *Sierra Pac. Indus. v Carter* (1980) 104 CA3d 579, 581, 163 CR 764; §§3.17, 11.54.
- Utmost good faith and honesty. See *Batson v Strehlow* (1968) 68 C2d 662, 674, 68 CR 589; §§3.43, 3.45, 11.55.
- Disclosure of all facts within the broker's knowledge that are material to the transaction. See *Michel v Moore & Assocs*. (2007) 156 CA4th 756, 67 CR3d 797; §§3.39-3.42, 11.56.
- Inspection of the property. See *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 20, 73 CR2d 784; §§3.38, 11.57.
- To account for all funds held on behalf of the principal and avoid commingling the principal's funds with the broker's own funds. See *Brown v Gordon* (1966) 240 CA2d 659, 49 CR 901; *Holloway v Thiele* (1953) 116 CA2d 68, 71, 253 P2d 131; §§3.52-3.54, 11.59.

For further discussion of these and other fiduciary duties owed by brokers to their principals, see chap 3.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.40 VI. ADDITIONAL TORT THEORIES

§4.40 VI. ADDITIONAL TORT THEORIES

Although claimants most commonly elect to pursue fraud, negligence, and breach of fiduciary theories when suing a broker, there are additional tort theories that may be pursued, including:

- Civil conspiracy (see §§4.41-4.43);
- Intentional infliction of emotional distress (see §§4.44-4.45);
- Interference with contract (see §§4.46-4.47); and
- Interference with prospective economic advantage (see §§4.48-4.51).

For a discussion of other additional damages recoverable for, *e.g.,* personal injuries, emotional distress, interest, punitive damages, and attorney fees, see California Real Property Remedies and Damages §§3.53-3.56 (2d ed Cal CEB 2002).

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A. Civil Conspiracy

§4.41 1. Liability Theory, Not a Cause of Action

Conspiracy is not a cause of action, but a doctrine that imposes liability on persons who, although not actually committing a tort themselves, share with the immediate tortfeasors a common plan in its perpetration. Standing alone, a conspiracy does no harm and engenders no tort liability. A civil conspiracy does not per se give rise to a cause of action unless a civil wrong has been committed resulting in damage. *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 511, 28 CR2d 475.

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§4.42 2. Elements of Civil Conspiracy Claims

A claimant should plead civil conspiracy against a broker if

- The broker combined or agreed with another person to commit a tort (*e.g.,* fraud);
- Someone other than the broker actually committed the tort; and
- Damage was caused and ultimately suffered by the claimant.

Proving civil conspiracy does not require evidence of an express agreement between the broker and the party committing the tort. Instead, a conspiracy may be inferred from the nature of the acts performed, the relationship of the parties, the interests of the alleged conspirators and other relevant circumstances. In *Zikratch v Stillwell* (1961) 196 CA2d 535, 542, 16 CR 660, the court held that there was sufficient inferential evidence to find that the defendant broker was guilty of civil conspiracy for purchasing land from the plaintiff and quickly reselling the property to a developer at a significant profit. In examining the evidence, the court found that prior to purchasing the land, the broker became associated with two businessmen who wanted to purchase land in order to construct an apartment complex. The two businessmen remained in constant contact with the defendant broker throughout his negotiations with the seller, well aware of the fact that the seller was at all times completely ignorant of the businessmen's interest in the land and their side negotiations with a construction company regarding the property.

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§4.43 3. Limitations on Conspiracy Claims

Under the "last overt act" doctrine, if the broker commits additional wrongful acts in pursuance of the conspiracy after the initial overt act, the cause of action does not begin to run until the culminating act of conspiracy. See *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 786, 157 CR 392. Also, because conspiracy is not an independent tort, the applicable statute of limitations requires that an action for conspiracy arising out of fraud be brought within 3 years of accrual. See CCP §338(d). An action for conspiracy arising out of breach of an oral contract must be brought within 2 years of accrual. See CCP §339(1).

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B. Intentional Infliction of Emotional Distress

§4.44 1. Elements of Emotional Distress Claims

Intentional infliction of emotional distress may be found if a broker commits extreme and outrageous conduct with the intent of causing (or recklessly disregarding the probability of causing) emotional or mental distress to the claimant and the claimant does in fact suffer severe emotional or mental distress as a direct result of the broker's conduct. See *Cervantez v J. C. Penny Co.* (1979) 24 C3d 579, 593, 156 CR 198.

In *Godfrey v Steinpress* (1982) 128 CA3d 154, 180 CR 95, a real estate broker concealed from buyers a report showing that the house had extensive termite damage, and instead led the buyers to believe that it was in good condition. The buyers ultimately discovered termites and dry rot so extensive that the cost of repair exceeded the value of the home. The wife experienced upset, headaches, depression, and trouble sleeping; the marriage deteriorated; the husband began drinking; the wife moved to her parents' home. An award of damages for intentional infliction of emotional distress was affirmed.

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§4.45 2. Limitations on Emotional Distress Claims

A claim of intentional infliction of emotional distress must be brought within 2 years from the act causing the emotional distress, similar to other personal injury claims. CCP §335.1. This statute of limitations begins to run once the emotional or mental distress suffered by the party bringing the action is sufficiently "severe" to warrant the potential award of damages. As such, the precise point of accrual is often a question of fact. *Pugliese v Superior Court* (2007) 146 CA4th 1444, 1450, 53 CR3d 681. If the claimant did in fact suffer severe emotional or mental distress, the claim should be brought as soon as possible to substantiate the actual severity of the distress endured by the claimant.

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C. Interference With Contract

§4.46 1. Elements of Interference With Contract Claims

A claim for tortious interference with contract by a broker must include the following elements (*PG&E v Bear Stearns & Co*. (1990) 50 C3d 1118, 1126, 270 CR 1):

- There was a valid contract between the claimant and another party;
- The broker knew of the contract and intended to induce a breach or to disrupt the contractual relationship;
- The broker did in fact commit intentional acts designed to induce a breach or to disrupt the contractual relationship;
- The contract or the relationship was in fact disrupted as a result of the broker's conduct (*e.g.,* the claimant's performance was made more expensive or burdensome); and
- The claimant suffered damages as a proximate result of the broker's conduct.

EXAMPLE: An example of such a claim by a principal against a broker might occur when the listing agreement carves out "excluded parties" the principal is dealing with personally (see §§2.42, 7.24). If the principal enters into a contract with such a party but the broker interferes with the completion of the sale, the principal would have a claim for interference against the broker.

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§4.47 2. Limitations on Interference With Contract Claims

If the complaint is based on damages for fraudulent inducement of breach of contract, the claim must be brought within 2 years. See *Trembath v Digardi* (1974) 43 CA3d 834, 118 CR 124. For further discussion of claims regarding interference with contracts, see California Business Litigation §§11.3-11.33 (Cal CEB 2002).

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§4.48 D. Interference With Prospective Economic Advantage

The tort of interference with prospective economic advantage falls into one of two subcategories—intentional or negligent interference with economic advantage. Intentional interference with economic advantage requires a showing that the claimant had an economic relationship with a third party which contained the probability of future economic benefit and that the broker, being well aware of the existence of the relationship, committed intentional acts designed to disrupt (or that were certain or substantially certain to disrupt) the relationship.

Negligent interference with economic advantage involves the same economic relationship between the claimant and a third party as the tort of interference with prospective economic advantage, but additionally requires a showing that the broker owed a duty of care to the claimant, which the broker breached by interfering with the claimant's economic interests.

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§4.49 1. Elements of Intentional Interference With Prospective Economic Advantage Claims

A claim for intentional interference with a prospective economic advantage against a broker must contain the following elements:

- The existence of a prospective economic relationship with the probability of future economic benefit to the claimant;
- The broker's knowledge of the relationship and intent to disrupt it;
- Actual disruption of the relationship;
- An independently wrongful act by the broker, which is wrongful beyond the fact of the interference itself; and
- Actual harm to the claimant.

See *Stevenson Real Estate Servs., Inc. v CB Richard Ellis Real Estate Servs., Inc.* (2006) 138 CA4th 1215, 1220, 42 CR3d 235; *Bed, Bath & Beyond of La Jolla, Inc. v La Jolla Village Square Venture Partners* (1997) 52 CA4th 867, 60 CR2d 830. See also *Korea Supply Co. v Lockheed Martin Corp.* (2003) 29 C4th 1134, 1164, 131 CR2d 29; *Della Penna v Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436.

For further discussion of claims regarding intentional interference with prospective economic advantage, see California Business Litigation §§11.11-11.17 (Cal CEB 2002).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/4 Broker Liabilities to Principals and Third Parties/§4.50 2. Elements of Negligent Interference With Prospective Economic Advantage Claims

§4.50 2. Elements of Negligent Interference With Prospective Economic Advantage Claims

The California courts recognize causes of action for negligent interference with contractual relationships. See *J'Aire Corp. v Gregory* (1979) 24 C3d 799, 157 CR 407; *Chameleon Eng'g Corp. v Air Dynamics, Inc.* (1980) 101 CA3d 418, 161 CR 463. A claim for negligent interference with a prospective economic advantage against a broker must contain the following elements:

- The existence of a duty of care to the claimant;
- A breach of that duty that is wrongful by some measure beyond the mere fact of the interference itself;
- Causation; and
- Actual harm to the claimant.

For further discussion of claims regarding negligent interference with prospective economic advantage, see California Business Litigation §§11.18-11.20 (Cal CEB 2002).

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§4.51 3. Limitations on Interference With Prospective Economic Advantage Claims

The statute of limitations is 3 years from the discovery of the facts constituting the fraud if the basis of the action is fraud or misrepresentation, or 2 years if fraud is not the basis of the action. CCP §338(d) (fraud); *Knoell v Petrovich* (1999) 76 CA4th 164, 90 CR2d 162 (interference with prospective economic advantage).

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5

Principal's Duties, Liabilities, and Defenses

Todd J. Wenzel

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I. PRINCIPAL'S DUTIES TO BROKER

§5.1 A. Discharge; Performance Under Contract

A principal always possesses the power to discharge an agent, but the right to discharge without liability depends on circumstances such as the parties' contractual relationship. *Long Beach Drug Co. v United Drug Co.* (1939) 13 C2d 158, 173, 89 P2d 386; *Lynch v Gagnon* (1929) 96 CA 512, 518, 274 P 584. The principal's termination of the agency prior to its expiration will ordinarily result in a breach of the agreement between the agent and the principal. *Stoll v Stoll* (1936) 5 C2d 687, 691, 56 P2d 226.

Under an agency agreement to sell residential real estate, the seller's obligation is limited to disclosing what the seller knows, unless there are contractual requirements to the contrary. The seller is not required to inspect or investigate the property. On agency, see chap 3; on broker contracts, see chap 2.

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§5.2 B. Payment of Compensation

An agency relationship must exist between a principal and an agent for the agent to be entitled to compensation from the principal. In many instances, more than one person claims to be entitled to a commission, the additional claimant being a lawfully appointed subagent or an authorized cooperating broker. Whether a subagent who procures a ready, willing, and able buyer has the right to a commission depends on the specific language of the subagent agreement or cooperation agreement.

To recover a commission a broker must:

- Be licensed as required by Bus & P C §§10130 and 10150 (see chap 8);
- Have a written commission or listing agreement with the principal (for listing brokers) (CC §1624(a)(4); see chap 2); and
- Have performed in accordance with the agreement.

In response to the real estate mortgage crisis of 2008-2009, Bus & P C §10150 was amended to add a requirement that mortgage loan originators submit an application for endorsement by the Real Estate Commissioner. The legislature also enacted Bus & P C §10085.6, which prohibits brokers involved in residential loan modifications from collecting "advance fees" or a power of attorney from clients, and CC §2944.7, which prohibits anyone from collecting such fees or obtaining a power of attorney from clients. Penalties for violating these statutes include fines of up to $50,000 for entities and $10,000 and/or 1 year imprisonment in county jail for individuals. For further analysis, see §§8.20, 8.24.

On agency generally, see chap 3. On issues relating to broker commissions, see chap 7.

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§5.3 1. Subagents and Cooperating Brokers

If the purported agent is in fact only a subagent appointed by an agent who lacks authority to appoint new agents for the principal, the subagent must look to the agent for compensation. *Goodwin v Glick* (1956) 139 CA2d Supp 936, 938, 294 P2d 192. In *Goodwin*, the seller entered into an exclusive listing agreement with a realty company. The agreement authorized the realty company to refer the listing to the local realty board or its members to act as subagents in procuring a purchaser for the property. The court found that the exclusive listing agreement authorized the realty company to appoint members of the realty board to act as its agents and not the agents of the seller. Subsequent cases dealt with slightly different listing agreement terms.

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§5.4 2. Cooperating Agreements

A subagent's rights are generally governed by the cooperation agreement and the seller's authorization of the subagent's acts. In *Steve Schmidt & Co. v Berry* (1986) 183 CA3d 1299, 1311, 228 CR 689, the plaintiff was a cooperating broker who entered into a written cooperation agreement with the listing broker, stating that the plaintiff would be paid a commission if it found a buyer for the property. Thereafter, the president of the plaintiff corporation offered to buy the property, but the seller refused on the terms offered. The plaintiff, as cooperating broker, sued the seller for its commission for producing a ready, willing, and able buyer, consistent with the written cooperation agreement. The court found in favor of the plaintiff on the basis of the terms of the agreement.

However, in *Colbaugh v Hartline* (1994) 29 CA4th 1516, 35 CR2d 213, the plaintiffs were cooperating brokers pursuant to an oral agreement, who procured a ready, willing, and able buyer. The listing agreement did not authorize the listing broker to divide any commission with subagents, but only authorized cooperation with subagents. The court held that when the cooperating broker is the procuring cause of the sale, his or her right to a recovery from the listing broker is limited to the terms of the cooperation agreement. Whether the broker has a direct claim against the seller depends on whether the seller was aware of or expressly authorized the cooperation agreement, whether the seller accepted the offer presented by the buyer procured by the cooperating broker, and whether the sale was ultimately consummated.

On procuring cause and ready, willing, and able buyer, see chap 7.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/5 Principal's Duties, Liabilities, and Defenses/ §5.5 3. Listing and Purchase Agreements

§5.5 3. Listing and Purchase Agreements

In most instances, the written commission or listing agreement will control the broker's right to a commission; however, it is equally permissible to include the commission provision in the purchase agreement, lease, or documents executed by the party obliged to pay the commission. On broker contracts, see chap 2; on broker commissions, see chap 7.

PRACTICE TIP: No matter which agreement contains the provisions providing for the broker's commissions, the commission agreement must be preceded by the notice of negotiability of commissions required by Bus & P C §10147.5. See §2.41. Counsel should carefully review all documents in the entire transaction.

See also *Torelli v J.P. Enters.* (1997) 52 CA4th 1250, 61 CR2d 76, in which, after the listing expired, the seller and a buyer procured by the broker attempted to consummate the sale without the broker. The court found the broker was entitled to a commission even though the broker's listing had expired.

Standardized forms like those available from local and statewide broker trade associations or from private publishing companies will almost certainly contain commission provisions. See §1.10. For example, the California Association of Realtor®'s Residential Listing Agreement (CAR form RLA) provides three circumstances under which a broker will be compensated, only one of which pertains to the seller's acceptance of an offer. One of the other two circumstances is provided for by the "safety" clause (see §§5.6, 7.24) and the other is triggered "if, without Broker's prior written consent, the Property is withdrawn from sale, conveyed, leased, rented, otherwise transferred, or made unmarketable by a voluntary act of Seller during the Listing Period." For a copy of CAR's Residential Listing Agreement, see California Real Property Sales Transactions §2.57 (4th ed Cal CEB 2007).

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§5.6 a. Under Listing Agreement

A "safety" clause in a commission or listing agreement entitles the broker to a commission if the property is sold within a stated period after the listing expires to a buyer identified during the listing period. The effect of a safety clause is to favor brokers over principals with respect to commissions from sales to buyers introduced by the broker. Absent a safety clause in a commission or listing agreement, California statutory law would apply. See form clause and Comment in §2.43. See also discussion in §7.24.

The safety clause in CAR's Residential Listing Agreement, for example, states that the commission is due when the seller enters into a contract to "sell, convey, lease, or otherwise transfer the property." CAR Form RLA, ¶4A(2). Under California law, a property is considered sold (which includes leased or exchanged) "when a legally binding commitment to sell the property comes into existence." CC §1086(i). Thus, without a provision for method and time of payment in these agreements, the commission would be earned under §1086(i) when the seller's obligation becomes binding, regardless of whether the transaction is a sale, a lease, or an exchange.

Although CC §1086(i) seems to provide that a property is sold when the seller is bound to sell, regardless of conditions precedent to the buyer's obligation to buy, this interpretation would lead a broker to have potentially earned a commission even if the buyer's conditions are never satisfied. The better interpretation is that a property is "sold" when all conditions are satisfied and the obligations of both buyer and seller are binding. There are no reported cases addressing this perceived flaw in §1086(i). Case law has defined a "sale" to mean the making of an executory contract by which the property is to be sold. *Leonard v Fallas* (1959) 51 C2d 649, 652, 335 P2d 665.

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§5.7 b. Under Purchase and Sale Agreement

Like most other standardized purchase and sale agreements, the CAR Residential Purchase Agreement and Joint Escrow Instructions (see California Real Property Sales Transactions §6.24 (4th ed Cal CEB 2007)) provides that a broker's commission is to be paid on close of escrow or, if escrow does not close, pursuant to a separate written agreement. CAR Form RPA-CA, ¶32. It is possible that this language conditions the earning of a commission on the occurrence of one or more of the enumerated events rather than on the property merely being sold within the meaning of CC §1086(i). There are no reported cases, however, deciding whether the CAR form and others like it create additional conditions to the earning of the commission or whether the contract merely specifies the time and method for payment of the commission. See *Steve Schmidt & Co. v Berry* (1986) 183 CA3d 1299, 228 CR 689; *Austin v Richards* (1956) 146 CA2d 436, 304 P2d 132. Usually, the seller will argue that a commission need not be paid unless the transaction closed. For further discussion of broker's right to commission, see chap 7.

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§5.8 C. Reimbursement of Appropriate Expenditures

Except when the agency contract provides otherwise, an agent "ordinarily is entitled… to reimbursement from his principal for all advances and expenditures properly made in carrying into effect the purpose of the agency." *Dolman Co. v Rubber Corp. of America* (1930) 109 CA 353, 360, 293 P 129.

PRACTICE TIP: Standard practice may dictate what expenditures are borne by which party, *e.g.,* the broker pays for all marketing costs except staging, and the seller pays for rehabilitation costs expended to prepare the property for sale.

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§5.9 D. No Absolute Right to Reimbursement

A broker has no right to reimbursement of expenses that the broker agreed to pay in consideration of an exclusive agency. *Myers v Gager* (1959) 175 CA2d 314, 325, 346 P2d 251. In *Myers*, a broker agreed to put his time and effort into a project to develop property owned by the defendants and to make necessary expenditures for rezoning the property. He obtained the rezoning but failed to perform other obligations under the agreement and the property was not developed as contemplated. The court held that he had no right to recoup his expenses when the development did not occur.

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II. PRINCIPAL'S LIABILITY TO BROKER

§5.10 A. Failure to Perform: Implied Promise to Perform and Third Party Beneficiary Theories

When a broker is employed by a seller, the listing and purchase agreements typically require the seller to pay the commission out of the proceeds of the sale of the property, and the seller is liable to the broker if the seller breaches the purchase agreement. Courts generally do not permit recovery of the commission from the buyer when the seller is in breach. See *Hunter v Vernon* (1948) 85 CA2d 525, 193 P2d 139. When the buyer employs the broker and the broker negotiates a satisfactory purchase agreement between the buyer and seller, the law implies a promise on the part of the buyer to complete the transaction. Thus, if the buyer refuses to honor the purchase agreement, and the broker is prevented from earning the commission, the buyer becomes liable to the broker for the breach of the implied promise. *Donnellan v Rocks* (1972) 22 CA3d 925, 931, 99 CR 692.

In most cases, the purchase agreement contains a promise to pay the broker and the broker thus becomes a third party beneficiary to the agreement. The broker need not be specifically named in the agreement but the breaching party, whether seller or buyer, is responsible for the commission. See, *e.g.*, *Super 7 Motel Assocs. v Wang* (1993) 16 CA4th 541, 546, 20 CR2d 193; *Chan v Tsang* (1991) 1 CA4th 1578, 1585, 3 CR2d 14; *Lane v Davis* (1959) 172 CA2d 302, 342 P2d 267. Both the CAR forms and the Professional Publishing forms expressly state that brokers are not parties to the purchase agreement.

In short, the relationship and liability can be expressed as follow:

- Seller and broker as principal and agent, seller's breach: the seller is likely responsible for its broker's commission under general contract law theories;
- Seller and broker as principal and agent, buyer's breach: the broker may be able to seek his commission from the breaching buyer under third party beneficiary rules, if the purchase and sale agreement contains a promise to pay the broker;
- Buyer and broker as principal and agent, seller's breach: the seller may be responsible for the buyer's broker's commission under third party beneficiary theory if the purchase and sale agreement contains a promise to pay the broker;
- Buyer and broker as principal and agent, buyer's breach: the buyer is likely responsible for its broker's commission under implied promise to perform theory.

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§5.11 B. Indemnity Owed to Broker

Normally, an agent acting within the scope of his or her authority who becomes personally liable for the performance of a contract undertaken for the principal may look to the principal for implied indemnity for damages sustained because of breach of the contract. *Sunset-Sternau Food Co. v Bonzi* (1964) 60 C2d 834, 837, 36 CR 741; *Rimington v General Acc. Group of Ins. Cos*. (1962) 205 CA2d 394, 397, 23 CR 40.

It is well settled that a cause of action for implied indemnity does not accrue or come into existence until the indemnitee has suffered actual loss through payment. *Sunset-Sternau Food Co. v Bonzi* (1964) 60 C2d 834, 843, 36 CR 741; *Card Constr. Co. v Ledbetter* (1971) 16 CA3d 472, 480, 94 CR 570.

Restatement (Third) of Agency §8.14 (2006) provides that a principal has a duty to indemnify an agent "in accordance with the terms of any contract between them." Unless they agree otherwise, the principal also has a duty to indemnify the agent

> (a) when the agent makes a payment (i) within the scope of the agent's actual authority, or (ii) that is beneficial to the principal, unless the agent acts officiously in making the payment; or (b) when the agent suffers a loss that fairly should be borne by the principal in light of their relationship.

The agent's right to indemnification in general is discussed in Comment (b) to Restatement §8.14, which provides that

> a principal's obligation to indemnify an agent arises when the agent makes a payment or incurs an expense or other loss while acting on behalf of the principal. An agent's actions on behalf of a principal may result in pecuniary loss for the agent. For example, an agent may be required to make payments to third parties to carry out the agent's work for the principal. Actions taken by an agent may also result in litigation against the agent brought by third parties with whom the agent has interacted on the principal's behalf.

PRACTICE TIP: Property managers (*i.e.*, broker licensees) often advance money on behalf of their principals for repairs, payment of mortgages, and other related expenses.

Restatement §8.14, Comment (d) addresses indemnification in connection with litigation in particular. If the agent and the principal have not expressly agreed that the principal will indemnify the agent in connection with litigation against the agent, the

> principal has a duty to indemnify the agent against expenses and other losses incurred by the agent in defending against actions brought by third parties if the agent acted with actual authority in taking the action challenged by the third party's suit. The agent's right is limited to recovery of expenses and losses in amounts that are reasonable.

The "expenses" of a successful defense for which indemnification is claimed by an agent ordinarily include attorney fees. See *Douglas v Los Angeles Herald-Examiner* (1975) 50 CA3d 449, 465, 123 CR 683 (expenses incurred by innocent employee in defense of lawsuit for conduct within scope of employment included attorney fees under Lab C §2802).

PRACTICE TIP: Counsel representing brokers and salespersons should give careful consideration to cross-complaining against sellers in the context of a buyer versus seller and broker lawsuit. It often makes more sense from a tactical point of view for the defendants to display a united defense against the buyer, rather than file a series of cross-complaints. Often, tolling agreements will be entered into between the various defendants who agree to wait to file cross-complaints until after the case in chief is over.

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III. PRINCIPAL'S DEFENSES TO CLAIMS BY BROKER

§5.12 A. Broker's Lack of Authority

A principal's primary defense to a claim by his or her broker is that the broker had no authority to act on the principal's behalf. As an example, when a broker had authority to accept a purchase price at a certain price, and then accepted a purchase price on behalf of the principal for less than the agreed amount, the principal could, in a claim for the commission, raise the defense that the broker exceeded his or her authority.

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§5.13 B. Actions Beyond the Scope of Agency Contract

A substantial variance from an agent's authority may defeat the right to compensation, even if the variance was advantageous to the principal. *J. C. Peacock, Inc. v Hasko* (1961) 196 CA2d 353, 358, 16 CR 518. Accordingly, fraud, bad faith, gross misconduct, gross mismanagement, or a failure to follow instructions on the part of the agent forfeits the right to compensation for services performed. 196 CA2d at 358.

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§5.14 C. Broker's Fraud or Misrepresentation

An agent can never have actual or ostensible authority to do an act that is a fraud on the principal, and that is known or suspected by the person with whom he or she deals to be a fraud on the principal. CC §2306. See chaps 3, 11. When an agent exceeds his or her authority, the principal is bound by the authorized acts only so far as they can be plainly separated from the unauthorized acts. CC §2333.

An agent who defrauds a principal is subject to criminal liability. Under Pen C §536, a broker or salesperson who makes a false statement about the price obtained for property, the quality or quantity of the property, or expenses incurred in connection with the property, is guilty of a misdemeanor.

PRACTICE TIP: Counsel representing brokers and salespersons must be aware that certain conduct by their clients may create potential criminal liability. As a result, the civil attorney is strongly urged to refer his or her client to a criminal defense attorney at the inception of the representation to deal with potential Fifth Amendment issues in the context of civil litigation.

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§5.15 D. Broker's Breach of Agency Contract

A principal is entitled to damages suffered as a result of an agent's breach of the agency contract. *Spitzer v Pathe Exchange, Inc.* (1933) 132 CA 612, 619, 23 P2d 308. See the detailed discussion of damages for breach contained in chap 11.

A broker owes his or her principal the following duties (*Pollack v Lytle* (1981) 120 CA3d 931, 940, 175 CR 81, disapproved on other grounds in *Beck v Wecht* (2002) 28 C4th 289, 298, 48 P3d 417):

- To make the fullest disclosure of material facts known to the broker that might affect the principal's decision making;
- To use reasonable care, skill, and diligence in performing the object of the agency; and
- To refrain from competing with the principal on matters connected with the agency.

These duties are discussed in detail in chap 3.

The breach of an agent's fiduciary duty to the principal is tortious. *Pollack,* 120 CA3d at 940. An agent's acquisition of an interest adverse to the principal, or misrepresentation or concealment regarding the subject matter of the agency and the agent's interest therein, is breach of the agent's duty. *Wade v Diamond A Cattle Co*. (1975) 44 CA3d 453, 458, 118 CR 695.

A broker's fiduciary duties to the seller to disclose all material facts continue even though he or she may be a principal in the transaction. *Roberts v Lomanto* (2003) 112 CA4th 1553, 1563, 5 CR3d 866. In *Roberts*, the broker entered into a contract with the seller (after the expiration of the listing agreement) to purchase the property for $11 million and then assigned the contract to a third party with the seller's consent. It was not until after the transaction closed, however, that the seller learned that the buyer paid $12.2 million, and that the difference was paid to the broker as an assignment fee. The broker's failure to disclose the material fact of the fee was a breach of her fiduciary duties to the seller.

An agent who violates the duty to use reasonable care, skill, and diligence is liable for any damages the principal sustained as a result of the agent's negligence or breach of duty. *Timmsen v Forest E. Olson, Inc.* (1970) 6 CA3d 860, 871, 86 CR 359. But see *Safeco Ins. Co. v J&D Painting* (1993) 17 CA4th 1199, 21 CR2d 903 (plaintiff in suit for negligent damage to real property is allowed to recover either cost of repair or diminution in value, but not both); *Orndorff v Christiana Community Builders* (1990) 217 CA3d 683, 266 CR 193 (if building is used for purpose personal to its owner, damages ordinarily include amount for repairs, even if greater than entire value of building); *Raven's Cove Townhomes, Inc. v Knuppe Dev. Co.* (1981) 114 CA3d 783, 171 CR 334 (permissible measure of damages is reasonable cost of repair or restoration of property to original condition, together with value of lost use during period of injury). On the measure of damages, see §§11.89-11.106.

Brokers sued for breaching the standard of care (see §3.20) need to retain an expert in the standard of care for real estate brokers for their defense. On standard of care experts, see chap 13.

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§5.16 E. Broker's Failure to Account

An agent is required to account for all benefits and advantages received as an outgrowth of the agency. *Kennard v Glick* (1960) 183 CA2d 246, 250, 7 CR 88. Under the *Kennard* case, once a failure to keep a proper account is established, the agent must then account for every cent that passed into the agent's possession. The agent owes to the principal any amount of money alleged to be owed that the agent cannot account for. The consequences of failure to account were described by the court as follows (183 CA2d at 250):

> An agent who fails to keep an account raises thereby a suspicion of infidelity or neglect, creates a presumption against himself, and brings upon himself the burden of accounting to the utmost for all that has come into his hands; and in such case every doubt will be resolved against the agent, and in favor of the principal; and if he renders an untrue account, giving a false balance, he becomes at once liable to his principal.

See also discussion at §§3.52-3.55.

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§5.17 F. Broker's Realization of Undisclosed or "Secret" Profits

A principal is entitled to recover undisclosed profits the agent realizes from an agency transaction despite the fairness of the price the principal paid. *Wade v Diamond A Cattle Co*. (1975) 44 CA3d 453, 458, 118 CR 695; *Store of Happiness v Carmona & Allen, Inc.* (1957) 152 CA2d 266, 272, 312 P2d 1104. See discussion of secret profits in §§3.35-3.37, 3.72-3.74.

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IV. PRINCIPAL'S LIABILITY TO THIRD PARTIES FOR BROKER'S ACTIONS

§5.18 A. Principal's General Liability to Third Parties

Rights and liabilities that would have accrued to an agent from a transaction within the scope of agency authority, had the transaction been entered into by the agent on his or her own account, accrue to the principal. CC §2330. Generally, a principal is liable for any wrongful act of an agent specifically authorized by principal. *Maberto v Wolfe* (1930) 106 CA 202, 206, 289 P 218.

Third parties may hold an undisclosed principal liable for a contract entered into in the agent's name alone. *Gardiner v Gaither* (1958) 162 CA2d 607, 618, 329 P2d 22.

A principal is liable to third parties for the wrongful acts of an agent transacting the business of the agency. CC §§2338-2339. Further, the principal may be liable for exemplary damages based on acts of the agent. *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 822, 169 CR 691.

PRACTICE TIP: Attorneys representing brokers and salespersons should be aware of a potential conflict of interest in representing both the principal and agent when the principal is exposed to potential punitive damages as a result of acts by the agent. It is best practice that defense counsel always obtain conflict of interest waivers at the inception of such cases, and particularly when there is potential exposure to the principal for exemplary damages or other liability based on acts of the agent which are not covered by insurance. Counsel for plaintiffs suing brokers and salespersons for punitive damages should be aware that they may very well "plead themselves out of coverage" by alleging punitive damages as well as other potentially uncovered causes of action.

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§5.19 B. Respondeat Superior

If an agent is also the principal's employee, the employer-principal is liable under the doctrine of respondeat superior for all of the employee-agent's torts that are committed in the scope of employment. See *Perez v Van Groningen & Sons, Inc.* (1986) 41 C3d 962, 967, 227 CR 106. See also *Baker v Hazelwood (In re Exxon Valdez)* (9th Cir 2001) 270 F3d 1215, 1233 (corporation could be held vicariously liable for punitive damages based on captain's actions resulting in oil spill). Note that the United States Supreme Court, in *Exxon Shipping Co. v Baker* (2008) __ US __, 171 L Ed 2d 570, 128 S Ct 2605, vacated and remanded on the amount of punitive damages and limited punitive damages to the amount of compensatory damages. However, the Court was equally divided on the owner's derivative liability for punitive damages under maritime law, leaving the 9th Circuit opinion undisturbed in that respect. Thus a broker is responsible under the respondeat superior theory for the acts of its employee-salespersons. *Grubb & Ellis Co. v Spengler* (1983) 143 CA3d 890, 895, 192 CR 637. See also *California Real Estate Loans, Inc. v Wallace* (1993) 18 CA4th 1575, 1581, 23 CR2d 462 (broker liable as matter of law for all damages caused to third persons by tortious acts of salesperson committed within course and scope of employment); *Alhino v Starr* (1980) 112 CA3d 158, 173, 169 CR 136 (when broker either approved or ratified salesperson's fraudulent conduct, ratification supported award of punitive damages). Under respondeat superior, if the employee was acting within the scope of employment, it is unnecessary to determine whether the employee was acting with actual or ostensible authority in doing the particular tortious act. *Johnson v Monson* (1920) 183 C 149, 150, 190 P 635. See *Rodgers v Kemper Constr. Co.* (1975) 50 CA3d 608, 617, 124 CR 143 (employer liable for battery committed by employees within scope of employment; policy behind respondeat superior does not require that act be expressly authorized by employer).

However, in *Saks v Charity Mission Baptist Church* (2001) 90 CA4th 1116, 1137, 110 CR2d 45, a church was not liable under respondeat superior for the actions of its pastor in a fraud claim by a real estate investor. The pastor had signed promissory notes in a scheme, in which the plaintiff had acquiesced, to wrongfully use the church's name to obtain financial benefit for the individuals involved. The doctrines of respondeat superior, ostensible authority, and equitable estoppel did not provide grounds for imposition of liability.

For more on respondeat superior, see §§3.58, 11.15-11.17. On the relationship between brokers and salespersons, see §§8.32-8.42.

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§5.20 C. Imputed Knowledge

The knowledge of an agent is imputed to the principal. This is not a presumption but a rule of law. CC §2332. A showing that the principal did not learn of facts imparted to the agent is normally irrelevant. *Columbia Pictures Corp. v DeToth* (1948) 87 CA2d 620, 630, 197 P2d 580.

Civil Code §2332 provides that, "[a]s against a principal, both principal and agent are deemed to have notice of whatever either has notice of, and ought, in good faith and the exercise of ordinary care and diligence, to communicate to the other." This rule recognizes an agent's duty to communicate with his or her principal, but does not depend on the agent's exercise of that duty. The rule charges the principal with the knowledge of the agent. In dealings with third parties, the agent acts in place of the principal. *Columbia Pictures Corp. v DeToth* (1948) 87 CA2d 620, 630, 197 P2d 580. But see *Freeman v Superior Court of San Diego County* (1955) 44 C2d 533, 537, 282 P2d 857 (for purposes of criminal contempt action, principal's knowledge is disputably presumed); *Snook v Netherby* (1954) 124 CA2d 797, 801, 269 P2d 195 (imputed knowledge insufficient when subjective knowledge is required for bad faith damages under CC §3306).

PRACTICE TIP: A complaint seeking to impute liability to the principal for compensatory damages for torts committed by an agent of the defendant principal is based on CC §§2332, 2338-2339.

The doctrine of respondeat superior is based on the rationale that an enterprise should be responsible for risks that are inherent in, or created by, the enterprise. One way to determine whether a risk fits this description is to determine whether the occurrence was a generally foreseeable consequence of the activity. If a risk is fairly regarded as typical of or broadly incident to the principal's enterprise, it is reasonably foreseeable for purposes of imputing liability without fault for the torts of an agent. *Clark Equipment Co. v Wheat* (1979) 92 CA3d 503, 522, 154 CR 874. The agent's knowledge of the falsity of representations is imputed to the principal if the agent's representations were made within the scope of authority. 92 CA3d at 521.

Knowledge acquired by an agent is not imputed to the principal immediately on receipt by the agent. Rather, a lapse of time reasonable for the communication of the knowledge is allowed before the principal is charged. *Kelley v British Commercial Ins. Co.* (1963) 221 CA2d 554, 561, 34 CR 564. Thus, a principal is not affected by an agent's knowledge until it is communicated to him or her or until the agent has committed a fault either in transacting something for the principal or in failing to communicate the knowledge to others who are to act on it. *Civil Serv. Employees Ins. Co. v Blake* (1966) 245 CA2d 196, 199, 53 CR 701; *Kelley v British Commercial Ins. Co.* (1963) 221 CA2d 554, 561, 34 CR 564.

NOTE: Given the speed of communications through cell phones and email, the amount of time between when the information is learned by the agent and when the information is communicated to the principal has been greatly shortened. Undoubtedly future case law will determine what is a reasonable amount of time given current communications technology.

Under certain circumstances, knowledge of the agent is not imputed to the principal. Knowledge is not imputed if the source of the information knows that the agent will not communicate the knowledge to the principal. *Wagner v Benson* (1980) 101 CA3d 27, 35, 161 CR 516. The agent's knowledge of facts outside the scope of authority is not imputed to the principal. Further, knowledge of the agent is imputed to the principal only if matters within scope of agency are learned while acting in the course of the agency. *Redman v Walters* (1979) 88 CA3d 448, 454, 152 CR 42.

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§5.21 D. Agent's Ostensible Authority to Bind Principal

Ostensible agency exists when a principal intentionally or through lack of ordinary care causes a third party to believe that someone who is not employed by the principal is the principal's agent. CC §2300. The principal is liable for the agent's acts under ostensible authority when a third party has in good faith "incurred a liability or parted with value" in reliance on the ostensible agency. CC §2334.

Ostensible agency requires a showing sufficient to establish estoppel. *Associated Creditors' Agency v Davis* (1975) 13 C3d 374, 403, 118 CR 772. Liability of a principal for an ostensible agent's acts rests on the doctrine of estoppel, which includes the essential elements of (*Kelley v R.F. Jones Co.* (1969) 272 CA2d 113, 121, 77 CR 170):

- Representations by the principal;
- Justifiable reliance thereon by the third party; and
- Damages or injury resulting from such reliance.

Ostensible agency arises from the reasonable belief of a third party in an agent's authority, engendered by the conduct of the principal. CC §§2300, 2317; *Tomerlin v Canadian Indem. Co.* (1964) 61 C2d 638, 643, 39 CR 731; *Mannion v Campbell Soup Co.* (1966) 243 CA2d 317, 320, 52 CR 246. The appointment of an agent to a particular position is sufficient conduct by a principal to create ostensible agency in the appointee. The acts or declarations of the principal relied on for the creation of ostensible agency need not have been made to the third party directly. *Meyer v Ford Motor Co.* (1969) 275 CA2d 90, 102, 79 CR 816.

Lack of negligence by a third party in relying on ostensible authority is a prerequisite to recovery from the principal for the act of an ostensible agent. *People v Surety Ins. Co.* (1982) 136 CA3d 556, 562, 186 CR 385.

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§5.22 E. Ratification

A principal who accepts or retains the benefit of an unauthorized act of an agent may ratify the act of the agent. CC §2310. For example, a principal's retention of funds acquired by an agent in an unauthorized transaction is ratification of the transaction. *Reusche v California Pac. Title Ins. Co.* (1965) 231 CA2d 731, 737, 42 CR 262. "Ratification can be made only in the manner that would have been necessary to confer an original authority for the act ratified, or where an oral authorization would suffice, by accepting or retaining the benefit of the act, with notice thereof." CC §2310. A ratification is not valid unless, at the time of ratifying the act, the principal has the power to confer authority for such an act. CC §2312.

The unauthorized act of an agent is ratifiable either expressly or by implication from the principal's conduct. *Union Trust & Realty Co. v Best* (1911) 160 C 263, 267, 116 P 737. A purported agent's act may be adopted by implication based on conduct of principal from which an intention to consent to or adopt the agent's act is inferable, including conduct inconsistent with any other reasonable intention. *Rakestraw v Rodrigues* (1972) 8 C3d 67, 73, 104 CR 57.

Generally, a principal must be aware of all the facts of the transaction before he or she will be held to have ratified the unauthorized acts of an agent. *Reusche v California Pac. Title Ins. Co.* (1965) 231 CA2d 731, 737, 42 CR 262. Ratification made without knowledge of the material facts involved in the agent's acts, including the legal effect of the acts, is void. *Bate v Marsteller* (1959) 175 CA2d 573, 582, 346 P2d 903; *Estate of Fletcher* (1940) 36 CA2d 567, 573, 97 P2d 1039. However, ratification is possible despite ignorance of the facts when the ignorance arises from the principal's failure to investigate when a reasonable person would do so. *Reusche v California Pac. Title Ins. Co.* (1965) 231 CA2d 731, 737, 42 CR 262.

A principal cannot ratify the beneficial parts of an unauthorized transaction while disavowing the burdens of the same transaction. Ratification of part of the transaction is ratification of the entire transaction. CC §2311; *Navrides v Zurich Ins. Co.* (1971) 5 C3d 698, 704, 97 CR 309; *Price v McConnell* (1960) 184 CA2d 660, 666, 7 CR 695.

A power of attorney that included a power to ratify, executed after the agent executed a document on behalf of the principal, was substantial evidence of ratification. *White v Moriarty* (1993) 15 CA4th 1290, 1295, 19 CR2d 200. Punitive damages for the fraudulent acts of an agent are properly awarded against the principal who ratified the agent's acts. *Walker v Signal Cos., Inc.* (1978) 84 CA3d 982, 999, 149 CR 119. See also CC §3294.

Acts taken to minimize loss when rescission of the unauthorized act is impossible are not ratification. *Pacific Vinegar & Pickle Works v Smith* (1907) 152 C 507, 511, 93 P 85.

A ratification can be rescinded, but only when the ratification was "made without such consent as is required in a contract, or with an imperfect knowledge of the material facts of the transaction ratified." CC §2314.

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V. PRINCIPAL'S DEFENSES TO CLAIMS BY THIRD PARTIES

§5.23 A. Breach of Contract

In the context of a claim by a third party buyer against a principal seller, the first defense raised is usually that the buyer breached the contract. There are many ways a buyer might breach a purchase and sale agreement. For further discussion of breach of real property purchase and sale agreements, see chap 2, §§4.2-4.10; California Real Property Remedies and Damages §4.30 (2d ed Cal CEB 2002).

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§5.24 B. Statute of Limitations

A real property buyer's action for damages is generally governed by CCP §337(1), which provides for a 4-year limitation period for an action on a written contract for either damages or specific performance. *McAuliffe v Foglesong* (1961) 193 CA2d 525, 14 CR 397; *Reiner v Hermann* (1947) 79 CA2d 543, 180 P2d 385.

When an oral contract is enforceable because it has been partly performed, the statute of limitations is 2 years. CCP §339(1). The statute of limitations for fraud is 3 years after the date of discovery. CCP §338(d). The statute of limitations for rescission is 2 years after the date of discovery. CCP §339. See §§11.32, 11.63-11.65.

PRACTICE TIP: These different statutes of limitations should be carefully considered so that an otherwise available remedy is not lost. For example, these limits could affect a cause of action for rescission that is based on fraud or based on breach of contract. Thus, the wisest choice is to file within the earliest time period.

If the buyer has fully performed, the statute of limitations does not begin to run until the seller has made an unequivocal repudiation. If the buyer is in possession, the seller's repudiation does not start the statute running unless the seller also takes actual possession of the property. *Kidd v Kidd* (1964) 61 C2d 479, 481, 39 CR 203.

In addition, there is a 2-year statute of limitations on actions brought under CC §2079 regarding visual inspection of the property by brokers. On brokers' §2079 duty to investigate, see chap 3.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/5 Principal's Duties, Liabilities, and Defenses/ §5.25 C. Invalid Contract

§5.25 C. Invalid Contract

The mere existence of a purchase and sale agreement is no guaranty that a legally valid and binding contract has been formed. Consequently, the formation and provisions of the agreement must be analyzed with basic contract principles in mind. Potential defenses with respect to the valid formation of a purchase and sale contract include:

- Missing or uncertain material terms (see §5.26);
- Failure to comply with the statute of frauds (see §5.27);
- Failure of consideration/illusory contract (see §5.28);
- Lack of acceptance or failed agreements to agree (see §5.29);
- Broker's lack of authority to bind principal (see §5.30);
- Equitable defenses (see §§5.31-5.32);
- Third party's failure to inquire (see §5.33); and
- Lack of legal capacity to contract (see §§5.34-5.35).

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§5.26 D. Indefinite and Uncertain Agreement

An enforceable contract for the sale of real property requires basic material terms—parties, price, and description of the property—or there is no contract at all. *King v Stanley* (1948) 32 C2d 584, 589, 197 P2d 321. A contract will fail if one of the material terms is too uncertain or ambiguous, thereby making it difficult or impossible to ascertain the parties' intent. *California Lettuce Growers, Inc. v Union Sugar Co.* (1955) 45 C2d 474, 481, 289 P2d 785.

Uncertainty of a material term is an effective defense to an action for specific performance. *Gorges v Johnson* (1959) 167 CA2d 349, 334 P2d 621. If damages are sought, a lesser degree of certainty is required than would be necessary in an action to specifically enforce the agreement. *Yackey v Pacific Dev. Co.* (1979) 99 CA3d 776, 784, 160 CR 430. On specific performance, see California Real Property Remedies and Damages, chap 5 (2d ed Cal CEB 2002).

The length of the escrow period is not included among terms that must be certain. The escrow period has been determined to be an incidental and not material term to a real estate purchase agreement. Thus, if a purchase agreement fails to state the length of escrow, yet all other terms are ascertainable, specific performance of that contract may be ordered. See *Patel v Liebermensch* (2008) 45 C4th 344, 86 CR3d 366.

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§5.27 E. Statute of Frauds

The Statute of Frauds (CC §1624) provides that contracts for the sale of real property, or of an interest in real property, are invalid unless "they, or some note or memorandum thereof, are in writing and subscribed by the party to be charged or by the party's agent." CC §1624(a)(3). See also CCP §1971.

The Statute of Frauds is an affirmative defense but it may be waived if the defendant does not raise it. *Howard v Adams* (1940) 16 C2d 253, 257, 105 P2d 971. Partial performance by a party can be sufficient to remove this bar to enforcement under both case law and statute. See CCP §1972(a) (court not prohibited by CCP §1971 from compelling specific performance in case of partial performance of agreement); *Sutton v Warner* (1993) 12 CA4th 415, 421, 15 CR2d 632 (upholding of oral contract supported by evidence of mortgage payments and residential improvements). See also *Engasser v Jones* (1948) 88 CA2d 171, 175, 198 P2d 546 (possession by buyer with seller's consent).

For more on the Statute of Frauds, see §§2.6-2.19, 7.14-7.15.

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§5.28 F. Illusory Agreements

For a contract to be enforceable, both parties must be bound by the agreement. For example, if one party retains an unrestricted right to withdraw from the contract, the agreement will be held to be illusory and unenforceable by either party, because it lacks mutuality of obligation. *Kowal v Day* (1971) 20 CA3d 720, 724, 98 CR 118. In the past, if the buyer's performance under a purchase agreement was subject to conditions within his or her control, the buyer's promise was considered illusory, and the contract was unenforceable for lack of mutuality of obligation. See, *e.g., Lewis v McWhirter Petroleum Co.* (1948) 89 CA2d 453, 200 P2d 856 (gas station lease in which rent to be paid was based on gas sold, with no requirement to sell gas, was a promise unenforceable for want of consideration).

More recent cases have held that such conditions do not render the contract illusory, provided a certain standard is met. In *Mattei v Hopper* (1958) 51 C2d 119, 330 P2d 625, a sale was conditioned on the buyer's being able to obtain satisfactory leases. The court held that the real property sales agreement was enforceable because the buyer must make the effort to fulfill the conditions in good faith. Conditions involving personal satisfaction and judgment impose on the buyer a duty to act in *good faith*, while conditions involving commercial value or quality impose on the buyer a duty to accept or reject *reasonably*. 51 C2d at 122.

In *Moreland Dev. Co. v Gladstone Holmes, Inc.* (1982) 135 CA3d 973, 977, 186 CR 6, a provision in a contract for the sale of real property which conditioned the corporate buyer's obligations to purchase and close escrow on the approval of the transaction by the buyer's board of directors within a certain period of time, did not render the contract illusory. The condition of board approval did not give the corporation the absolute right to escape its obligations under the agreement since there was an implied obligation on the part of the buyer's officers to carry out the objectives of the contract in good faith by submitting the proposal to the board, and as part of that implied obligation, the board was required to actually confer and decide whether to approve the proposed purchase.

In another case, the court held that the buyer's approval under a condition concerning financing terms was subject to the reasonableness standard rather than the good faith standard, and a prepayment penalty and acceleration clause in the note did not afford an adequate reason to withdraw from the transaction. *Kadner v Shields* (1971) 20 CA3d 251, 97 CR 742.

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§5.29 G. No Acceptance

Frequently, real property purchase and sale agreements are formed after the exchange of an original offer and one or more counteroffers. Typically, a counteroffer will incorporate, reject, modify, or augment one or more provisions of the previous offer. To form a binding agreement, there must be an unqualified acceptance. Alternatively, an acceptance must "include in itself an acceptance of that character which the proposer can separate from the rest, and which will conclude the person accepting. A qualified acceptance is a new proposal." CC §1585.

The common practice of using multiple preprinted counteroffer forms and addendums in a single transaction may cause confusion about whether a contract was actually formed. See, *e.g.*, *Behniwal v Mix* (2005) 133 CA4th 1027, 1037, 35 CR3d 320 (concluding that signatures on addendum showed acceptance of particular provisions embodied in counteroffer that addendum specifically referenced).

Consent of the parties is necessary for the existence of a contract. The parties' consent must be free, mutual, and communicated by each to the other. If an acceptance is qualified, the result is a counteroffer that, if not accepted as a new offer, creates no binding agreement. *Roth v Malson* (1998) 67 CA4th 552, 557, 79 CR2d 226; *Krasley v Superior Court* (1980) 101 CA3d 425, 161 CR 629.

PRACTICE TIP: Most purchase and sale transactions use form contracts that give notice of whether the contract is being accepted "as is" or whether it is subject to a counteroffer. These forms also state a time limit after which the offer or counteroffer cannot be accepted. Although rare, a final counteroffer can be accepted orally. In that event, counsel should investigate whether the parties' conduct or the conduct of one of them provides the partial performance necessary to avoid the bar of the Statute of Frauds, as discussed in §5.27.

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§5.30 H. Broker's Lack of Authority to Bind Principal

A real estate broker's authority is limited to that actually or ostensibly conferred by the principal. CC §2315; §§3.9, 5.21. The listing agreement should specify the extent of the broker's authority, because an agent is authorized by statute to do everything "necessary or proper and usual" to carry out the purpose of the agency. CC §2319(1). Such broad implied authority invites disputes.

Generally, the broker's authority is limited to negotiating the terms of the transaction; the broker has no authority to bind the seller contractually, even if the buyer makes an unconditional offer that is based on all the terms and conditions of sale in the listing agreement. *Holland v McCarthy* (1916) 173 C 597, 600, 160 P 1069. For example, the broker may not sign a contract of sale on the principal's behalf without specific authority. *Lyne v Bonner* (1954) 129 CA2d 743, 746, 277 P2d 941.

The "equal dignities" rule of CC §2309 "provides that a principal's oral authorization to an agent 'is sufficient for any purpose, except that an authority to enter into a contract required by law to be in writing can only be given by an instrument in writing.'" *Estate of Stephens* (2002) 28 C4th 665, 672, 122 CR2d 358.

A husband's authority to act as agent for the wife in the sale of real estate need not be in writing but may be implied or inferred. *Miller v Busby* (1950) 101 CA2d 83, 92, 224 P2d 754.

PRACTICE TIP: Counsel should advise their broker clients that they should never sign offers or counteroffers on behalf of their principals, and that brokers should not become the attorney-in-fact on behalf of a principal pursuant to a power of attorney signed by the principal. By signing documents as attorney-in-fact on behalf of the principal, a broker risks being second-guessed by the principal as to the terms of the offer or counteroffer (*i.e.*, the principal may argue that while a power of attorney was provided to the broker, the broker did not have authority to accept or offer certain language which, after the fact, the principal rejects).

A purchase contract that is invalid because the broker lacked authority to sign on behalf of the seller may be ratified, if the ratification is in writing. See *Behniwal v Mix* (2005) 133 CA4th 1027, 35 CR3d 320 (sellers ratified broker's forgery on contract by signing disclosures). On ratification of broker authority, see §§3.10, 5.22.

A broker is rarely given express authority to accept the purchase price, as distinguished from the deposit, on the seller's behalf. *Sarten v Pomatto* (1961) 192 CA2d 288, 294, 13 CR 588 (seller authorized broker to accept deposit). If the seller has led the buyer to believe that the broker can receive the purchase price, however, then ostensible authority exists, and the buyer will be able to recover from the seller if the broker misappropriates the funds. *Hicks v Wilson* (1925) 197 C 269, 240 P 289.

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I. Equitable Defenses

§5.31 1. Unclean Hands

It is axiomatic that a party who seeks to invoke a court's equitable power must come to court with clean hands. See, *e.g., Gavina v Smith* (1944) 25 C2d 501, 506, 154 P2d 681. See also CC §3391(3), which provides that specific performance is not available against a party whose assent was obtained by misrepresentation, concealment, circumvention, or unfair practices of the party seeking performance. See, *e.g., Cornblith v Valentine* (1930) 211 C 243, 294 P 1065. See also *Milton Kauffman, Inc. v Smith* (1947) 82 CA2d 302, 186 P2d 11. The concept of unclean hands, however, is broader than the statutory language of CC §3391(3) and includes any unconscionable conduct that prejudices the other party. *Soon v Beckman* (1965) 234 CA2d 33, 44 CR 190.

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§5.32 2. Laches

The defense of laches is based on the principle that equity will not aid a plaintiff who unreasonably delays bringing suit, when the delay is so prejudicial to the adverse party that granting the plaintiff's requested relief would be inequitable. See *Martin v Kehl* (1983) 145 CA3d 228, 241, 193 CR 312. See also *Property Controllers, Inc. v Shewfelt* (1966) 245 CA2d 755, 762, 54 CR 218. A somewhat more pithy enunciation of the laches doctrine is in the maxims of jurisprudence: "The law helps the vigilant, before those who sleep on their rights." CC §3527.

The defense of laches applies only in an action in equity. See *Unilogic, Inc. v Burroughs Corp.* (1992) 10 CA4th 612, 619, 12 CR2d 741. What constitutes an unreasonable delay is governed by the facts of each case. The statute of limitations for a comparable legal action (see *Holmberg v Armbrecht* (1946) 327 US 392, 90 L Ed 743, 66 S Ct 582) may provide guidance for an outer limit, but the defense of laches could succeed within the statute of limitations period.

Unreasonable delay alone does not amount to laches; there must also be a showing that the defendant was prejudiced by the delay. *Kling v Hallmark Cards, Inc.* (9th Cir 2000) 225 F3d 1030, 1036.

On brokers' use of laches as an affirmative defense, see §11.66. See also California Civil Procedure Before Trial §25.47 (4th ed Cal CEB 2004).

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§5.33 J. Third Party's Duty of Inquiry

Third parties have a duty to inquire into the authority of the agent when no ostensible agency is established. *Ernst v Searle* (1933) 218 C 233, 240, 22 P2d 715. No additional duty on a third party to investigate is required once ostensible agency is established. *Beck v Arthur Murray, Inc.* (1966) 245 CA2d 976, 981, 54 CR 328; *Myers v Stephens* (1965) 233 CA2d 104, 115, 43 CR 420.

Failure to make inquiry into the extent of the authority when circumstances would lead a reasonable person to do so will permit an action against a principal by a third party only to the extent of the agent's actual authority. *United States Credit Bureau, Inc. v Cheney* (1965) 235 CA2d 357, 361, 45 CR 525.

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K. Legal Capacity to Contract

§5.34 1. Minors

A minor cannot give a delegation of power or make a contract relating to real property or any interest in real property or relating to any personal property not in his or her immediate possession or control. Fam C §6701. An unemancipated minor has no power to make a contract of hiring. *Aetna Life Ins. Co. v Industrial Acc. Comm'n* (1917) 175 C 91, 165 P 15. For discussion of mental incapacity, see §5.35. For further discussion of legal incapacity to contract, see §2.2; California Real Property Sales Transactions §§4.14-4.18 (4th ed Cal CEB 2007).

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§5.35 2. Mental Incapacity

A person "entirely without understanding" does not have the power to make a contract of any kind. CC §38. Such a person, however, is liable for the reasonable value of things furnished to him or her that are necessary for the person's support or for the support of his or her family. CC §38. Insane persons are incapable of entering into contracts. *Harrigan v Harrigan* (1902) 135 C 397, 398, 67 P 506. For discussion of minors' incapacity to contract, see §5.34. For further discussion of legal incapacity to contract, see §2.2; California Real Property Sales Transactions §§4.14-4.18 (4th ed Cal CEB 2007).

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6

Alternative Dispute Resolution

Michele K. Trausch

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I. INTRODUCTION

§6.1 A. Why ADR?

Historically, alternative dispute resolution (ADR) provisions, usually arbitration clauses, were included in real property contracts to address issues of appraisal or fair market value. As court congestion and the cost of litigation have increased, more parties have come to use methods of ADR as a means of resolving disputes outside the confines of the court system. The most common ADR methods are:

- Mediation (see §§6.13-6.27);
- Arbitration by private agreement or under statute (CCP §§1141.10-1141.31, 1280-1294.2) (see §§6.28-6.39); and
- Reference (CCP §§638-645.1) (see §§6.40-6.47).

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§6.2 1. ADR of Real Estate Disputes

Real estate brokers and their clients are most often involved in ADR to address the following issues:

- **Purchase and sale of residences.** The California Association of Realtors® includes both arbitration and mandatory mediation provisions in residential purchase contracts and joint escrow instructions documents. See, *e.g.*, California Real Property Sales Transactions §6.24 (4th ed Cal CEB 2007). Other residential real estate companies or local real estate boards may develop their own ADR forms. See §§1.8, 1.12-1.13.
- **Purchase and sale or lease of commercial property.** ADR is useful in the commercial real estate industry when the parties have a continuing relationship that can be better maintained and preserved in arbitration or mediation rather than in litigation. Some parties have been more reluctant to accept ADR in commercial real estate transactions than in residential transactions. This may be a result of a higher level of sophistication in these parties, involvement of counsel, or prior negative experiences with the ADR process in general and the binding nature of arbitration awards in particular. On the other hand, some large commercial brokerage firms and industry organizations have included ADR clauses in their standard form purchase and sale agreements. Commercial leases may contain ADR provisions, but in the event of a tenant default, arbitration and even mediation of landlord-tenant disputes is disfavored because of the summary process afforded by unlawful detainer proceedings and the need for a speedy process and a final judgment for possession in the event of a default.
- **Listing agreements.** The listing agreement establishes the contractual obligations of the listing broker to the seller of real property, which may differ from the statutory or common law obligations of a fiduciary relationship or those arising from negligence. Some form listing agreements provide for mediation and arbitration of all disputes that arise between a seller and the listing broker, while others provide for mandatory arbitration between the seller and the listing broker. Often, listing agreements provide that only disputes over the commission are required to be arbitrated. Hence, it is important to review each listing agreement for the actual language. In many instances, this review will serve more than one purpose. On ADR and the landlord-tenant relationship, see Retail Leasing: Drafting and Negotiating the Lease, chap 36 (Cal CEB 2007).

PRACTICE TIP: Brokers' counsel should advise their clients that they risk involving disputes in more than one forum if the dispute resolution provisions in the listing agreement do not match the dispute resolution provisions in the purchase agreement. See §6.7.

- **Commission disputes.** In addition to the provisions of the listing agreement, most local boards of realtors have rules and procedures that require voluntary mediation and mandatory arbitration for commission disputes between brokers. These ADR procedures are discussed in chap 7.

Other types of real property contracts may also include ADR provisions, although they generally will not involve real estate brokers. These include home building and improvement contracts, property and title insurance, construction contracts, property management agreements, and mortgage financing contracts.

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§6.3 2. Advantages of ADR

ADR offers many advantages. It is often (though not always) quicker and less costly than litigation. ADR participants may choose a neutral party of appropriate experience and skill to mediate their dispute or render a binding decision, which can reduce the many uncertainties associated with litigation.

ADR gives the parties and the neutral the flexibility of scheduling their matter to a date both convenient and certain, thus avoiding the expense and frustration of preparing for trial only to find there are no available courtrooms or of being reassigned a trial date months in the future. Further, if the parties have an ongoing relationship—whether legal, business, personal, or a combination of these—solving disputes in a less formal setting may preserve, rather than destroy, that relationship. Such relationships may be highly important to a real estate broker or property owner who is regularly involved in real estate transactions. Dispute resolution through ADR may be most advantageous to their ongoing business interests and reputation.

ADR can also control or limit the amount and forms of available discovery, and faster resolution of disputes brings certainty more quickly in business and financial affairs, as well as limits downtime, lost opportunity costs, and personal aggravation from prolonged litigation proceedings.

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§6.4 B. An Overview

The parties can decide to include ADR provisions in their pre-dispute contracts or may stipulate to ADR after a dispute has arisen, either before or after litigation has actually commenced. This chapter covers both scenarios.

Counsel advising clients to include an ADR provision in a pre-dispute contract or by post-dispute stipulation should carefully explain the differences among the various procedures. Counsel and client must assess the parties' needs, resources, and relationships to ascertain the best method and whether they should create customized rules that provide for more efficient dispute resolution than is offered by the statutes.

PRACTICE TIP: Practitioners all too often fail to cover all possibilities when drafting ADR provisions in agreements. Even parties to a stipulation for ADR can create unintended issues through imprecise drafting. See *Sy First Family Ltd. Partnership v Cheung* (1999) 70 CA4th 1334, 83 CR2d 340 (stipulation for ADR was unclear on whether parties intended arbitration or reference; court held "hybrid" stipulation impermissible). The result of an ambiguous ADR provision can be expensive satellite litigation. If the client elects ADR, counsel should thoroughly understand the ramifications of this choice and be precise in drafting.

WARNING: Counsel often provide for initialing of an ADR provision in an agreement or a checkbox system for electing an ADR procedure. Counsel should take care that the provision is properly completed because any failure to do so may cause the provision to be unenforceable. See *Bushley v Credit Suisse First Boston* (9th Cir 2004) 360 F3d 1149. The situation becomes more complicated if one party takes steps to "elect" ADT and the other party (intentionally or otherwise) does not. Arguably, this would indicate that there is a lack of a "meeting of the minds," which may cause the entire contract to be considered invalid.

This chapter is intended as an overview of ADR procedures and strategy applicable to real estate clients. Alternative dispute resolution between brokers is discussed in chap 7. Methods of ADR are also discussed in California Real Property Remedies and Damages, chap 14 (2d ed Cal CEB 2002). Additional guidance may be found in California Construction Contracts, Defects, and Litigation, chap 7 (Cal CEB 2008); Retail Leasing: Drafting and Negotiating the Lease, chap 36 (Cal CEB 2007); and Office Leasing: Drafting and Negotiating the Lease, chap 33 (Cal CEB 1996).

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II. STRATEGIC ISSUES

§6.5 A. Specifying the Parties Bound by Contractual ADR Provisions

The vast majority of matters submitted to ADR move smoothly through the process and result in resolution of disputes without resorting to the judicial system. However, the practitioner should consider the pros and cons of the ADR process or processes selected and, if drafting those provisions himself or herself, exactly what he or she is trying to accomplish for the client. The belated realization that some of the persons or entities involved in a dispute are not bound by the contract's ADR provision is a frequent cause of wasteful satellite litigation and the frustration of the parties' expectations. Who is to be bound should, therefore, be clearly addressed in the provision. Individuals and entities related to a party to the agreement or stipulation (for example, brokers, salespersons, representatives, and property managers) may not be required to participate in the dispute resolution process if they are not actual signatories to the agreement or stipulation. If the contract or stipulation does not specify and require the signature or acknowledgment of all those intended to be bound by the ADR provision, the parties may be forced to litigate that issue in court before proceeding. See CCP §1281.2(c); *Retail Clerks Union v L. Bloom Sons Co.* (1959) 173 CA2d 701, 703, 344 P2d 51 (court must resolve whether alleged alter ego bound by arbitration provision).

PRACTICE TIP: If the parties stipulate to arbitration after a dispute arises, it is crucial to get all parties to sign the stipulation. In *Toal v Tardif* (2009) 178 CA4th 1208, 101 CR3d 97, *e.g.*, the court held that a stipulation to arbitrate signed only by the attorneys for the parties was not sufficient to obligate the parties to arbitrate without substantial evidence beyond the agreement itself showing that the objecting party had expressly authorized the attorney to sign on his or her behalf.

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§6.6 B. Related Third Parties

Generally, a party that is not a signatory of the agreement or stipulation is not bound by the agreement's dispute resolution procedure without a court's decision on the party's status. See *American Builder's Ass'n v Au-Yang* (1990) 226 CA3d 170, 178, 276 CR 262. Even if the nonsignatory has a preexisting relationship with a signatory, application to a court may be required. See, *e.g.*, *Dryer v Los Angeles Rams* (1985) 40 C3d 406, 220 CR 807 (agent of signatory entitled to benefit of arbitration provisions); *Rowe v Exline* (2007) 153 CA4th 1276, 63 CR3d 787 (nonsignatory sued as alter ego may compel arbitration); *Michaelis v Schori* (1993) 20 CA4th 133, 24 CR2d 380 (employees of arbitrating party may enforce arbitration provision); *Keller Constr. Co. v Kashani* (1990) 220 CA3d 222, 225, 269 CR 259 (general partner bound by arbitration provision signed on behalf of limited partnership); *Harris v Superior Court* (1986) 188 CA3d 475, 233 CR 186 (employee acting on employer's behalf bound by employer's obligations under arbitration agreement). An arbitration award against a principal does not bind a guarantor. CC §2855.

In *Westra v Marcus & Millichap Real Estate Inv. Brokerage Co.* (2005) 129 CA4th 759, 28 CR3d 752, the buyer of real property sued the seller and the broker, who had acted as a dual agent. The purchase agreement provided that the buyer, seller, and broker would agree to binding arbitration in the event of a dispute. The arbitration provision was initialed by the buyer and the seller, but not the broker. The broker moved to compel arbitration and the seller resisted, but the court held that because the buyer and seller had agreed to arbitrate their disputes, the broker was entitled to enforce the arbitration provision as an agent for a signatory party, despite its failure to initial the provision.

A nonparty is bound by a dispute resolution provision if the provision (or the contract containing the provision) is incorporated by reference into another agreement which the nonparty has signed. See *Slaught v Bencomo Roofing Co.* (1994) 25 CA4th 744, 30 CR2d 618. The court may amend a judgment confirming an arbitration award to include an alter ego of the judgment debtor. See *Hall, Goodhue, Haisley & Barker, Inc. v Marconi Conf. Ctr. Bd.* (1996) 41 CA4th 1551, 49 CR2d 286.

A judicial forum-selection clause may be enforced against a nonsignatory who is "closely related to the contractual relationship." See *JAAG Linhas Aereas de Angola v Transamerica Airlines, Inc.* (9th Cir 1990) 915 F2d 1351, 1354; *Net2phone, Inc. v Superior Court* (2003) 109 CA4th 583, 587, 135 CR2d 149. In contrast, enforcement of an ADR clause against a nonsignatory requires more than a connection to the contract or stipulation. See, *e.g., Buckner v Tamarin* (2002) 98 CA4th 140, 143, 119 CR2d 489 (patient's arbitration agreement with medical providers not binding on survivors); *Benasra v Marciano* (2001) 92 CA4th 987, 990, 112 CR2d 358 (corporate officer's execution of arbitration agreement does not apply to officer's personal claims); *Kaneko Ford Design v Citipark, Inc.* (1988) 202 CA3d 1220, 1229, 249 CR 544 (arbitration clause in contract between designer and lessee not binding on property owner).

PRACTICE TIP: Counsel should specify and obtain the agreement of any parties potentially related to a signatory that are to be bound by the provision. See §6.8 for language specifying the parties to be bound.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.7 C. Unrelated Third Parties

§6.7 C. Unrelated Third Parties

It is not always possible to bind all necessary third parties to a dispute to the resolution mechanisms of the agreement; some parties may be neither signatories nor related to the signatories to the agreement. If it is likely that a party to a dispute would not be bound by the contractual ADR procedure, then counsel and the parties to the contract or stipulation must weigh the desirability of arbitration or mediation against the possibility of multiple proceedings.

EXAMPLE 1: A buyer and seller enter into a contract for the purchase and sale of real property. The contract contains an arbitration clause. A dispute arises over disclosures made by the seller and implicates the listing broker, who is not a party to the purchase agreement. Although the dispute between the buyer and seller is arbitrable, the broker cannot be forced to join the arbitration. As a result, the dispute must be both arbitrated and litigated if all parties are to be pursued.

EXAMPLE 2: The same scenario as above, but the listing agreement between the seller and its broker contains an arbitration clause. Nonetheless, there is no authority to compel the broker to participate in the arbitration proceeding between the buyer and seller.

NOTE: The California Association of Realtors® Residential Purchase Agreement, the standard form used in virtually all California residential property sales transaction, specifically excludes brokers from ADR provisions unless the broker gives its consent and elects to participate.

PRACTICE TIP: Frequently parties and their trial attorneys react to disputes by automatically adding the broker as a plaintiff or by filing a cross-complaint to bring the broker into the litigation. Counsel should consider the tactical advantages and disadvantages first. If there is no solid claim against the client's broker, a seller could be faced with paying the broker's attorney fees if there is a fee provision in the listing agreement. Proceeding first with ADR may lead one side or the other to establish actual damages which may result in a stronger subsequent case against the broker.

The failure to bind third parties to the ADR provisions often results in (1) satellite litigation attempting to stay either the ADR process or the litigation or (2) proceeding on both tracks. See CCP §§1281.2, 1281.4; *Henry v Alcove Inv.* (1991) 233 CA3d 94, 284 CR 255 (arbitration stayed due to conflict with litigation). In either case the result is delay, extra expense, risk of inconsistent results, and unexpected consequences. See, *e.g.*, *Thibodeau v Crum* (1992) 4 CA4th 749, 6 CR2d 27 (res judicata doctrine bars subsequent litigation of claim between defendant and third party that could have been asserted in prior arbitration). Careful negotiation and drafting of the agreement or stipulation for ADR can avoid these pitfalls.

PRACTICE TIP: Failure to bind third parties to the ADR provisions need not always be fatal, particularly with respect to arbitration. Code of Civil Procedure §1281.2 gives courts discretion when a necessary party cannot be compelled to participate in arbitration either to stay the court action against a non-signatory to the arbitration agreement or to stay the arbitration to avoid the two matters proceeding simultaneously with potentially inconsistent findings or awards. A court also has discretion under §1281.2 to disregard the arbitration agreement entirely and order the joinder of all parties in a single court action for fairness and judicial economy.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.8 D. Binding Unrelated Parties to ADR Provisions or Stipulation

§6.8 D. Binding Unrelated Parties to ADR Provisions or Stipulation

If it is likely that parties foreign to the pre-dispute agreement will be involved in future disputes, the signatories can ask the potential third parties to directly agree to the ADR provisions by signing the agreement at the outset of the transaction. In a sale or purchase of real property this may be accomplished by requiring the brokers for the buyer and seller to initial the ADR provisions of the purchase and sale agreement. Alternatively, the buyer and seller may wish to incorporate the ADR provisions of the purchase and sale agreement by reference in their individual agreement with their respective brokers.

Counsel drafting a post-dispute ADR stipulation should consider all of the parties required for full resolution of the issues of the dispute and make every attempt to include those parties in the stipulation, providing a signature line for each party intended to be bound by the ADR procedure. If a related party is bound *only* to the ADR procedure, the signature line for that party could state

Only as to paragraph _ _[*number*]_ _ concerning dispute resolution.

In California, counsel rarely get involved in drafting residential purchase and sale agreements, and the clauses in the standard residential forms used statewide vary considerably. At least in residential property disputes, it may not be advisable for brokers to agree to binding arbitration. In some instances, arbitration between the principals alone is sufficient to resolve the case without involvement of the brokers. Under the California Association of Realtors® (CAR) Residential Purchase Agreement the brokers, at the request of the principals, may elect to participate in ADR if they wish to do so.

A binding provision (in a commercial purchase and sale agreement, for instance) might appear as one of the follow clauses:

***Parties Bound*. In addition to the Principals to this Agreement _ _[*or Stipulation*]_ _, _ _[*identify party, e.g., the brokers for the parties*]_ _ has/have signed below to signify agreement to be bound by these dispute resolution procedures as to any claim by or against any of the Principals arising out of this Agreement or the Transaction to which it relates.**

***Best Efforts to Bind Third Parties*. Each Principal will make its best effort to provide that _ _[*identify party, e.g., the brokers for the parties*]_ _ will participate in the dispute resolution procedure set forth in this Agreement. Each Principal will furnish proof to all other Principals of _ _[*e.g., their brokers*]_ _ at the time of engagement of _ _[*e.g., broker*]_ _. Any Principal failing to bind its respective _ _[*broker*]_ _ to the dispute resolution procedure established by this Agreement will indemnify, defend, and hold harmless the other party against all liability, claims, costs, loss, damage, settlement, and expense (including reasonable attorney fees, accounting fees, expert witness fees, costs, and expenses) _ _[*reasonably*]_ _ incurred because of such failure.**

If the unrelated parties are signatories to a different contract containing an ADR provision (a listing agreement and a purchase and sale agreement, for instance), counsel should consider adding a provision like the following covering consolidation of the arbitrations. See CCP §1281.3.

***Consolidation of Related Arbitrations*. The Parties agree to be bound by the dispute resolution process contained in this _ _[*e.g., Listing/Buyer's Representative*]_ _Agreement as well as that in any _ _[*e.g., Purchase and Sale Agreement*]_ _ ensuing from this Agreement. The Parties further agree not to oppose consolidation of any arbitration under this Agreement with any arbitration proceeding under any ensuing purchase and sale agreement if common issues of fact predominate in the two arbitrations. The Parties will take all action necessary or desirable to achieve consolidation.**

This clause is useful in joining parties subject to separate ADR provisions, such as a seller who is obligated to participate in ADR with a buyer under a purchase agreement but who is also obligated to participate in ADR with its broker under a listing agreement.

If it is not possible to ensure that outside parties will be bound to the dispute resolution mechanism anticipated,

counsel should consider whether an ADR provision will complicate rather than ease dispute resolution. It may be preferable to have all parties before a court rather than to face dual proceedings.

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§6.9 E. Specifying the Issues Covered by ADR

The contract or stipulation must clearly specify the types of disputes or issues to be covered by the ADR provisions. Because ADR is a matter of contract, the parties may agree to submit only certain disputes to ADR, reserving the right to litigate other disputes. See *O'Malley v Wilshire Oil Co.* (1963) 59 C2d 482, 30 CR 452; *Coon v Nicola* (1993) 17 CA4th 1225, 21 CR2d 846. However, if a court finds that the parties failed to create an enforceable contract, the ADR provisions will be equally unenforceable. See *Lopez v Charles Schwab & Co., Inc.* (2004) 118 CA4th 1224, 13 CR3d 544. Moreover, an arbitrator may interpret the contract to determine whether it includes a particular issue or not. See *Gueyffier v Ann Summers, Ltd*. (2008) 43 C4th 1179, 77 CR3d 613 (arbitrator empowered to conclude that notice and cure provision did not apply to facts he found to exist); *Reigelsperger v Siller* (2007) 40 C4th 574, 53 CR3d 887 (finding that treatment "now or in the future" covered by arbitration provision); *Cobler v Stanley Barber* (1990) 217 CA3d 518, 265 CR 868 (arbitration agreement covering "a dispute arising from this agreement" held not to cover tort claims).

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§6.10 1. Judicial Review

The California Supreme Court, in *Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229, clarified the possible scope of review of an arbitrator's decision by the court. Prior to this decision, it had generally been thought that judicial review of an arbitration award was extremely narrow and confined to such grounds as corruption or fraud on the part of the arbitrator but not an actual review of the merits of the decision. However, the parties in *Cable Connection* crafted an arbitration provision that effectively deprived the arbitrators from committing "legal error." The court held that because of the wording of the agreement, if the arbitrators committed "legal errors," they would actually be exceeding their powers, and therefore judicial review of the merits of the award was appropriate under CCP §§1286.2(a)(4) and 1286.6(b). If the parties wish to have the option of judicial review of the merits of an arbitrator's award, they must carefully draft the language of the provision to bring it within the somewhat narrow scope of that decision. It is recommended that the following language be used:

The arbitrators do not have the power to commit errors of law or legal reasoning, and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error.

PRACTICE TIP: If the intent of the parties is to preserve the right to appeal the merits of the award, some of the informalities of a more standard arbitration hearing may be inappropriate. For example, counsel should then have a court reporter present to record the testimony and rulings.

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§6.11 2. Attorney Fees

In *Moshonov v Walsh* (2000) 22 C4th 771, 94 CR2d 597, the parties agreed post-dispute "to send this matter to binding arbitration." After the arbitrator ruled for the defendants, the arbitrator denied all requests for attorney fees on the ground that the attorney fees provision in the contract did not apply to the claims disputed. The California Supreme Court held that the recovery of attorney fees was a contested issue submitted to the arbitrator for decision. That decision was final and could not be reviewed for error. This case suggests that in some situations, the parties may be better off specifying that attorney fee disputes be litigated rather than arbitrated.

WARNING: Just as in litigation, if the complaining party does not present claims that fall within the scope of the arbitration clause to the arbitrator, that party will likely be barred from raising them afterwards. *Thibodeau v Crum* (1992) 4 CA4th 749, 6 CR2d 27.

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§6.12 3. Attorney Fees for Tort Claims

An agreement calling for arbitration of all claims "arising from or relating to the contract," leads to arbitration of both tort and contract claims. See *Berman v Dean Witter & Co.* (1975) 44 CA3d 999, 1003, 119 CR 130; *Tate v Saratoga Sav. & Loan Ass'n* (1989) 216 CA3d 843, 854, 265 CR 440. If it is the parties' intent to arbitrate contract claims and litigate tort claims, the best practice is to state so precisely in the contract. The wording of the arbitration provision is key to the scope of what will be arbitrated. A provision to arbitrate "all disputes" would cover claims under both tort and breach of contract theories while a provision to arbitrate disputes "arising from the enforcement of this agreement" would arguably only cover breach of contract claims, and tort claims would need to be litigated in the judicial system. See *Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830.

PRACTICE TIP: Applying different dispute resolution procedures to different claims can result in two or more proceedings for a single dispute, increasing the time and cost involved. Counsel and the parties must weigh these costs against the desire for particular types of dispute resolution mechanism for different claims. Construction defect litigation is unusual in this respect: state law provides that a property owner may pursue an action for construction defect damages even when there is an otherwise binding arbitration clause, so the contractual choice may be overridden by statute. CCP §§337.1, 337.15, 1298.7. See *Villa Milano Homeowners Ass'n v Il Davorge* (2000) 84 CA4th 819, 102 CR2d 1.

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III. MEDIATION

§6.13 A. Description of Mediation

The use of mediation has been growing along with its success in resolving disputes without the confrontation, disruption, delay, and cost of arbitration or litigation. Mediation is a voluntary process involving an impartial third party who acts as a facilitator, rather than as a decisionmaker, to help disputing parties reach a resolution of their dispute. Although voluntary, an attempt at mediation is sometimes required by pre-dispute contract. See, *e.g.,* the form contracts developed by the California Association of Realtors® and discussed in chap 2.

NOTE: In some California Superior Courts, the parties are required to participate in some form of ADR before trial. See, *e.g.,* Cal Rules of Ct 3.722(a). Mediation is sometimes viewed as another type of settlement conference. Because mediation is a voluntary process, a court cannot compel the parties to participate in mediation, regardless of its good intentions in managing its docket. *Jeld-Wen, Inc. v Superior Court* (2007) 146 CA4th 536, 53 CR3d 115.

Mediation can take a variety of forms depending on the methods of the mediator, the nature of the dispute, and the style and personalities of the participants. The most common forms include:

- **Facilitative**: developing the parties' understanding of their respective positions rather than evaluating their merits, with a goal of finding common ground; and
- **Evaluative**: including aspects of expressing judgment as to the merits, legal and otherwise, of the parties' positions.

The mediation can include formal or informal statements of position by the parties and separate and group meetings with the mediator. If an agreement is reached, it is frequently documented on the spot. It is no longer a "sign of weakness" to suggest or agree to mediation post-dispute. Rather, mediation should be treated as one of the many tools of an effective litigator.

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§6.14 B. Selection of the Mediator

Mediation procedures are not statutorily defined; the parties choose the style of mediation and the rules to be followed, sometimes unconsciously, by their choice of mediator. Selection of the "right" mediator can be a crucial factor in whether a dispute is settled or not. Mediators can influence the tone and style of the mediation, depending on their own training and experiences, as can the nature of the dispute and the relationships of the parties. Some believe that nonlawyer mediators are less focused on the law and more apt to conduct the proceedings like a business negotiation. Using the opposite reasoning, some parties favor lawyers. Some parties prefer retired judges because of their experience in deciding disputes. Nevertheless, a mediator who does not understand the issues or appreciate the parties' perspective—whether lawyer, judge, or businessman—can be detrimental to a quick and successful resolution of a dispute.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.15 C. Effective Mediation

§6.15 C. Effective Mediation

For an effective mediation, counsel must actively prepare and participate. Counsel and client should not simply attend as passive observers of the process. Some suggestions for improving the chances that the mediation will be successful are set forth below:

- **Prepare a mediation brief.** The brief is counsel's opportunity to present a careful and persuasive analysis of the client's case, and it can be used as an educational tool for the opposing party as well as for the mediator. When the mediation is like a settlement conference, it may be preferable to submit the brief in confidence to the mediator alone. The mediation brief can provide the mediator with a roadmap to help resolve the dispute. Insights into the parties' motives and goals may at times be more useful than a legal analysis of applicable case law, although this also may be the type of information best conveyed in a confidential brief to the mediator or orally in a private session.
- **Prepare the client.** Make certain the client understands the process and what to expect. If the client is unsophisticated or unfamiliar with the mediation process, make sure he or she realizes that the mediator does not decide the merits of the case. Try to avoid setting a figure or position in stone before the session. Consider, instead, multiple "decision trees." For more on preparing clients for mediation, see California Real Property Remedies and Damages §§14.76-14.78 (2d ed Cal CEB 2002).
- **Know the client or client representative.** Client control issues can influence the outcome of the mediation. In drastic circumstances, counsel may choose to let the mediator know of these issues confidentially before the session begins. See Real Property Remedies §§14.83.
- **Ascertain that the client representative has decision-making authority.** While there are times when a settlement or resolution must be approved by a client's board of directors or managing partner, it is important that the individual or individuals who can speak for and bind the client are present at the mediation, subject to any further approval necessary under the client's organizational structure. If it is impossible to have management present, try to have the decision-maker available by telephone. If one of the parties has insurance coverage for the dispute, counsel for that party will need to analyze the advantages and disadvantages of having an insurance adjuster present for the mediation as opposed to available by telephone. See discussion of insurance in §6.21.
- **Be creative.** An advantage to ADR in general, and mediation in particular, is the ability to structure a resolution not tied to the pleadings. Rather than the "win-lose" result of a trial, the parties are not bound by legal remedies. Adept mediation participants "think outside the box" to propose resolutions that avoid the zero-sum game. Identify any nonmonetary issues and solutions. Mediation is not bound by "what a judge or jury would do."
- **Assess whether there is an ongoing relationship worth preserving.** Consider tactics with that relationship in mind. Consider how a resolution can be framed to avoid future disputes or misunderstandings.
- **Prepare a draft settlement agreement in advance.** Many ADR providers and mediators have their own form of settlement agreement that they will offer the parties at the end of a successful mediation. Consider, however, bringing your own draft in electronic form, along with a laptop, so that the document can be revised and completed at the end of the mediation session, rather than a day or two later when the details of the agreement may become additional issues.
- **Consider including expert witnesses.** Having an expert present can be effective in the right case. It shows both the mediator and the other side that your client is serious about its case and that you have a strong claim. It also provides yet another advocate for your position. Of course, these factors need to be weighed against the costs that will be incurred and giving the opposing side "free discovery" if the dispute does not resolve. On litigation strategies, see chap 12. On standard of care expert witnesses, see chap 13.

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§6.16 D. Confidentiality of Mediation

Discussions during the course of mediation are inadmissible as evidence and not subject to discovery in any civil action or administrative proceeding unless the parties expressly agree otherwise. Evid C §§1119(a), 1122. See *Foxgate Homeowners' Ass'n v Bramalea Cal.* (2001) 26 C4th 1, 14, 108 CR2d 642. Similarly, the mediated agreement is only admissible as evidence if the agreement is signed and the agreement provides for admissibility, is binding or enforceable, or the parties expressly agree to its disclosure. Evid C §§1119(b), 1123, 1152. The agreement is admissible, however, to show fraud, duress, or illegality relevant to an issue in dispute (Evid C §1123(d)), or as otherwise provided in Evid C §1152.

For more on the confidentiality of mediation, see California Real Property Remedies and Damages §14.32B (2d ed Cal CEB 2002).

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§6.17 E. Contract Provisions for Mediation

A pre-dispute provision for mediation may specify rules for the mediation, if desired. Specific matters may be excluded from mediation or, alternatively, matters subject to mediation may be identified. Increasingly, contracts involving the sale of real property include provisions for "mandatory" mediation before the filing of a suit or a demand for arbitration. See, *e.g.*, the CAR forms discussed in chap 2.

NOTE: The CAR mediation provision shifts responsibility for attorney fees if a party fails or refuses to submit to mediation, regardless of whether that party ultimately prevails in litigation.

The type of provision found in the CAR forms and in other standard residential forms has been held enforceable. See *Lange v Schilling* (2008) 163 CA4th 1412, 78 CR3d 356, in which the court refused to award attorney fees to the prevailing plaintiff who filed and served the complaint before proposing to stay the litigation and mediate. In other words, said the court, the provision "means what it says."

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F. Special Challenges to Mediating Broker Cases

§6.18 1. High-End Litigation

California's sharp increases and decreases in real property values often results in litigation against real estate brokers and others who were involved in the transaction. Attorney fees and expert testimony make these cases very expensive to litigate. Often the litigation costs exceed the amount in dispute, and cannot be recovered absent a contractual attorney fees clause (which typically does not apply to the brokers). Many cases are susceptible to early mediation, but broker cases offer unique challenges to the mediator.

Mediators can assist the parties and counsel to explore a variety of workable solutions, some of which may even preserve relationships that have not been irreparably damaged. The decision of whether to pay or accept a given sum to settle the case or consider other less obvious solutions should ultimately be a business decision. Parties and counsel who agree that litigation is mostly a gamble will take advantage of the skilled mediator's experience and tact.

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§6.19 2. Multiple Parties

Broker cases typically involve multiple parties. One of the biggest hurdles facing settlement is getting all the players to attend the mediation. Several forms of residential purchase agreements require buyers and sellers to mediate their disputes. Some listing agreements also mandate mediation between sellers and listing brokers. Selling brokers usually have no such obligations; nor do other potential defendants such as termite and home inspectors. When they are encouraged to participate, usually under the threat of being separately sued, the mediator is faced with reconciling differing factual scenarios, legal theories, and measures of damages. Thus, multiparty cases tend to be more time-consuming, often necessitating prolonged caucusing with the mediator.

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§6.20 3. Emotional Issues

Because broker cases invariably involve allegations of professional negligence, or even fraud, emotions run deep. This often presents the biggest challenge to settlement. Buyers may allege that sellers deliberately concealed material defects and that brokers misrepresented or negligently failed to properly inspect and discover them. Professional inspectors may be labeled incompetent. Buyers may threaten to report professionals to their respective licensing authorities. Brokers often resent the challenge to their "professional integrity," deny that they did anything wrong, and may blame the sellers for not following their advice to disclose everything. Sellers usually doggedly defend their disclosures as truthful, argue ignorance of the need for permits when remodeling, and justify non-code-compliant work as safe. All defendants dismissively assert "buyer's remorse" and challenge overstated repair costs as a "shakedown" of them and their insurers. To be effective, the mediator must recognize that these cases engender significant emotional overlay and must be prepared for shifts among defendants who initially seemed to be unified but suddenly point fingers at one another. The parties should be encouraged to check their emotions at the door and acknowledge that settlement will ultimately involve making unemotional business decisions that will allow them to move on with their lives and careers.

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§6.21 4. Availability of Insurance Coverage

Insurance issues often permeate brokerage cases. Some claims may be covered, whereas others, such as fraud, may not be. Coverage may be denied to a broker or salesperson who has sold his or her own property through the brokerage. Financial elder abuse, increasingly associated with "creative" seller-financing, may generate reservation of rights by insurers. So, too, might lawsuits involving housing discrimination, because the various statutes under which they are brought allow fines, penalties, or multiple damages that are excluded from coverage under most errors and omissions insurance policies. These situations are particularly challenging even for experienced mediators and may generate "mini mediations" with insurers, their coverage attorneys, and *Cumis* counsel. Sometimes, the case may evolve into separate coverage litigation in different federal or state courts and require several mediation sessions if a global settlement is to be achieved. For further discussion of insurance coverage issues, see chap 10.

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§6.22 5. Difficult Settlement

In broker cases, the parties almost always seek inconsistent settlement outcomes. For example, a defrauded buyer may be unsatisfied with a monetary settlement and prefer to rescind the transaction and recoup the purchase price plus out-of-pocket costs, including mortgage payments, taxes, moving expenses, and redecorating expenses. The seller may be only too pleased to accept rescission, especially in a rising market, or may reject rescission if the sale proceeds have been spent on other acquisitions. Brokers will usually reject rescission, particularly if it means returning commissions or if it is clear that the seller, rather than the brokerage, was at fault. Sometimes, however, brokers will cooperate if they can be assured of the chance to re-list the property or are guaranteed to recoup lost commissions in other transactions. Similarly, intransigent insurers may be prevailed on to contribute even if coverage is questionable in order to close the file and avoid the risk and the high cost of litigating through trial. The skillful mediator will help shape a solution that satisfies needs and interests leading the parties away from positional-based negotiating.

Real estate disputes in general, and cases involving brokers in particular, often offer a wide range of opportunities for structuring settlements that do not simply involve an exchange of money. Conflicting preferences and valuations may be among the tools a mediator uses to fashion an agreement. The broker's expertise and knowledge of market conditions can assist in this process. For example, an unhappy buyer may be willing to resolve a claim against a broker in exchange for the broker agreeing to market the property for a reduced commission.

PRACTICE TIP: Also consider a partial settlement that extricates some of the disputants while leaving others as defendants in the litigation. This dynamic may cause parties who appear to be locked in intransigent positions to re-evaluate their settlement posture.

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§6.23 6. Taxation Issues

There may be tax consequences to settlements, which can be further complicated if the property involved was acquired in an IRC §1031 exchange. Before engaging in a mediation involving potential rescission, counsel should be familiar with the technicalities of "undoing" transactions and consult with the buyer's lender and tax advisor. When warranted, accountants, appraisers, and other relevant professionals should be asked for written opinions, expressly made subject to the mediation privilege, or even to attend the mediation. The mediator must never be put in the position of giving legal advice on such critical issues or losing his or her neutrality.

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§6.24 7. Attorney Fees

Mediators experienced in broker cases will know that only certain parties in the litigation, usually only the buyer and seller, will be entitled to "prevailing party" attorney fees. These cases tend to be driven by their costs. A buyer paying counsel on a contingency fee basis may consider "rolling the dice," believing that, if successful, his attorney fees will be paid by the seller, or borne by his own attorney if he loses. Sellers, evaluating the possibility of loss, might threaten bankruptcy as a bargaining ploy, in which case the outcome of the case becomes less relevant when compared to the seller's resources, the defense lawyer's likelihood of being paid, and the value placed on avoiding bankruptcy. The mediator should explore with brokers, who may not be exposed to another parties' attorney fees, the possibility that an adverse judgment might still affect their insurability, premium rates, or even licensing status.

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§6.25 8. Keeping Negotiations Moving When Parties Are Ready to Quit

Being persistent and willing to stay with the process when a perceived impasse is raised by a party (or when the parties are ready to end the mediation) is an attribute of a good mediator that runs across case distinctions. Regardless of his or her knowledge of case-specific law, a persistent mediator can be effective by using facilitative and evaluative techniques or by suggesting nontraditional resolutions to bridge the dispute and reach resolution. See Cahill, *Judge's Perspective: Conducting Effective Settlement Conferences and Mediations*, 29 CEB Civ Litigation Rep 48 (April 2007).

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§6.26 9. Documenting the Settlement

After all of the time, expense, and emotion have been spent in achieving a mediated agreement, the last thing anyone wants is for the agreement to be unenforceable. In complex commercial cases or even in relatively simple residential disputes, the settlement terms may involve the parties' doing more than accepting or paying money. Sometimes rescission, requiring return of down payment, mortgage payments, or tax considerations, may be part of the mediated settlement. Vacating property or putting it on the market by critical dates may be an important term. Often, these "details" are negotiated late at night when parties, counsel, insurers, and the mediator are tired and perhaps frustrated. Nevertheless, no one should leave the mediation without all parties signing a writing that clearly states the key points of agreement and leaves nothing to future negotiation. When necessary, a party, such as a spouse signing on behalf of another spouse, should have the writing reflect that full authority exists.

The writing must clearly reflect that it is a settlement agreement and not simply a memorandum of terms for a future agreement. Before stating the terms of the agreement, the writing should directly state, clearly and unequivocally, that it constitutes a binding and enforceable agreement or words to that effect. This language satisfies the admissibility requirements of Evid C §1123(b) in the event that a party needs to bring an action or file a motion to enforce the agreement. See *Fair v Bakhtiari* (2006) 40 C4th 189, 199, 51 CR3d 871. Further, because most mediated agreements are entered into outside of court, language should be inserted that the agreement "is enforceable pursuant to CCP §664.6," so that a court can enter judgment based on the settlement agreement. On requirements for admissibility of mediation settlement agreements, see California Real Property Remedies and Damages §14.32B (2d ed Cal CEB 2002).

PRACTICE TIP: A waiver of confidentiality that applies to the agreement itself should always be considered. See *Stewart v Preston Pipeline, Inc.* (2005) 134 CA4th 1565, 36 CR3d 901, which reviews how consent to a settlement should be memorialized and when settlements in mediation are (or are not) confidential for the purposes of enforceability under CCP §664.6 or a motion for summary judgment. See §6.16. Note, however, that §664.6 applies only to pending litigation. Thus, disputes settled in mediation before filing, such as those mandated by the provisions of the CAR and Professional Publishing residential forms, cannot take advantage of the benefits available under the statute and would need other settlement enforcement mechanisms (such as a law suit) for breach of contract.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.27 G. Form: Mandatory Mediation

§6.27 G. Form: Mandatory Mediation

***Submission to Mediation*. Before _ _**[*invoking the binding dispute resolution mechanism set forth in Section __ of this Agreement or filing suit in superior court*]**_ _, the Parties must first participate in mediation of any and all disputes, claims, controversies, or breaches arising out of or relating to this Agreement**

[*If appropriate, add*]

, other than controversies or claims relating to _ _[*specify excluded issues, e.g., unlawful detainer actions, matters filed in small claims court, claims for provisional relief, etc.*]**_ _. Failure to initiate or respond to a request for mediation using the notice provisions of this Agreement will constitute a waiver of any right to attorney fees in connection with an award or judgment in any proceeding under the dispute resolution mechanism. If no response is made to a mediation request, the requesting Party, or if the mediation is unsuccessful, either Party, may invoke the dispute resolution mechanism of this Agreement.**

[*Alternative: mediator named or described*]

***Selection of Mediator.* The mediator will be _ _**[*name or description of mediator*]**_ _ or, if _ _**[*he/she*]**_ _ is unavailable, then _ _**[*name or description of alternate mediator*]**_ _. The mediation will be held at _ _**[*location*]**_ _. The mediation will be conducted according to the rules of _ _**[*specify*]**_ _. The cost of mediation will be borne by the Parties equally.**

[*Alternative: mediator selection process*]

***Selection of Mediator.* The Parties will select one mediator. The mediator must be an _ _**[*e.g., attorney, broker, retired judge*]**_ _ with a minimum of _ _**[*e.g., 10 years of*]**_ _ experience in representing parties in transactions like those contemplated by this Agreement.**

If the Parties cannot agree on a mediator, any Party may petition the superior court of the county in which the property is located for the appointment of a mediator by the presiding judge. The mediation will be held at _ _[*location*]**_ _. The mediation will be conducted according to the rules of _ _**[*specify*]**_ _.**

[*Continue*]

***Commencement of Mediation*. At least _ _**[*e.g., 10 business days*]**_ _ before the date of the mediation, each Party may provide the mediator with a statement of its position and copies of all supporting documents. The mediation will begin within _ _**[*e.g., 10 business days*]**_ _ following the submittal of documents and will be concluded within _ _**[*e.g., 30 business days*]**_ _ from the beginning of the mediation unless the Parties agree to extend the mediation period.**

***Mediation Agreement*. Before the mediation proceedings begin, the mediator and all Parties to the mediation will execute an agreement to maintain confidentiality of the proceedings under California Evidence Code §§703.5 and 1115-1128 and California Code of Civil Procedure §1775.10, or successor statutes, in order to exclude the use of any testimony or evidence produced at the mediation in any subsequent dispute resolution including court proceedings, arbitration, or reference hearings. Further, the mediation agreement will provide that the expenses of witnesses and consultants for either side will be paid by the Party producing the witnesses, and all other expenses of the mediation, including required travel and other expenses of the mediator and the cost of any witnesses or expert advice produced at the mediator's direct request, will be paid equally by the Parties unless they agree otherwise.**

***Conduct of Mediation*. Each Party must send to the mediation a person who has authority to bind the Party. If a subsequent dispute involves third parties, such as insurers, agents, or other brokers, they must be asked to participate in the mediation. All other persons or entities may attend the mediation sessions only with the permission of the Parties. Confidential information disclosed to a mediator by the Parties or by witnesses during the course of the mediation will not be divulged by the mediator. All records, reports, or other documents received by the mediator will be confidential. There _ _**[*will be/ will not be*]**_ _stenographic or tape recording of the mediation process.**

***Further Action*. A Party may _ _**[*invoke the dispute resolution provisions in Section _ _ of this Agreement or file suit in superior court*]**_ _only after participating in mediation as contemplated by this Section _ _.**

Comment: As is the case with arbitration and reference, unlawful detainer matters should be specifically excluded if the agreement concerns a tenancy; otherwise the landlord will lose its right to a summary proceeding under CCP §§1159-1179a. On unlawful detainers, see California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002).

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IV. ARBITRATION

§6.28 A. Description of Arbitration

Binding arbitrations are widely used in the commercial real estate world. In arbitration, parties present their dispute to a third party who hears and considers the evidence and then renders a final and binding decision or "award." The hope is that the dispute can be heard by an expert in the field more quickly (without time-consuming discovery and pretrial motion practice), at less cost and without the acrimony of litigation. Arbitration has long been used when the parties have an ongoing relationship, such as in construction or union-versus-management disputes. Parties with ongoing relationships often decide to arbitrate disputes arising from their relationship rather than put the relationship itself at risk with full-blown litigation in the court system.

With rare exceptions, agreements to arbitrate must be in writing. See *Law Offices of Ian Herzog v Law Offices of Joseph M. Predrics* (1998) 61 CA4th 672, 71 CR2d 771. The courts favor arbitration for its speed, economy, and ability to relieve the pressure on court calendars; public policy also strongly favors arbitration. See *Madden v Kaiser Foundation Hosps.* (1976) 17 C3d 699, 706, 131 CR 882.

The Code of Civil Procedure specifically provides that an agreement to arbitrate an existing dispute or one arising thereafter is valid and enforceable unless grounds for revocation of contract exist. CCP §1281. Controversy over the arbitration clause itself is most likely to occur in adhesion contracts. When the parties have unequal bargaining strength over the terms of the contract, the arbitration provisions may be more susceptible to challenges based on unconscionability. See *Parada v Superior Court* (2009) 176 CA4th 1554, 98 CR3d 743; *Thompson v Toll Dublin, LLC* (2008) 165 CA4th 1360, 81 CR3d 736. In *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76, the supreme court held that under California law a provision waiving class-wide arbitration was unconscionable in a contract of adhesion under which individual consumers are cheated out of small sums of money. See also *Izzi v Mesquite Country Club* (1986) 186 CA3d 1309, 231 CR 315 (recognizing class-wide arbitration); *Independent Ass'n of Mailbox Ctr. Owners v Superior Court* (2005) 133 CA4th 396, 34 CR3d 659 (striking ban on class-wide arbitration from franchise agreement).

This discussion does not cover nonbinding arbitration, which may be ordered by a court if the amount in controversy does not exceed $50,000. CCP §1141.11 (Nonbinding arbitration gives both parties the right to demand a trial de novo under CCP §1141.20).

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§6.29 1. Deciding Arbitrability

Contractual arbitration provisions should specify what the parties do and do not wish to arbitrate. The arbitrator may consider only the issues or disputes covered by the arbitration agreement. See §6.9; *Mansdorf v California Physicians' Servs.* (1978) 87 CA3d 412, 151 CR 388. When the agreement is unclear regarding the arbitrability of an issue or dispute, the arbitrator or the court has to rule on that question before arbitration commences. If the agreement expressly provides that the question of arbitrability will be submitted to arbitration, the arbitrator decides this question. In the absence of any such provision, the courts decide whether the issue dispute is arbitrable. *First Options of Chicago v Kaplan* (1995) 514 US 938, 131 L Ed 2d 985, 115 S Ct 1920. Compare *Howsam v Dean Witter Reynolds* (2002) 537 US 79, 123 SCt 588, 154 L Ed 2d 491 (applicability of time limit rule was presumptively for arbitrator and did not raise question of substantive arbitrability requiring judicial intervention).

The issue as to whether the court or the arbitrator decides on enforceability of the arbitration clause depends in part on the facts of the case and the language of the clause itself. In *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh v 100 Oak Street* (1983) 35 C3d 312, 197 CR 581, the court found that, in the absence of an indication of contrary intent, and when the arbitration clause is reasonably susceptible of such an interpretation, claims of fraud in the inducement of the contract (as distinguished from claims of fraud directed to the arbitration clause itself) should be adjudicated by the arbitrator and not the court.

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§6.30 2. Review of Arbitration Award

The arbitrator's award is not self-executing. If a party does not voluntarily perform as ordered by the arbitrator, the prevailing party must file a petition in the superior court to confirm the award and obtain a judgment, enforceable like any other. If the award is challenged, and the parties have not expressly agreed otherwise, the court gives limited review to the arbitrator's award and considers any evidence of arbitrator misconduct, but does not review the award for errors of fact or law. See *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 10 CR2d 183. The court then either confirms the award and enters a judgment or vacates the award. See CCP §§1285-1286. However, in *Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229, the California Supreme Court has extended the rule of limited judicial review of arbitrator error. For the five-member majority, Justice Corrigan wrote:

> Our reasoning in *Moncharsh* centered not on statutory restriction of the parties' contractual options, but on the parties' intent and the powers of the arbitrators as defined in the agreement. These factors support the enforcement of agreements for an expanded scope of review. If the parties constrain the arbitrators' authority by requiring a dispute to be decided according to the rule of law, and make plain their intention that the award is reviewable for legal error, the general rule of limited review has been displaced by the parties' agreement. Their expectation is not that the result of the arbitration will be final and conclusive, but rather that it will be reviewed on the merits at the request of either party. That expectation has a foundation in the statutes governing judicial review, which include the ground that "[t]he arbitrators exceeded their powers." 44 C4th at 1355.

WARNING: It is likely that this extension of court review will be interpreted narrowly. The parties must explicitly restrict the arbitrator's authority by requiring that the dispute be decided based on the rule of law and must "make plain their intention that the award is reviewable for legal error." Under the Federal Arbitration Act (9 USC §§1-16) this type of review for legal error is not available. See §6.31.

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§6.31 3. Federal Arbitration Act

The Federal Arbitration Act (FAA) (9 USC §§1-16) provides that a party may enforce an arbitration provision in a transaction involving interstate commerce. 9 USC §2. The standard for "involving interstate commerce" is as broad as the commerce clause. *Southland Corp. v Keating* (1984) 465 US 1, 79 L Ed 2d 1, 104 S Ct 852. The slightest nexus with interstate commerce has been held sufficient to bring the arbitration provision within the FAA. *Allied-Bruce Terminix Cas. v Dobson* (1995) 513 US 265, 130 L Ed 2d 753, 115 S Ct 834; *A.J. Taft Coal Co. v Randolph* (Ala 1992) 602 SO2d 395. The FAA is applicable in both federal and state courts. *Moses H. Cone Mem. Hosp. v Mercury Constr. Corp.* (1983) 460 US 1, 25, 74 L Ed 2d 765, 786, 103 S Ct 927. The FAA will also apply if the arbitration clause designates the FAA as the parties' choice of law.

In *Volt Info. Sciences Inc. v Board of Trustees of Leland Stanford Junior Univ.* (1989) 489 US 468, 479, 103 L Ed 2d 488, 500, 109 S Ct 1248, *e.g.*, the United States Supreme Court applied California procedural law, ruling that if the property is located in California and the contract calls for arbitration under state rules, California law is not preempted by the FAA. The same result was reached in *Cronus Invs., Inc. v Concierge Servs.* (2005) 35 C4th 376, 25 CR3d 540, in which the California Supreme Court noted that parties may expressly designate in the contract that federal law rather than state law will govern enforcement of the arbitration agreement. 35 C4th at 394. In a subsequent case, *Gravillis v Coldwell Banker Residential Brokerage Co.* (2006) 143 CA4th 761, 784, 49 CR3d 531, the court did not consider a sentence in the real property purchase contract requiring the arbitration clause to be interpreted under the FAA; rather, the court (1) observed that the contract expressly stated that California procedural law governed the motion to compel arbitration, and (2) reiterated the rule in *Volt* that when a choice-of-law clause provides that state law will apply, a trial court may apply state law even if the underlying transaction involves interstate commerce.

PRACTICE TIP: The courts distinguish procedural enforcement of an arbitration clause under the FAA from "generally applicable contract defenses, such as fraud, duress, or unconscionability." See, *e.g., Discover Bank v Superior Court* (2005) 36 C4th 148, 165, 30 CR3d 76, quoting *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892. Consequently, even if the arbitration clause is governed by the FAA, a court may apply California law to adjudicate the issue of unconscionability of the clause.

Application of the FAA may have a different effect than application of the California Arbitration Act (CAA) (CCP §§1280-1294.2). Accordingly, counsel need to consider the FAA when advising clients. For example, under the FAA the parties may not expand the scope of judicial review by agreement. *Hall St. Assocs., LLC v Mattel, Inc.* (2008) 552 US 576, 170 L Ed 2d 254, 128 S Ct 1396. For a more detailed discussion of application of the FAA in California transactions, see California Real Property Remedies and Damages §§14.38C-14.38D (2d ed Cal CEB 2002).

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§6.32 B. Contract Provisions for Arbitration

Counsel should set out the arbitration provisions in large, bold type and require the other party to initial the provision, especially if the parties are not of equal bargaining power. See *Spence v Omnibus Indus.* (1975) 44 CA3d 970, 119 CR 171 (criticizing arbitration provision buried in small type on reverse page of contract); *Wheeler v St. Joseph Hosp.* (1976) 63 CA3d 345, 133 CR 775 (voiding arbitration provision not explained to hospital patient). Compare *Izzi v Mesquite Country Club* (1986) 186 CA3d 1309, 1318, 231 CR 315 (party's failure to read purchase agreement arbitration provision does not make it unenforceable).

There are specific requirements for arbitration provisions in real estate contracts. They must include specific language, be in bold type of a specified size and color, and be initialed by the parties. CCP §1298. There are also special requirements for arbitration provisions applicable to construction defect disputes. To preserve any right of arbitration under a written agreement, parties filing action for purposes of recording a notice of pending action must at the time of filing also file an application to stay the action pending arbitration. CCP §1298.5.

Arbitration provisions do not preclude actions for bodily injury or wrongful death. CCP §1298.7. Finally, agreements that are shown to be unconscionable will not be enforced. See *Thompson v Toll Dublin, LLC* (2008) 165 CA4th 1360, 81 CR3d 736.

WARNING: If a case involves the FAA or interstate commerce, the provisions of CCP §1298 may be inapplicable due to the Supremacy Clause of the United States Constitution. See *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 134 L Ed 2d 902, 116 S Ct 1652; *Hedges v Carrigan* (2004) 117 CA4th 578, 11 CR3d 787 (dicta). See also *Volt Info. Sciences Inc. v Board of Trustees of Leland Stanford Junior Univ.* (1989) 489 US 468, 479, 103 L Ed 2d 488, 109 S Ct 1248, and California cases interpreting *Volt*, discussed in §6.31.

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§6.33 1. Enforceability

Counsel must consider whether the arbitration agreement is one of adhesion or unconscionable. Like contracts generally, an agreement to arbitrate may not be enforced if it is unconscionable. *Armendariz v Foundation Health Psychcare Servs.*, *Inc.* (2000) 24 C4th 83, 99 CR2d 745; CC §1670.5. A party defending a motion to compel arbitration and seeking to avoid an arbitration provision must show that the arbitration agreement is both procedurally and substantively unconscionable. *Armendariz*, 24 C4th at 114. The procedural element of the doctrine focuses on oppression or surprise resulting from unequal bargaining power; the substantive element is characterized by overly harsh or one-sided terms. A finding of procedural unconscionability is a prerequisite to determining that the arbitration agreement as a whole is unconscionable; after making that finding, the court will scrutinize the substantive terms of the contract to ensure that they are not unfair or one-sided. *Gentry v Superior Court* (2007) 42 C4th 443, 469, 64 CR3d 773.

The one-sided nature of an arbitration clause as it concerns real estate brokers can severely disadvantage a broker. See, *e.g*., *Nguyen v Tran* (2007) 157 CA4th 1032, 68 CR3d 906 (buyer's broker could successfully compel buyers, but not listing broker, to arbitrate). This particular problem does not arise if the arbitration clause, *e.g.,* clearly states that buyer, seller, and agent all agree that disputes under the agreement "shall be settled by final, binding arbitration." See *Westra v Marcus & Millichap Real Estate Inv. Brokerage Co.* (2005) 129 CA4th 759, 766, 28 CR3d 752. For further discussion on enforceability of arbitration agreements, see California Real Property Remedies and Damages §§14.40-14.42D (2d ed Cal CEB 2002). On enforcing arbitration clauses in real property residential purchase contracts, see Real Property Remedies §§14.38-14.39.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.34 2. Selection of Arbitrator

§6.34 2. Selection of Arbitrator

The arbitration agreement may name a specific arbitrator or arbitration service or may describe the selection procedure to be used. Some providers, such as Judicial Arbitration and Mediation Services, Inc. (JAMS), specialize in retired judges. Others, notably the American Arbitration Association (AAA) and the National Arbitration Forum (NAF), include lawyers and nonlawyers as well. Issues to address include:

- **Single or multiple arbitrators.** A panel of arbitrators, which brings several minds to the problem, is often perceived as more likely to reach a reasonable outcome. Having multiple arbitrators also allows the panel to include attorneys as well as industry experts. Many agreements provide that each party will name their own arbitrator and those arbitrators in turn will select a third arbitrator. Additional arbitrators will add to both the cost and the difficulty of scheduling hearings.
- **Neutrality.** It is not necessary that all the arbitrators be neutral. *Dinong v Superior Court* (1981) 120 CA3d 300, 174 CR 590. All arbitrators do have a duty, however, to disclose any facts that might create an appearance of partiality. *Schniitz v Zilveti* (9th Cir 1994) 20 F3d 1043. Proposed arbitrators must make broad disclosures of potential conflicts and must, under certain circumstances, disqualify themselves. CCP §§1281.9-1281.95.
- **Type of arbitrator.** The parties can select a retired judge, an attorney, a practitioner or expert in the field (*e.g.,* broker, architect, or accountant), any other party, or any combination of these.

PRACTICE TIP: If the dispute is likely to require the interpretation of an agreement, the parties may want the arbitrator (or one of the arbitrators) to be an attorney who is familiar with the particular type of agreement.

An arbitrator who possesses special expertise, such as a broker or an architect, may understand the factual issues better than a generalist. If the parties want the arbitrator to have specialized knowledge, the agreement should state the minimum qualifications that the arbitrator must possess to eliminate needless haggling over competence. Arbitrators who do not possess the relevant characteristics may not be used absent agreement of the parties. Names of arbitrators meeting special requirements may be available through commercial arbitration services.

PRACTICE TIP: If the parties want to name a particular person as arbitrator, counsel should make sure the selected party is willing and able to serve if needed. Counsel should also provide a backup mechanism to select an alternative arbitrator if the named person is unavailable.

In the absence or failure of the selection procedure, a party may petition the court to choose the arbitrator. The court will nominate five persons chosen from a list supplied jointly by the parties, by a government agency, or by a private disinterested association dealing with arbitration. The parties have 5 days after receiving notice of the nominees to select an arbitrator, either from the list or otherwise. If they do not make a selection, the court chooses the arbitrator from the list of nominees. CCP §1281.6.

PRACTICE TIP: Some services charge hourly for the arbitrator's time in and outside the hearing, others charge by the number of parties involved, and still others charge only an administrative fee for the first day of a hearing (adding the arbitration fee for subsequent days). Counsel should review the fees charged to decide which of the services will be most appropriate.

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§6.35 3. Selection of Arbitration Rules

The federal and state arbitration statutes provide only the bare minimum structure for arbitration. The California Arbitration Act (CAA) (CCP §§1280-1294.2), for example, does not permit discovery depositions without leave from the arbitrator. See CCP §1283.05(e). Specifying the governing rules for the arbitration in the contract or stipulation can reduce the risk of collateral disputes. Most arbitration providers have their own quite extensive list of rules. The American Arbitration Association (AAA) has its own general rules of procedure, as well as rules developed for particular industries, such as construction or title insurance. For instance, the AAA requires that three arbitrators must be used when the dispute is categorized above a certain value. The National Arbitration Forum (NAF) also has its own procedural rules, which may differ a little or significantly from those of the AAA. Alternatively, the parties may craft custom rules for a particular contract. See §6.36.

WARNING: Whether drafting a contract provision or a post-dispute stipulation for binding arbitration, counsel must be familiar with the specific rules (and their implications) of the arbitration service invoked to avoid unintended consequences. For a graphic representation of how complex the differences in rules from various arbitration providers can be, see California Title Insurance Practice §14.13 (2d ed Cal CEB 1997).

Although designating the ground rules avoids the time and expense of arguments over procedure, the parties must take care that the rules they choose do not create new problems. In *Harper v Ultimo* (2003) 113 CA4th 1402, 7 CR3d 418, for example, an arbitration clause that provided for arbitration under the rules of the Better Business Bureau was held procedurally unconscionable because those rules limited the claimant's recovery, limited the scope of the claims that could be pursued, and were not attached to the agreement. The clause was also deemed substantively unconscionable because the claimant lacked even a theoretical possibility of being made whole.

PRACTICE TIP: If the parties wish to designate particular rules to govern the arbitration, the agreement should clarify whether the rules that apply are those in effect at the time of the contract or those in effect at the time of the dispute. If dealing with parties of unequal bargaining power, it is good practice to specify that the applicable rules are those in effect at the time of the contract and to include a copy of those rules as an attachment. See *Harper v Ultimo, supra*.

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§6.36 4. Crafting Rules Specific to Transaction

The parties should consider (1) designating in the agreement the type of rules that are to apply, *e.g.,* the AAA Commercial Arbitration Rules or AAA Construction Industry Rules, or (2) crafting a set of procedures suitable to the given situation.

For example, the parties may want the arbitrator to follow the rules of evidence as if the matter were being tried in a court, or they may prefer that the arbitrator provide a reasoned statement of decision that sets out the basis for the award and that gives the parties an opportunity to comment. If the agreement specifies such procedures, the court reviews the arbitrator's award to determine if the arbitrator followed the agreement. If the arbitrator does not follow the agreement, the award may be set aside. *Bonshire v Thompson* (1997) 52 CA4th 803, 60 CR2d 716.

Even though arbitrations are private, the parties can provide that the arbitration record will be kept confidential. The agreement may also specify a timeline for the arbitration. Short deadlines will spur all concerned to proceed in a timely manner, increasing the chances of achieving prompt resolution, but they also may work against settlement.

WARNING: If the agreement specifies a deadline for the arbitrator's decision and the decision is not timely rendered, the effectiveness of the decision may be in doubt. The losing party may argue that the decision, being untimely, is beyond the arbitrator's jurisdiction and therefore void. See CCP §1283.8; *Bosworth v Whitmore* (2006) 135 CA4th 536, 37 CR3d 560.

The agreement may specify the location of the arbitration, which is especially useful if the agreement is between parties from distant locations. This step avoids the possibility of disagreements over location after the parties are at loggerheads. The agreement may specify that a court reporter transcribe the arbitration and, if he or she does so, how payment of the reporter is to be allocated.

Witnesses other than parties appearing under subpoena are entitled to the same appearance fees and mileage as witnesses in superior court civil actions. Payment is made by the party that subpoenas the witness or, if the witness is subpoenaed by a neutral arbitrator, the responsibility for paying these costs is the same as that for paying the arbitrator's expenses. CCP §1283.2.

NOTE: No attorney fees may be awarded in arbitration unless a court could have awarded them, *i.e.*, attorney fees must be allowed by the agreement or by statute. *Thompson v Jespersen* (1990) 222 CA3d 964, 272 CR 132. Even if there is an attorney fees provision, the arbitrator has substantial discretion regarding whether to award fees. See *Moore v First Bank of San Luis Obispo* (2000) 22 C4th 782, 94 CR2d 603; *Moshonov v Walsh* (2000) 22 C4th 771, 94 CR2d 597.

The agreement may also allocate responsibility for the costs of the arbitration. A typical provision requires each party to pay a prorata share of the arbitrator and administrative fees of the arbitration, with the arbitrator allocating other costs as part of the award. The agreement may also include a default provision to address the consequences if one party refuses to pay its share. If a party to an arbitration is unable to pay its share of the arbitration fees, an arbitrator may have discretion to allow the arbitration to proceed on condition that the other party advance the remaining fees. *Lifescan, Inc. v Premier Diabetic Servs., Inc.* (9th Cir 2004) 363 F3d 1010. Often, these decisions may be made by the service rather than by an individual arbitrator.

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§6.37 5. Discovery in Arbitration

There is little statutory right to discovery in arbitration, unless the parties provide in the agreement for the incorporation of the provisions of CCP §1283.05. CCP §1283.1(b). However, discovery rights are conclusively deemed to be included in an arbitration agreement in matters of personal injury or wrongful death (CCP §1238.1(a)), although discovery depositions still require leave from the arbitrator (CCP §1283.05).

In a dispute involving a claim for more than $50,000, however, parties may demand a list of witnesses (including experts) and a list of documents to be introduced at the hearing. CCP §1282.2(a)(2)(A). Parties also have access to subpoenas for evidentiary depositions and the production of witnesses, documents, and other evidence at the arbitration hearing. CCP §§1282.6, 1283. However, nonparty discovery is subject to full judicial review. *Berglund v Arthroscopic & Laser Surgery Ctr.* (2008) 44 C4th 528, 79 CR3d 370. Parties may also invoke the rules of a particular provider, such as JAMS, which provide in its rules for certain discovery rights.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.38 C. Advantages and Disadvantages of Arbitration

§6.38 C. Advantages and Disadvantages of Arbitration

Arbitration can be a useful tool or a hindrance to the parties' goals. The following are some matters to consider:

- **Time to resolution.** Although arbitration proceedings have been known to continue for years without resolution, arbitration is usually speedier than litigation. See *Baar v Tigerman* (1983) 140 CA3d 979, 189 CR 834. Speed can be ensured by a written requirement that the arbitrator submit a ruling within a specified time period. Generally, arbitration saves time by eliminating discovery and dispositive motions and, of course, by avoiding court congestion. When the procedures are tailored to more complicated cases (*e.g.,* wrongful death or damages exceeding $50,000), some of the economies of arbitration can be lost.
- **Avoiding the court system.** Arbitration saves the cost of demurrers, discovery motions, summary judgment, and other dispositive motions as well as technical trial requirements such as in limine motions and jury instructions. It also avoids the need to repeatedly prepare a case for trial when a courtroom is not available and the trial date is continued.
- **Expense.** Historically, arbitration has been less expensive than litigation, but this is no longer always true. Essentially, the same preparation is needed for arbitration as for trial. Arbitration saves expense when it avoids the costs of document production and discovery depositions. While courts impose relatively modest administrative fees, arbitration fees, based on the dollar amount at issue, can be substantial. Arbitrators are paid by the hour, by the litigants (often at the same level as the attorneys appearing before them), while judges and their staffs are paid by the state. Moreover, judges, unlike arbitrators, have an incentive to conduct the pretrial process and the trial expeditiously.
- **Discovery.** The lack of discovery in traditional arbitration saves money and time, but may also prevent thorough investigation into the conduct and theories of the other side. For example, the inability to depose an opponent's expert witness can severely impede preparation of the case. In complex litigation, both sides usually opt for discovery, adding time and expense to the matter.
- **Finality and judicial review.** Arbitration awards are almost always final and not subject to judicial review, unless the arbitration provision has been drafted to specifically provide otherwise. Under CCP §1286.2, there are limited grounds for vacating an arbitration award; judicial review does not extend to the merits of the dispute, the sufficiency of evidence to support the award, or the arbitrator's reasoning. *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 25, 10 CR2d 183; *Santa Clara-San Benito Chapter of Nat'l Elec. Contractors' Ass'nv Local Union No. 332* (1974) 40 CA3d 431, 437, 114 CR 909. Although under the California Arbitration Act (CAA) (CCP §§1280-1294.2) the agreement may be tailored to require decision in accordance with law or to be overturned for legal error, and presumably for lack of substantial evidence (*Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229); under the FAA, parties may not expand by contract the court's power or jurisdiction to review the decision. See *Hall St. Assocs., LLC v Mattel, Inc.* (2008) 552 US 576, 170 L Ed 2d 254, 128 S Ct 1396; *Kyocera Corp. v Prudential-Bache Trade Servs.* (9th Cir 2003) 341 F3d 987.
- **Enforceability.** Moreover, an arbitration award is not in itself enforceable. If the losing party does not comply with the award, the prevailing party must petition for confirmation of the award to obtain a judgment that can be enforced by traditional measures.
- **Expertise.** Professionals knowledgeable about the subject matter (*e.g.,* brokers, architects, accountants) can serve as arbitrators and may need less education about esoteric matters of their subject than a judge or jury. Also, the parties have control over the selection of the trier of fact. Nevertheless, there is a risk associated with having a single trier of fact, acting as both judge and jury instead of the collective judgment of 12 jurors.
- **Privacy.** Arbitration can be conducted confidentially, avoiding public airing of trade secrets and other confidential matters.
- **Rules of evidence.** Arbitration follows less strict rules of evidence than court proceedings, *e.g.,* allowing the admission of hearsay and testimony by telephone, which may save expense and expedite resolution. See CCP §1282.2(d). On the other hand, it is more difficult to exclude nonprobative material that may be prejudicial or

time-consuming.

- **Settlement and compromise.** Some people believe that arbitrators tend to compromise or "split the baby," leaving both parties unsatisfied. However, if compromise is desired, the same result can be obtained in a settlement proceeding. Although court settlement proceedings may be unavailable, private mediation or supervised settlement conferences are not precluded. Unlike a judge or appointed referee, arbitrators may be more likely to consider novel awards which do equity, but perhaps would not be permitted under law. Of course, private settlement proceedings are equally a route to an equitable result. In real estate arbitrations, the parties sometimes choose what is known as "baseball arbitration" in which each side makes its last best offer, which may or may not be communicated to the arbitrator, and whichever side's final offer is closest to the arbitrator's award becomes the final award.
- **Formality.** Arbitrations, usually held in a conference room, are often, but not always, less formal than court proceedings, because they are not as intimidating and have fewer rules than the courthouse.
- **Satellite litigation**. If third parties or nonarbitrable issues are a part of the dispute but cannot be brought into the arbitration, expensive satellite litigation or litigation in two forums may result. It may be better to have all parties appear before a court than to risk inconsistent results and the cost of duplicate proceedings. See *Fitzhugh v Granada Healthcare and Rehabilitation Center* (2007) 150 CA4th 469, 58 CR3d 585 (only one of multiple claims subject to arbitration); *Henry v Alcove Inv.* (1991) 233 CA3d 94, 284 CR 255 (impact of arbitration on parties in dispute but not involved in arbitration); *C. V. Starr & Co. v Boston Reinsurance Corp.* (1987) 190 CA3d 1637, 236 CR 167 (party in pending court action not compelled to arbitrate).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.39 D. Form: Arbitration Clause

§6.39 D. Form: Arbitration Clause

[*Alternative: All disputes to be arbitrated, with specified exceptions*]

***Arbitration of Disputes*. Any and all disputes, claims, controversies, or breaches arising out of or relating to this Agreement, whether seeking damages or equitable relief, must be resolved by neutral binding arbitration[.]**

[*If appropriate, add*]

, other than controversies or claims relating to _ _[*specify excluded issues, e.g., unlawful detainer actions, matters filed in small claims court, claims for provisional relief*]**_ _.**

[*Alternative: Specified disputes only*]

***Arbitration of Disputes*. Any dispute that is required by the express terms of this Agreement to be resolved by arbitration must be resolved by neutral binding arbitration.**

***Selection of Arbitrator(s)*. The arbitration will be held before _ _**[*e.g., a single arbitrator/a panel of three arbitrators*]**_ _, in accordance with the _ _**[*e.g., commercial/real estate*]**_ _ arbitration rules of _ _**[*name of arbitration service*]**_ _. Judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction over the dispute. The arbitrator(s) must be a _ _**[*e.g., licensed real estate broker/appraiser*]**_ _ who has been active in the leasing or appraisal of real properties substantially similar in nature to the Property in the _ _**[*e.g., Los Angeles*]**_ _ area during the last _ _**[*e.g., 10*]**_ _-year period. The arbitrator(s) must be independent of any Party and have no economic interest in the outcome of the arbitration apart from receiving payment of customary arbitration fees.**

***Venue*. Arbitration hearings will be held in _ _**[*e.g., Los Angeles*]**_ _, California, or another venue determined by mutual agreement of the Parties.**

***Demand and Limitation on Claims*. Any demand for arbitration must be made in writing to the other Party and to the_ _**[*name of arbitration service*]**_ _. No demand for arbitration may be made after the date on which the institution of legal proceedings based on the claim, dispute, or other matter is barred by the applicable statute of limitations.**

***Provisional Remedies*. The Parties will each have the right to file with a court of competent jurisdiction an application for temporary or preliminary injunctive relief, writ of attachment, writ of possession, temporary protective order, or appointment of a receiver if the arbitration award to which the applicant may be entitled may be rendered ineffectual in the absence of the relief or if there is no other adequate remedy. This application will not waive a Party's arbitration rights under this Agreement.**

***Discovery*. The Parties will have the right to discovery in accordance with California Code of Civil Procedure §§1283.05 and 1283.1 as long as the _ _**[*arbitrator's/arbitrators'*]**_ _ permission is not required to take a discovery deposition and _ _**[*specify any limits on discovery, e.g., discovery by means of interrogatories and requests for admission will not be permitted/neither party may take more than three depositions without the approval of the other party or the arbitrator*]**_ _. All discovery disputes will be resolved by the arbitrator(s).**

***Application of California Evidence Code.* The provisions of the California Evidence Code will apply to the arbitration hearing.**

***Cost of Arbitration and Attorney Fees.* The cost of the arbitration, including attorney fees, will be paid _ _**[*e.g., as determined by the arbitrator(s)/by the nonprevailing party unless the arbitrator(s) for good cause determine(s) otherwise*]**_ _.**

***Notice.* BY INITIALING IN THE SPACE BELOW, YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THIS "ARBITRATION OF DISPUTES" PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW, AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE**

BELOW, YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS THOSE RIGHTS ARE SPECIFICALLY INCLUDED IN THIS "ARBITRATION OF DISPUTES" PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY.

WE HAVE READ AND UNDERSTOOD THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION TO NEUTRAL ARBITRATION.

_____ _____

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Comment: Careful drafting is important. An arbitration clause that reads: "Disputes as to a breach of this contract must be resolved by binding arbitration" likely would only result in enforceable arbitration of contract claims and not of tort claims arising from the contractual relationship of the parties. See, *e.g., Bono v David* (2007) 147 CA4th 1055, 1067, 54 CR3d 837.

As with other methods of ADR, unlawful detainers should be excepted from arbitration or the landlord risks the loss of its right to a summary proceeding under CCP §§1159-1179a. On unlawful detainers, see California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002).

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V. REFERENCE

§6.40 A. Description of Procedure

The reference procedures in CCP §§638-645.1 combine features of arbitration and litigation. There are two types of reference:

- General (sometimes called "judicial") reference (CCP §638), to which the parties consent. The referee's report from a general reference is binding; and
- Special reference (CCP §639), which the court may impose on the parties in limited circumstances. The referee's report from a special reference is merely advisory. Special references are most commonly used by the courts in the areas of discovery disputes and accountings.

A principal difference between reference and arbitration is the right to appeal a decision of a referee. CCP §§644(a), 904.1(a)(1). Accordingly, a referee is bound to follow the rules of law, unlike an arbitrator, who is not bound by rules of law but may base a decision on broad principles of justice and equity. While this may give some predictability to the outcome of a decision, the formality may also increase the cost and time of the decision-making process. The decision in *Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229 (discussed in §§6.10, 6.30) may afford litigants a similar review with two caveats: first, the wording of an arbitration clause to provide for judicial review must be precise and, second, the review anticipated by *Cable Connection* is presumably at the trial court level whereas the reference process provides for review at the appellate level. An agreement providing for reference eliminates any question as to review and by what body as well as possible tangential litigation over the review process.

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§6.41 B. Contract Provisions for Reference; Prohibition on Jury Waivers

Although the statutes regarding reference were enacted in 1872, judicial reference was not commonly specified as an ADR method in contracts until the California Supreme Court issued its decision in *Grafton Partners v Superior Court* (2005) 36 C4th 944, 32 CR3d 5. The parties in *Grafton,* a limited partnership and its accounting firm, had signed an engagement letter providing that they would waive their rights to a jury in the event of a dispute. This type of provision was commonly found in commercial agreements, including most commercial leases, security agreements, and similar documents. Sophisticated parties took the position that juries might either be prejudiced against them or not fully comprehend the intricacies of their business or contractual agreements. Thus, an agreement to waive a jury would result in a court trial that would remove their disputes from the vagaries of a jury of ordinary citizens.

However, in *Grafton,* the California Supreme Court focused on CCP §631, enacted to implement California Constitution article I, §16, a provision intended to safeguard the right to jury trial. Code of Civil Procedure §631(d) provides for six specific ways to waive the right to jury trial, all of which are post-dispute and post-filing. A contractual pre-dispute agreement to a jury waiver, the court held, did not come within §631. The court noted that arbitration (and reference) provisions, however, are valid despite the fact that they, too, could be categorized as pre-dispute jury waivers. This is because "the Legislature has enacted a comprehensive scheme *authorizing* pre-dispute arbitration agreements (§1280 et seq.), expressing a strong state policy favoring arbitration." *Grafton,* 36 C4th at 964 (emphasis in original).

Post-*Grafton*, drafting attorneys and their clients have used the option of arbitration or reference in agreements to ensure that future disputes will not be subject to jury trial. In existing contracts with jury waivers, those waivers are unenforceable. In light of continued court congestion and, until recently, the lack of appellate review of arbitration awards (see §6.38), the alternative of reference is now receiving more attention.

NOTE: In federal court, however, federal law determines whether the right to a jury trial may be waived by an advance agreement. The Ninth Circuit has held that a jury trial waiver is an enforceable contractual right, although such waivers are to be construed narrowly. *Paracor Fin., Inc. v General Elec. Capital Corp.* (9th Cir 1996) 96 F3d 1151, 1166 n2l. Nor do the Federal Rules of Civil Procedure provide for reference or appointment of a referee. However, there are provisions for stipulation to trial before a United States Magistrate rather than a judge. 28 USC §636(c).

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§6.42 C. Judicial Reference

Judicial reference requires the agreement of the parties. That agreement may be either by pre-dispute contract or by stipulation after a dispute has arisen. In either case, any party to the contract or stipulation may move the court for an order directing reference. CCP §638. However, in *TREO @ Kettner Homeowners Ass'n v Superior Court* (2008) 166 CA4th 1055, 83 CR3d 318, the court of appeal ruled that such a clause in the covenants, conditions, and restrictions (CC&Rs) of a homeowners association does not qualify as a "contract" for this purpose. The court of appeal did not consider whether such a jury waiver is unconscionable. See also *Villa Milano Homeowners Ass'n v Il Davorge* (2000) 84 CA4th 819, 102 CR2d 1 (CC&Rs may be construed as contract in various circumstances, but finding arbitration clause in CC&Rs to be unconscionable).

The supreme court accepted for review a decision interpreting the law governing a judicial reference clause in a lease on a dispute involving multiple parties. The court of appeal in *Tarrant Bell Prop. v Superior Court* (review granted Feb. 18, 2010, S179378; superseded opinion at 179 CA4th 1283, 102 CR3d 235) ruled that the trial court had discretion to deny enforcement of the judicial reference clause if there was a possibility of conflicting rulings or other circumstances related to judicial economy, similar to that given to trial courts under CCP §1281.2(c) to deny enforcement of an arbitration agreement.

The parties define the scope of the reference (either the entire dispute or portions of it), they select the referee, and they may define or limit the conduct of the reference to include or exclude discovery, specify location, and allocate costs and expenses. An action is filed in superior court, which retains jurisdiction over the matter. If the parties cannot agree to a specific referee, CCP §640(b) includes a mechanism for selection of a referee by the court. The referee, whether selected by the parties or the court, is appointed by the court under CCP §640(a) and Cal Rules of Ct 3.901-3.902. Objections to a specific referee are allowed under CCP §641; they must be in writing and are ruled on by the court, not the referee. CCP §642; Cal Rules of Ct 3.905.

A referee must consent to serve and agree to be bound by Canon 6 of the Code of Judicial Ethics and to make certain disclosures as would other judicial officers. Cal Rules of Ct 3.904. After appointment, the parties' agreement as to the conduct of the reference dictates the process by which the litigation proceeds. Within 20 days after the hearing, the referee submits a Statement of Decision to the superior court. CCP §643. That decision stands as the decision of the court itself and, if it encompasses all of the issues in the case, judgment may be entered on it. CCP §644(a). The superior court does not review the Statement of Decision de novo but is bound by it. If judgment is entered on the referee's determination, that judgment is appealable to the court of appeal. CCP §645.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/6 Alternative Dispute Resolution/§6.43 1. Reference by Contract

§6.43 1. Reference by Contract

Drafting counsel may provide for reference as a type of ADR. Immediately after the *Grafton* decision, there was some movement to enact legislation to statutorily provide for jury waivers, but to date those efforts have not proved fruitful. Currently, many practitioners include language immediately prior to a reference provision along the lines of the following:

***Waiver of Jury Trial*. To the extent now or hereafter permitted by law, the Parties hereby waive their respective rights to trial by jury of any cause of action, claim, counterclaim, or cross-complaint in any action, proceeding, or other hearing on any matter whatsoever arising out of or relating to this Agreement, the relationship of the Parties, any claim of injury or damage, or the enforcement of any remedy under any law, statute, regulation, code, or ordinance, emergency or otherwise, now or hereafter in effect. If the jury waiver provisions of this section are not enforceable under California law, then the following provisions will apply.**

_____ _____

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Such a provision is intended to "spring into effect" if the legislature subsequently enacts laws allowing for pre-dispute jury waivers (*i.e.,* overturning *Grafton*).

WARNING: Contractual reference provisions are generally held to the same standard of conscionability as are arbitration clauses. In *Thompson v Toll Dublin, LLC* (2008) 165 CA4th 1360, 81 CR3d 736, a court ruled that both the arbitration and reference provisions in a contract of adhesion were unconscionable and unenforceable. Similarly, a judicial reference provision in a homeowner association's covenants, conditions, and restrictions was ruled unenforceable in *TREO @ Kettner Homeowners Ass'n v Superior Court* (2008) 166 CA4th 1055, 83 CR3d 318.

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§6.44 2. Reference by Stipulation

If the parties have no contractual obligation to submit to reference, they may stipulate to reference post-dispute, even after litigation has been filed. Such a stipulation may be limited to specific issues framed by the pleadings and the facts of the case (*e.g.,* "Was the property manager acting as the agent of the defendant?" "Did the parties enter into a binding agreement?") or can include all issues raised in the action. Post-dispute stipulations allow counsel and the parties to specify precisely which issues they wish adjudicated in order to narrow the issues remaining in the court system or position the case for settlement.

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§6.45 D. Drafting Considerations

In drafting either pre-dispute contractual provisions or post-dispute stipulations for reference, counsel should consider the following:

- **Qualifications of referee.** The parties may designate a specific individual. This is a simple proposition if the reference is agreed to post-dispute. For contractual reference, it is more useful to describe the individual's qualifications (*e.g.,* "a retired judge with JAMS," or "an attorney with a minimum of 15 years of experience in real estate litigation involving shopping centers"). The parties may also allow the superior court to designate the referee under CCP §640. Code of Civil Procedure §641 provides for objections to appointments. See also Cal Rules of Ct 3.903, 3.905.
- **Location of hearing.** Pre-dispute reference agreements may include the county in which the action will be filed and the location of the hearing. A post-dispute stipulation for reference may also provide for the location of the hearing (*e.g.,* "at the offices of counsel for defendant"). The California Rules of Court hold that when the parties use the services of a privately compensated referee, they have elected "to proceed outside the courthouse" and cannot use court facilities or court personnel without a finding by the presiding judge that such use would further the interests of justice. Cal Rules of Ct 3.909(a). Notice of a case pending before a referee must be posted in the courthouse and the reference hearing "must be heard at a site easily accessible to the public and appropriate for seating those who have notified the court of their intention to attend hearings." Cal Rules of Ct 3.909(b), 3.910. These rules emphasize the fact that unlike arbitrations, which are outside of the court's and the public's purview, a reference proceeding is part of the court's business and is as open to the public as any trial or other courtroom proceeding.
- **Provisional relief.** Consider whether remedies such as preliminary injunctions and other provisional relief should be subject to the reference provision. The process and notice periods for appointment of a referee may cause delays that would prove unacceptable to a party in need of the relatively rapid action of a court in such circumstances. Similarly, the parties may wish to exclude certain types of cases, such as unlawful detainers or small claims court actions, from a reference provision.
- **Discovery.** The parties to a reference agreement or stipulation have the ability to restrict discovery entirely or to limit it in scope or amount. Such limitations should be expressly itemized in the agreement or stipulation to avoid future misunderstandings and to allow the process to proceed smoothly.
- **Conduct of the hearing.** The referee should follow the law, including the rules of evidence. Generally, reference hearings are held in a conference room, similar to an arbitration hearing. Although the rules of evidence may be somewhat relaxed due to the setting, the referee's decision arising from the hearing is entered as a judgment by the clerk of the court and is appealable. Parties to a reference should retain a court reporter in order to have a complete record in the event of appeal.
- **Costs and expenses.** The reference procedure requires the parties to pay all costs, including the referee's compensation, as agreed by the parties. The parties may agree in writing to a rate of compensation and a manner of allocation. If the parties are unable to agree, the court may order the parties to pay the referee's fees in any fair and reasonable manner, including apportionment among the parties. The parties must also bear the expense of a court reporter, if used. CCP §§645.1, 1023.

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§6.46 E. Advantages and Disadvantages of Reference

- **Time to resolution.** Reference avoids court congestion. The referee is required to report a statement of decision as agreed by the parties and approved by the court. The parties set the pace of the litigation, subject to the schedule of the referee. The rules of evidence and procedure provide a structure for the litigation.
- **Expense.** Though a superior court judge is paid by the state, the hourly rate of a retired judge or other qualified referee may be substantial, but not necessarily more than that of a qualified arbitrator or panel. In an arbitration, if the parties agree that the arbitrator be bound by the law and subject to review for error, then the need and cost of the court reporter is the same.
- **Discovery.** The parties are entitled to discovery, but may agree to limit the scope and amount of discovery.
- **Finality and judicial review.** The referee's decision is entered like any judgment and is subject to appeal.
- **Expertise.** The parties can agree on a method of selection and the qualifications of the referee. In the absence of agreement, the court will appoint a referee just as in arbitration.
- **Privacy.** The reference proceeding is as public as any superior court litigation, but usually attracts less attention than a trial held at the court. The referee has the same powers as a superior court judge to enter protective orders.
- **Rules of Evidence.** The rules of evidence apply.
- **Settlement and compromise.** Referees, often retired judges, are accustomed to making decisions and unlikely to "compromise" the decision in a manner not provided by a rule of law.
- **Satellite litigation.** All necessary parties may be subpoenaed before the referee and all issues subject to the court's jurisdiction may be heard in one proceeding.

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§6.47 F. Form: Reference

***Submission to Reference*. In the event of any dispute, claim, controversy, or breach arising out of or relating to this Agreement, other than _ _[*e.g., unlawful detainer or any action for equitable or injunctive relief*]_ _, either Party may apply to the superior court of the County of _ _[*name of county*]_ _ for the appointment of a referee to hear the dispute in accordance with California Code of Civil Procedure §§638-645.2, for a determination that will be binding on the parties as if tried before a court or jury.**

***Selection and Qualifications of Referee*. Within _ _[*e.g., 5*]_ _ business days after service of a demand by a Party to this Agreement or the issuance of an order directing a trial by reference under California Code of Civil Procedure §638, the parties will agree on a single referee who is _ _[*e.g., a retired judge, licensed real estate broker*]_ _ and who will try all issues, whether of fact or law, and then report a finding or judgment. If the parties are unable to agree on a referee, either party may seek to have one appointed, under the procedure set forth in California Code of Civil Procedure §640(b). The referee will have the power to award damages and all other relief.**

***Cost of Reference and Attorney Fees*. The compensation of the referee will be the fee customarily charged by the referee for like services. The cost of the proceedings will initially be paid equally by the Parties. However, the prevailing party in the proceedings will be entitled, in addition to all other costs, to recover its contribution for the cost of the reference as an item of damages and recoverable costs in addition to all other costs, including attorney fees.**

***Conduct of Reference*. A reporter will be present at all proceedings, and the reporter's fees will be borne equally by the parties, subject to adjustment or allocation by the referee in favor of the prevailing party. The fees will be an item of recoverable costs.**

***Application of California Law and Procedure*. The referee will apply all California substantive and procedural law, including the Codes of Civil Procedure and Evidence, in deciding the issues to be heard. The Parties will have all rights of discovery permitted by the Code of Civil Procedure[.]**

[*add if appropriate*]

, except that the time periods will be shortened by agreement or by order of the referee, and the extent of discovery will also be limited, with the goal of completing all discovery within _ _[*e.g., 60 calendar days*]_ _.

***Referee Decision to Be Court Judgment*. The referee's decision under California Code of Civil Procedure §644 will stand as the judgment of the court, subject to appellate review as provided by the laws of the State of California. The referee will submit a reasoned statement of decision, citing both the law and the evidence relied on. After entry of judgment by the superior court, the judgment may be reviewed in the court of appeal under California Code of Civil Procedure §645.**

Comment: These reference clauses can be tailored to include some or all of the parties' disputes. As is the case with other forms of ADR, unlawful detainer matters should be specifically excluded or the landlord will lose its right to a summary proceeding under CCP §§1159-1179a. On unlawful detainers, see California Real Property Remedies and Damages, chap 10 (2d ed Cal CEB 2002).

The reference clause may specify the source for the reference judge, such as (1) a private "rent-a-judge" company, (2) a list of available retired judges maintained by a local court, or (3) a list of arbitrators maintained by a private arbitration organization. Parties may object to the appointment of a particular referee for lack of competence or for actual or apparent conflict of interest, bias, or prejudice. CCP §641. If the parties cannot agree on a referee, the court will select one. CCP §640. For more on judicial reference, see Drafting Business Contracts: Principles, Techniques & Forms §§16.42-16.46 (Cal CEB 1994).

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7

Broker Compensation and Claims

Lawrence H. Jacobson

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I. HOW BROKERS ARE COMPENSATED

§7.1 A. Setting the Commission

The amount of commission a broker receives in a successful transaction is governed by the listing agreement negotiated by the parties. On listing agreements generally, see chap 2; for form provisions contained in the listing agreement, see §§2.27-2.49; for provisions dealing specifically with broker commissions, see §§2.37-2.43. Commissions vary according to the broker, the region, the type of property, the type of transaction, and the relative bargaining positions of the parties to the agreement. If the listing agreement does not fix the amount, a reasonable commission will be allowed. *Beazell v Schrader* (1963) 59 C2d 577, 30 CR 534.

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§7.2 1. General Practice

Brokers commonly charge a percentage of the selling price or total rents to be paid, although occasionally a broker will accept a flat fee. In California, the exclusive right-to-sell and exclusive right-to-lease listing agreements are the most commonly used form of listing and broker employment agreements. See §§2.21-2.22. In large transactions, the property owner may prefer a schedule of declining percentages. The commission due under a percentage arrangement on a sale of property is generally computed on the total sale price regardless of the dollar amount of the encumbrances on the property.

In a commercial or industrial lease, if the commission is based on the stream of rental payments by a tenant (particularly if the broker is also the property manager), the commission may also include a percentage of other items, such as the tenant improvement allowance or common area fees. In some commercial leasing transactions, the commission is paid on an installment basis; that is, as annual rent is paid, the leasing commission for that year is also paid. This prevents full payment of the commission if the tenant abandons the premises early or payment of a second commission when a replacement tenant is found. For more on commercial leasing generally, see Retail Leasing: Drafting and Negotiating the Lease (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease (Cal CEB 1996).

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§7.3 2. Buyer Representation Agreement

A strong trend in California is the use of a "buyer representation agreement," which provides that the buyer will pay the commission to the buyer's broker if the seller does not. Some brokerages encourage their buyer clients to enter into such agreements in order to (1) avoid disputes with other brokers over "procuring cause" issues (see §§7.16-7.20) and (2) to ensure payment of commissions when the brokers introduce their buyers to properties that may eventually be acquired by the clients. These agreements generally identify the properties and the parameters of the property search (*e.g.,* property types, time period for acquisition, price range, and geographical location). See the California Association of Realtors® (CAR) Buyer Representation Agreement—Exclusive (CAR form BRE), discussed in §2.50. The CAR form is available to CAR members on the organization's website. See Directory for CAR's website information.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.4 3. Pocket Listing

§7.4 3. Pocket Listing

A "pocket listing" is a listing that is not entered into the Multiple Listing Service (MLS; see §§1.11-1.14) for a period of time (or that may not be entered at all). The listing agreement between the property owner and broker may be in writing or may be oral. If the agreement is oral, enforcement of the commission provisions is at best problematic, and it may be impossible. See discussion of the Statute of Frauds (CC §1624) in §§2.6-2.7, 2.15, 7.14-7.15. Pocket listings tend to be popular in two instances: (1) in times and areas where competition for properties is intense, a so-called "seller's market," because the listing broker has more time to develop one of its own buyers (thereby earning the full commission rather than sharing it with a cooperating broker); and (2) when the owner or tenant of the property has a high profile or requires privacy, perhaps because of some notoriety attached to the owner or property or because the owner or tenant is a celebrity or well-known person.

Although some brokerages encourage pocket listings, many discourage them for a number of reasons, including:

- Pocket listings may violate the rules of the local MLS, which could fine the brokerage and salesperson or bar them from future use of the MLS (see §§1.11-1.12);
- Exclusion from the MLS may limit exposure of the property, resulting in fewer offers and thus violate the broker's fiduciary duties to the client (see chap 3); and
- Salespersons may not inform their broker or other salespersons in their office of the listing until they have secured a buyer themselves (see discussion of the relationship between salespersons and brokers in §§8.32-8.42).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.5 4. Other Types of Compensation Agreements

§7.5 4. Other Types of Compensation Agreements

In addition to an exclusive right-to-sell or right-to-lease listing, other types of listing agreements providing for broker compensation include:

- Exclusive agency agreement (see §2.23);
- Open listing agreement (see §2.24);
- "One party" or "single party" listing agreement (see §2.25); and
- Net listing agreement (see §2.26).

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§7.6 5. Quantum Meruit

Quantum meruit is a common count or common law cause of action that may be available to a broker who rendered services to another with some expectation or understanding that he or she would be compensated for doing so. It is based on the quasi-contractual principle that the law will imply a promise to pay for services performed under circumstances indicating that the services were not performed gratuitously. *Huskinson & Brown v Wolf* (2004) 32 C4th 453, 458, 9 CR3d 693 (concerning legal services provided). It refers to an obligation created by law without regard to the parties' intentions. It is appropriate in situations when a party should be held accountable to another on the ground that otherwise one party would be unjustly enriched and the other would unjustly suffer a loss. *California Emergency Physicans Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 4 CR3d 583; *Hedging Concepts, Inc. v First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1419, 49 CR2d 191. The broker need not prove the existence of a contract to recover in quantum meruit. *Huskinson*, 32 C4th at 458. Quantum meruit may also be available when services have been rendered under a contract that is unenforceable, either because it is not in writing or for other reasons. See *Iverson, Yoakum, Papiano & Hatch v Berwald* (1999) 76 CA4th 990, 996, 90 CR2d 665.

To recover on a quantum meruit claim for the reasonable value of services rendered to the principal, the broker must establish that

- In performing the services, the broker was acting in accordance with an express or implied request from the defendant; and
- The services rendered were intended to, and in fact did, benefit the principal.

Ochs v PacifiCare of Cal. (2004) 115 CA4th 782, 794, 9 CR3d 734; *Day v Alta Bates Med. Ctr.* (2002) 98 CA4th 243, 248, 119 CR2d 606. The measure of recovery in quantum meruit is "the reasonable value of the services rendered provided they were of direct benefit to the defendant." *Day*, 98 CA4th at 249. Recovery in quantum meruit is not appropriate if it would frustrate the law or public policy. *Ochs*, 115 CA4th at 794.

WARNING: Generally, a broker would seek recovery of unpaid commissions through a breach of contract action. However, a broker cannot recover his or her commission without a writing that satisfies the Statute of Frauds (CC §1624). See §§2.6-2.7, 2.15, 7.14-7.15. Quantum meruit, if available, may allow a broker who does not have a written commission agreement to recover for services other than brokerage or incidental services. The broker must thus prove that he or she had performed services other than those that a broker "would reasonably be expected to perform." *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 241 CR 22.

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§7.7 6. Restrictions on Compensation

Broker attempts to set the amount of their commissions have been subject to several legal constraints. Agreements among brokers to fix commission rates violate federal and state antitrust laws. In *McLain v Real Estate Bd.* (1980) 444 US 232, 62 L Ed 2d 441, 100 S Ct 502, the Supreme Court held that the effect of brokerage activities on interstate commerce was sufficient to establish jurisdiction under the Sherman Antitrust Act (15 USC §§1-7). Local boards of real estate licensees have also been held subject to the Cartwright Act (Bus & P C §§16700-16770), which forbids or declares unlawful three specific arrangements: (1) trusts, (2) agreements in violation of the Act itself, and (3) certain exclusive dealing and tying agreements. *Marin County Bd. of Realtors, Inc. v Palsson* (1976) 16 C3d 920, 130 CR 1; *Glendale Bd. of Realtors v Hounsell* (1977) 72 CA3d 210, 139 CR 830.

California statutes and regulations further restrict broker activity in establishing commission rates. For example, Bus & P C §10147.5 requires the following with respect to sales of property consisting of less than four residential units:

- Printed listing agreement forms must state that the commission is not fixed by law and may be negotiated between the property owner and the broker; and
- The commission amount must not be printed in any listing agreement.

In addition, a listing broker cannot claim or receive a commission under an exclusive listing unless the agreement contains a "definite, specified date of final and complete termination." Bus & P C §10176(f).

PRACTICE TIP: The requirement in Bus & P C §10176(f) that an exclusive listing agreement contain a specific termination date sometimes becomes a problem for unwitting brokers of new housing or construction. In instances when the broker invests significant time and resources marketing property that is not yet developed, some brokers include as the termination date in the listing some period of time, for example, "*one year following the owner's receipt of the certificate of occupancy for the property*," without knowing when the certificate in fact will be issued. Under a strict interpretation of the statute, the broker would be barred from collecting the commission if disputed by the owner or developer. See, *e.g., Dale v Palmer* (1951) 106 CA2d 663, 235 P2d 650. But see *Schaffter v Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 754, 83 CR3d 19, in which the court stated "courts, however, have uniformly rejected *Dale v Palmer's* harsh rule when, as here, the broker seeks earned commissions" rather than commissions for services not yet performed under the contract.

Regulations of the Real Estate Commissioner subject brokers to discipline for stating or implying to a property owner that the broker is precluded by law, regulation, or the rules of an organization from charging less than the commission the broker has quoted. Bus & P C §§10167, 10177.

In *Bartley v California Ass'n of Realtors* (1980) 115 CA3d 930, 173 CR 284, allegations that a widely used CAR broker agreement for employment of an independent-contractor salesperson provided for a fixed commission rate were held insufficient to support a cause of action for an antitrust civil conspiracy.

On drafting and reviewing compensation provisions in a listing agreement and for forms, see §§2.20-2.49.

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§7.8 B. Compensation Disputes

Disputes concerning broker compensation arise in several ways. For example:

- A transaction closes and a broker asserts a right to a fee.
- Either principal breaches the agreement to close thus giving the broker a potential claim for commission even though the transaction did not close.
- The property owner refuses to proceed with the transaction even though the broker produced a buyer or tenant ready, willing, and able to buy or lease the property according to the terms of the listing agreement.
- A third party allegedly interferes with the agency relationship between the principal and the broker.

The real estate broker's claim for compensation is generally brought against the principal (§§7.21-7.24) or another broker (§§7.25-7.48). In residential transactions, the most common fee disputes are between brokers and relate to the allocation of the fee. In commercial transactions, the most common disputes tend to be between broker and principal over application of the "sunset" or "safety" clause in the listing agreement. See §7.21.

Compensation disputes involving residential transactions (whether between broker and principal or broker and broker) may be resolved by arbitration through procedures adopted by CAR. See §1.8. Commercial brokerage firms may submit commission disputes with principals to, for instance, the American Arbitration Association (AAA), the National Arbitration Forum (NAF), Judicial Arbitration and Mediation Services, Inc. (JAMS), or any number of local dispute resolution companies or solo providers. See discussion in §6.34. Those who are members of the AIR Commercial Real Estate Association (AIREA) submit commission disputes between brokers to that organization for arbitration. The AIREA arbitration manual, agreement, and procedures are available on the AIREA website. See the Directory for details.

NOTE: Listing agreements with arbitration or mediation provisions generally require that both the broker and the principal specifically initial these provisions in order to trigger the requirement. Many brokers fail to do so, the result of which is that the commission dispute is litigated rather than subjected to alternative dispute resolution.

On the different regulations affecting brokers and salespersons, see chap 8. On agency law, see chap 2. On alternative dispute resolution of broker disputes (broker versus principal), see chap 6. On CAR dispute resolution (broker versus broker), see §§7.25-7.48. On litigation of broker claims, see chaps 11-13.

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§7.9 II. NECESSARY ELEMENTS OF A CLAIM FOR COMPENSATION

There are three required elements to a claim for services rendered in connection with real property:

- The broker or salesperson who performed the services had a valid California real estate license at the time the services were rendered (Bus & P C §10136). See §§7.10-7.13.
- The obligation to pay compensation is reflected in a writing sufficient to satisfy the Statute of Frauds (CC §1624). See §7.14.
- With all types of listing agreements (other than exclusive right-to-sell or right-to-lease agreements), the broker procured a ready, willing, and able buyer or tenant, prepared to buy or lease the property on terms consistent with the listing agreement.
- In open listing agreements (see §§2.24), as in most types of listing agreements, the broker must be the "procuring cause" (see §§7.16-7.20) of the purchase agreement or lease between the principals.
- In exclusive agency agreements (see §2.23), the broker is entitled to a commission when the transaction is completed unless the property owner was the "procuring cause" of the transaction.
- In exclusive right-to-sell and right-to-lease listing agreements (see §2.21-2.22), the broker is entitled to the commission when the transaction is completed regardless of who is the "procuring cause."

In addition to the above requirements, which are applicable to any claim for compensation, the broker must be prepared to satisfy any other elements of the claim that may be unique to that particular transaction. For a form of complaint, see California Real Property Remedies and Damages §4.91 (2d ed Cal CEB 2002); California Civil Procedure Before Trial, chap 15 (4th ed Cal CEB 2004).

PRACTICE TIP: It is incumbent on broker's counsel to carefully evaluate any potential commission claim against a principal, fully apprise the broker client of the inherent risks in going forward, and then exhaust all available means to resolve the commission dispute with the principal prior to commencing litigation. Evaluation of a broker commission claim must include the strong possibility that the property owner will cross-complain against the broker once the owner is sued for a commission. The filing of the cross-complaint often frames the real issues in the dispute. Because the fiduciary relationship sets such a high standard of care on the part of the broker, the owner's cross-complaint often places the broker on the defensive—knowing that a finding of a breach of fiduciary duty against it not only will result in the loss of the commission, but likely will expose the broker to significant other damages, including attorney fees and costs. On broker fiduciary duties, see chap 3. On defending brokers in suits brought by principals and others, see chaps 11-13.

The filing of a cross-complaint against the broker also requires the broker to tender the cross-action to its errors and omissions (E&O) insurance carrier, and this alone may create additional issues that may affect the broker's bottom line. For example, and depending on its terms, the policy may require the broker to retain another attorney to defend the cross-action, at the broker's expense and up to the deductible (retention) under the policy. In such a case, the broker is now paying two separate attorneys: one to pursue the commission and another to defend the cross-complaint. If the E&O insurance contains a high deductible, the broker is in a "lose-lose" situation long before the commission action ever gets to trial. On broker E&O liability insurance, see chap 10.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.10 A. Valid License Required

§7.10 A. Valid License Required

Business and Professions Code §10136 provides:

> No person engaged in the business or acting in the capacity of a real estate broker or real estate salesmen within this State shall bring or maintain any action in the courts of this State for the collection of compensation for the performance of any of the acts mentioned in this Article without alleging and proving that he was a duly licensed real estate broker or real estate salesman at the time the alleged cause of action arose.

The phrase "at the time the alleged cause of action arose" means the broker must hold a valid license when performing the services that require a license. *Firpo v Murphy* (1925) 72 CA 249, 236 P 968. Brokers who perform services before receiving their licenses or while their licenses are suspended or revoked, may not maintain an action to recover a commission, even if they later obtain their licenses or have their licenses reinstated (even if they do so before filing the complaint). *Davis v Chipman* (1930) 210 C 609, 293 P 40. Brokers cannot cure the failure to perform services without a license. This is not merely a procedural matter. The failure to have a license at the time the services are rendered is an absolute bar to an action to collect a real estate commission. An affirmative representation that the broker was licensed at the time the services were rendered is a necessary allegation in the complaint; however, it is not necessary to have a license at the time the complaint is filed. A properly licensed real estate broker who performs services and whose license then lapses or is suspended or revoked may successfully maintain a suit for the recovery of compensation earned while the license was in effect. Bus & P C §10136.

Moreover, there is no alternative recovery in quantum meruit (see §7.6) for providing brokerage services while unlicensed, even if the party against whom the commission is sought has received the benefit of the services. The courts have consistently held that the purpose of the statutes regulating real estate licenses is to protect the public. *Firpo*, 72 CA at 253. The sanction for failing to have a license is the denial of any recovery of a commission. The actual performance and the acceptance of that performance will not defeat this absolute bar to recovery.

If an unlicensed broker enters into an agreement to provide both services that require a license and services that do not, the broker may seek compensation for the services for which no license is required. In *Venturi & Co. LLC v Pacific Malibu Dev. Corp.* (2009) 172 CA4th 1417, 92 CR3rd 123, a broker entered into a contract to act as a financial advisor with an owner of real property. The broker never located any financing for the project and the owner eventually organized his own financing. The unlicensed broker sued in quantum meruit for the reasonable value of its services. The court held that although the broker was barred from collecting compensation for real estate brokerage services it may have provided, it was not barred from compensation for services (if any) that were not real estate brokerage services (*e.g.*, financial consulting).

If a salesperson performs the services (rather than the broker), both the salesperson and the broker must have valid licenses when the services are performed. Bus & P C §§10136-10137; *Firpo*, 72 CA at 252. Neither an unlicensed broker nor an unlicensed salesperson (even if the broker is licensed) may recover a commission for services performed while unlicensed. *Firpo*, 72 CA at 254.

The broker does not have to hold a valid license when entering into a listing or other employment agreement. The broker must only have a valid license before commencing the actual services which require the license. *Ridich v Cernokus* (1924) 65 CA 452, 224 P 124. Nevertheless, the list of activities requiring a license is long and the consequences of performing services while unlicensed is severe. See Bus & P C §§10131-10131.7; §8.2.

A corporate broker must have a valid corporate license. Bus & P C §10130. It is not sufficient that the shareholder or president have an individual license. If the corporation is the contracting party, the corporation must be separately licensed even if the services are performed by the broker. Bus & P C §§7031(a), 10006, 10130; *Opp v St. Paul Fire & Marine Ins. Co.* (2007) 154 CA4th 71, 64 CR3d 260.

On licensing requirements generally, see chap 8.

PRACTICE TIP: There is a common misconception that in California attorneys are immune from the real estate licensure requirement. If acting as a broker or salesperson, attorneys may not collect a commission unless they

are licensed by the Department of Real Estate (DRE). In general, the educational requirements imposed on attorneys by the California State Bar Association will satisfy the educational requirements imposed on real estate licensees by the DRE; however, attorneys must still comply with all other DRE requirements, including passing licensing exams and meeting standards of ethical or moral conduct. An attorney who is solely rendering legal services to a real estate client need not be licensed by the DRE (Bus & P C §§10133(a)(3), 10133.1(a)(5)). See chap 8.

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§7.11 1. Salesperson's Right to Compensation

It is illegal for a salesperson to directly enter into a listing agreement with a property owner or to receive compensation directly from the compensating party. A broker performs specified services for members of the public, but a salesperson must be employed by a real estate broker and may perform services requiring a license only under the employment of a broker. The statutory scheme is based on broker supervision of the salesperson. See *Grovel v Griesinger* (1958) 160 CA2d 397, 406, 325 P2d 475. The broker, therefore, is the real party to the listing agreement. The salesperson's compensation flows entirely through the broker because the salesperson's rights are entirely derivative of the broker's rights. Bus & P C §10137. Thus the broker is also the plaintiff in any litigation or alternative dispute procedure to recover a commission due to a salesperson's efforts. On the relationship between brokers and salespersons, see §§8.32-8.42.

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§7.12 2. Finder's Right to Compensation

Unlike a broker (or a salesperson working for a broker), who may both introduce the parties and participate in negotiations, a finder is "one who simply finds and introduces two parties to a real estate transaction." *Tyrone v Kelley* (1973) 9 C3d 1, 106 CR 761. A finder is not required to be licensed. Finders, however, must strictly limit their activities to the introduction of parties. Any other participation in the transaction runs the risk of performing services that require a license. A broker has the discretion to advise or negotiate and therefore must have a license. See generally *McConnell v Cowan* (1955) 44 C2d 805, 285 P2d 261 (dual representation).

An unlicensed person acting merely as a finder may be paid a finder's fee. *Tyrone v Kelley, supra; McConnell v Cowan, supra*. However, numerous state and federal laws prohibit payment of referral fees in residential transactions. See discussion of brokers and finders in §§8.15-8.18.

PRACTICE TIP: Unlicensed "finders" are virtually never used in residential transactions due to restrictions under the Real Estate Settlement Procedures Act (RESPA) and state law. Licensed finders (*i.e.,* licensed brokers or salespersons) who introduce a client or a property are customarily compensated through a written referral fee agreement. Unlicensed finders are sometimes used in the area of business opportunity brokerage (see §8.27), in which salespersons and brokers often hear of potential clients by word of mouth and sometimes even use finders to canvass neighborhood businesses. Finders are rewarded (usually out of the broker's commission at close of escrow) if a transaction results from information they have provided. See §§8.16-8.18 on RESPA and the hazards of paying referral fees.

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§7.13 3. Out-of-State Transactions

A broker in California assisting parties in the sale or lease of real estate located in another state, or assisting residents of another state in the purchase or lease of real estate in California must determine whether, and to what extent, the broker must comply with the licensing laws of the other jurisdiction.

EXAMPLE: Owner is a California resident represented by a California broker, and buyer is a Nevada resident represented by a Nevada broker. Generally, a California broker who represents California residents in connection with the acquisition of land located *outside* of California is not required to have a license in the jurisdiction in which the real property is located, only in the jurisdiction where the services are performed. See *Cochran v Ellsworth* (1954) 126 CA2d 429, 435, 272 P 2d 904.

As a general rule, a contract with out-of-state brokers to sell property located out-of-state even to California residents is not invalidated by the fact that the out-of-state brokers are not licensed in California, provided they do not perform services requiring a license in California. See generally *Consul Ltd. v Solide Enterprises* (9th Cir 1986) 802 F2d 1143, 1149.

These issues also arise in connection with co-brokerage arrangements with out-of-state brokers.

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B. Compliance With Statute of Frauds

§7.14 1. Application to Brokers

To maintain an action to recover a real estate commission from a principal, the agreement providing for the commissions must be in writing and must satisfy the requirements of the Statute of Frauds (CC §1624). See §§2.6-2.19. This is an absolute requirement. Recovery is not permitted based on partial performance, quantum meruit, or estoppel. *Phillippe v Shapell Indus.* (1987) 43 C3d 1247, 241 CR 22; *Pacific S.W. Dev. Corp. v Western Pac. R.R.* (1956) 47 C2d 62, 301 P2d 825. Compare *Tenzer v Superscope, Inc.* (1985) 39 C3d 18, 216 CR 130, holding that a finder (*not a broker*) was entitled to invoke the doctrine of estoppel to overcome the Statute of Frauds.

There is no requirement that an agreement between brokers to split a commission be in writing, although best practice is to have a clear, written agreement in such instances. This may take the form of a letter agreement or any other clearly written expression of the agreed terms. See, *e.g.,* CAR's preprinted Cooperating Broker Commission (CAR form CBC) or Referral Fee Agreement (CAR form RFA). The CAR forms are available to CAR members on the organization's website. See Directory for CAR's website information.

In *Phillippe v Shapell Indus., supra,* the California Supreme Court noted that (1) written agreements avoid confusion and ensure that the parties are fully aware of their obligations and (2) real estate brokers, by virtue of their licenses, should know that to be enforceable, their compensation agreements must be in writing.

Some courts recognize a limited exception to the Statute of Frauds prohibition by finding that the writing requirement is satisfied even though the term of the writing has expired. See *Torelli v J.P. Enters.* (1997) 52 CA4th 1250, 61 CR2d 76. In *Torelli*, a listing broker produced a potential buyer after his listing agreement with the owner had expired. However, the broker prepared an offer, which included payment of a commission to the seller, who countered with an offer that also included a commission payment. The counteroffer also expired, and the seller and buyer then negotiated the transaction on primarily the same terms, but without a commission to the broker. The court awarded the broker his commission, reasoning that because the seller received the primary benefit of the broker's services—the finding of a buyer—the seller could not then accept the buyer's terms less the commission; to do so would violate the covenant of good faith and fair dealing implied in every contract. The court seemed satisfied that the seller's signing of the original counteroffer with the promise to pay a commission was sufficient compliance with the Statute of Frauds.

In general, courts may be becoming more lenient in the application of the Statute of Frauds so as not to frustrate the expectations of the parties and to give meaning and enforceability to agreements. See, *e.g., Sterling v Taylor* (2007) 40 C4th 757, 152 P3d 420, 55 CR3d 116 (note or memorandum satisfies Statute of Frauds; only essential terms must be stated, details or particulars need not be).

The Statute of Frauds rarely becomes an issue in commission disputes involving standard form listing agreements because such agreements contain commission clauses and are thus evidence of the obligation to pay a commission. In California, residential property is seldom, if ever, marketed without a listing agreement, except in the case of oral pocket listings (see §7.4). The same is generally true for commercial and industrial properties.

WARNING: Some brokers are more aggressive than careful in attempting to develop business. Whether in search of a better deal or reluctant to commit, some potential property owners avoid signing exclusive listings, preferring instead to tell the broker, in effect, "If you have a client, bring him to me; when we reach a deal, I will pay you a commission." Faced with the prospect of either passing on a deal or relying on the owner's good faith if a buyer is produced, some brokers proceed without the written agreement (in effect, entering into a "pocket listing"). They do so at their peril and frequently find that their time and effort has resulted only in a "gift" of services. When faced with a pocket listing situation, a broker should not introduce the client to the property without first getting the owner to agree to a single party listing agreement (providing that a commission is paid only if a specific client concludes the transaction, see §2.25). Even then, out of an abundance of caution, the broker may exclude the identity of the client until the single party agreement is actually signed by the owner. The broker's "value" is the identity of the client; once introduced to the owner, the broker loses all bargaining power with the owner, as there

is no "writing" ensuring the commission and no prohibition of the owner negotiating a sale directly with the client. An alternative way to avoid this problem is to require the client to first enter into a buyer representation agreement (see §§2.50, 7.3), which obligates the client to pay the commission at closing in the event the owner refuses to do so.

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§7.15 2. Application to Finders

State and federal law all but prohibit compensating "finders" in residential transactions. In nonresidential contexts, however, courts have extended the Statute of Frauds (CC §1624) requirement to claims by finders. See discussion in §7.12. A finder who claims a fee for introducing the prospective parties must have a written fee agreement. *Tenzer v Superscope, Inc.* (1985) 39 C3d 18, 216 CR 130. Courts, however, do distinguish between licensees (brokers and salespersons) acting as finders and nonlicensees acting as finders. The rationale that licensees should not receive quantum meruit (because they should have known that a writing was required) does not apply to nonlicensees (see §7.6). A nonlicensee who has successfully performed a verbal finder's fee agreement to the principal's benefit may recover under quantum meruit. The unlicensed finder (unlike the licensed finder), though subject to the Statute of Frauds, may also invoke equitable estoppel to defeat the principal's reliance on this defense. *Tenzer v Superscope, Inc., supra*.

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§7.16 C. Broker Must Be Procuring Cause

"Procuring cause" is the cause originating a series of events that, without a break in continuity, result in the accomplishment of the prime object of the employment. See *Rose v Hunter* (1957) 155 CA2d 319, 323, 317 P2d 1027. A broker who establishes that he or she was the procuring cause does not have "to prove that he was the first one to bring to the attention of the purchaser the fact that the property in question was for sale." *Rose*, 155 CA2d at 323. See the Procuring Cause Guidelines discussed in §7.42 and included in App D.

Once a broker "procures a customer able, ready and willing to enter into the transaction on terms acceptable to the principal, neither the principal nor the customer may defeat the broker's claim to compensation by concluding the transaction without his aid" (*Justice v Ackerman* (1960) 183 CA2d 649, 652, 6 CR 921, 923) unless there has been a break in the continuity of events (*Rose,* 155 CA2d at 323). The procuring cause is the one that is the first of a series of events without a break in continuity. On ready, willing, and able buyers or tenants, see §7.20.

If more than one broker has been involved in the transaction, it is necessary to determine which one was the first, and continuing without a break, the cause of the transaction being consummated. In other words, "where several agencies have been active in bringing about a sale the crucial question is, which was the predominantly efficient cause." *Rose v Hunter, supra*.

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§7.17 1. When the Issue of Procuring Cause Arises

Under an open listing agreement (see §2.24), the broker must prove that he or she alone, and no other party, including the property owner or any other broker, was the procuring cause of the transaction. In an exclusive agency listing (see §2.23), the broker must prove that someone other than the property owner was the procuring cause of the transaction. If a broker has an exclusive right-to-sell or right-to-lease listing (see §§2.21-2.22), a sale or lease to any party, even if the party is procured by the property owner or another broker, entitles the broker to compensation. Thus, being the procuring cause is most important for a broker under an open listing or comparable situation in which several brokers may be showing the property and a prospective party may be contacted by other brokers. If more than one broker has contributed to completing the transaction, the broker seeking the commission must prove that his or her activities were the predominant cause in bringing about the transaction. *Sessions v Pacific Improvement Co.* (1922) 57 CA 1, 206 P 653.

EXAMPLE: A broker may procure a buyer but not be considered a procuring cause of the sale. Suppose Broker No. 1 assists Buyer in finding a house to purchase; Buyer makes offers on two properties, but they are rejected. Suppose also that Buyer then decides not to pursue it further at that time. One year later, Buyer sees an ad for one of the properties on which she had made an offer. The price has been reduced by 40 percent. Buyer doesn't call Broker No. 1, but calls the new listing broker (Broker No. 2) and says she wants to make an offer at the new lower price. The offer is accepted. Although Broker No. 1 procured a purchaser (albeit a year earlier), because of the obvious "break in continuity," the year-long delay, and the significant change in the purchase offer price, Broker No. 2, not Broker No. 1, was the procuring cause of the sale. See CAR's procuring cause guidelines reproduced in App D.

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§7.18 2. Broker as Procuring Cause

Following are examples of cases in which courts determined that the broker was the procuring cause:

EXAMPLE 1: Broker was authorized to represent seller in the sale of a motel. The seller said that he would sell, but not exchange the property. The broker introduced the eventual buyer to the seller and furnished information concerning the motel to the buyer. The broker notified the seller that he considered himself to be the procuring broker and claimed a commission in the event of a sale. The seller notified the broker that he was taking the property off the market but continued to negotiate directly with the buyer, eventually consummating an exchange with the buyer. The court held that the broker was the procuring cause. *Rose v Hunter* (1957) 155 CA2d 319, 317 P2d 1027.

EXAMPLE 2: Broker obtained a listing from owner for the sale of a ranch. The day after he obtained the listing, broker contacted a party who he knew was interested in acquiring a ranch. He described the place thoroughly and gave the party detailed information concerning the improvements, the ability of the property to sustain a cattle-raising business, and possible means of acquiring the property, including taking other property in trade. The broker promptly informed the seller of the prospective buyer's interest. The seller said that he would fully cooperate if the proposed buyer appeared. The broker made several attempts to get the prospective buyer to see the property, urging him to either go see it with the broker or by himself. Finally, the prospective buyer went by himself, negotiated directly with the seller, and purchased the ranch from him. The court held that the broker was the procuring cause in the transaction. *Oaks v Brahs* (1955) 132 CA2d 182, 281 P2d 562.

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§7.19 3. Broker Not Procuring Cause

The following are examples of cases in which courts determined that the broker was *not* the procuring cause:

EXAMPLE 1: Broker was authorized to negotiate an oil lease for the owner. The broker discussed the possibility of leasing the property with several major oil companies and the owner eventually contracted with one of the companies with which the broker had discussed the property. At the time the broker introduced the eventual lessee to the lessor, the broad terms of the transaction (including the amount of land to be leased) had not been agreed on. The court held that the broker was not the procuring cause, because merely introducing the principal to a party who comes to an agreement with him after the termination of the agency but who was not ready, willing, and able to consummate the transaction during the life of the agency is insufficient to entitle a broker to a commission. *Tetrick v Sloan* (1959) 170 CA2d 540, 339 P2d 613. On the meaning of "ready, willing, and able," see §7.20.

EXAMPLE 2: Broker A had a listing with the seller and found a prospective buyer. The buyer told Broker A that the price was prohibitive, and after that, Broker A had no further dealings with the buyer. Shortly thereafter, Broker B (from a different real estate firm) approached the buyer and offered him the same tract of land for substantially less money. Broker A heard of the potential transaction and tried to induce the buyer to buy the property at the lower price through him. The buyer refused, indicating that because Broker B had offered the property for sale at a price he was willing to pay, he would conclude the purchase through Broker B. The court held that Broker A was not the procuring cause of the transaction, even through he had introduced the buyer to the property. The court noted that Broker A never introduced the buyer to the seller and that the buyer never made an offer through Broker A to the seller. Merely informing a prospective purchaser of a tract of property that is on the market will not suffice to entitle a broker to the commission, after the negotiations break down and later are picked up by others, provided there has been no bad faith or interference by the owner or the other broker. *Cone v Keil* (1912) 18 CA 675, 124 P 548. See also *Augustine v Trucco* (1954) 124 CA2d 229, 237, 268 P2d 780 (merely being first to cause buyer to find out about property is not by itself enough to make broker procuring cause).

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§7.20 4. "Ready, Willing, and Able"

In disputes in which the transaction is completed, the issue of a ready, willing, and able buyer or tenant is not relevant. The issue of "ready, willing, and able" occurs when the broker has procured a buyer or tenant, but the property owner refuses to go forward with the transaction. In such circumstances, the broker must not only prove that the broker "procured" the buyer or tenant, but that the buyer or tenant was "ready, willing, and able" to proceed.

PRACTICE TIP: As a practical matter, establishing whether a buyer or tenant was "ready, willing, and able" is complex and difficult. Accordingly, many brokers will not pursue a commission unless the other party first initiates litigation and seeks specific performance of the lease or purchase agreement. In such cases, it is not uncommon for the property owner to then cross-complain against the listing broker. The listing broker's right to a commission is viewed as a compulsory cross-complaint, and therefore must be asserted against the owner in the same litigation or risk waiving it. It may not be asserted in another action. CCP §426.30.

An "able" buyer or tenant has the legal and financial capacity to purchase or lease the property. For example, a minor does not have legal capacity to contract to buy the property and therefore cannot meet the definition of "able." On capacity to contract, see §2.2. Financial ability is the ability to perform at the closing of the transaction. Few parties are "able" to perform financially at the time they agree to the purchase contract. Most purchases of real estate are subject to a financing contingency. In common practice, a buyer who has a sufficient credit rating to obtain the necessary financing or can establish that other financial means to purchase the property (such as a distribution from an estate) will be available at closing is considered "financially able." The buyer or tenant is not required to have cash when the offer is made, but only to have sufficient credit, property, or other assets to allow him or her to obtain the necessary funds to timely perform the contract.

A "ready and willing" buyer or tenant is willing to enter into a contract to acquire the property on substantially the same terms as set forth in the listing. If there is any material variation between the offer and the listing's terms, the buyer or tenant is not considered to be "ready and willing." Whether an offer submitted contains terms that are materially or substantially at variance from the terms of the listing is a question of fact. See *Adams v Angelich* (1964) 231 CA2d 258, 41 CR 767; *Merzoian v Papazian* (1921) 53 CA 112, 115, 199 P 826 (principal must have objected to proffered contract based on terms alleged for those terms to be materially at variance from listing).

If the listing agreement requires that any offer be an all-cash offer, an offer that is subject to a financing contingency would be a material variance, even though the seller receives the full cash proceeds from the loan at the closing. Requiring the owner to bear the risk that the transaction would not close, if the buyer did not get his loan, is a material variance. See *Lawrence Block Co. v Palston* (1954) 123 CA2d 300, 266 P 2d 856 (broker's claim for commission failed along with contract that was subject to owner obtaining loan to be assumed by buyer, when owner was unable to obtain loan).

Seemingly innocuous variances may be considered material. For instance, if the listing agreement provides that each offer must include a deposit of no more than 10 percent with the balance of the purchase price to be paid over 10 years, one might think that the property owner would not be prejudiced if the broker produces an all-cash offer. However, if for tax reasons the owner wants the transaction treated as an installment sale, such a variance would be material. *Born v Koop* (1962) 200 CA2d 519, 19 CR 379.

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III. DISPUTES WITH PRINCIPALS

§7.21 A. Cancellation of Listing Agreement

When entering into a listing agreement with a broker, the property owner contractually agrees to pay a commission if the broker procures a ready, willing, and able buyer or tenant. See discussion in §7.20. If the property owner refuses to cooperate with the marketing of the property or unilaterally terminates the listing, may the broker recover the value of the commission? For example, an exclusive right to sell listing agreement generally provides that a commission *is* earned "*if the property is withdrawn from sale, conveyed, leased, rented, transferred, or made unmarketable by a voluntary act of seller during the listing period, or any extension of the listing period.*" Similarly, forms used in leasing transactions will generally provide that the commission is earned "*if the lessor removes or withdraws the property from the market; acts as if the property is not available for lease; breaches, terminates, cancels, or terminates the listing agreement; or changes the property's title, leases, or physical condition with adverse impact on value, use, desirability, leasability or marketability.*"

The parties to a broker's contract for the sale of real property may make the compensation dependent on any lawful conditions they include in the contract. *Blank v Borden* (1974) 11 C3d 963, 971, 115 CR 31 (withdrawal from sale clause in exclusive right to sell agreement is lawful and enforceable). These clauses do not constitute a void penalty. Even though the property has been listed, the owner is free to decide whether or not to sell the property, even if the broker procures a buyer.

An owner who elects not to proceed with the sale or lease and to withdraw the property from the market is obligated, by contract with the broker, to pay the broker's commission. By withdrawing the property from the market, the owner deprives the broker of the opportunity to earn a commission through the procurement of a ready, willing, and able buyer or tenant.

An exclusive right-to-sell or right-to-lease listing agreement (see §§2.21-2.22) reserves to the owner the power to choose whether to continue to market the property with the broker. An owner who elects not to continue may withdraw the property from the market and pay the broker the commission provided for in the listing agreement. This is considered alternative performance, not a penalty for failure to perform the main promise. *Blank*, 11 C3d at 970. This analysis, however, does not apply to an open listing agreement (see §§2.24) or a single party compensation agreement (see §2.25), which contemplate payment of a commission only if the broker procures a ready, willing, and able buyer or tenant, and the owner accepts the offer. If the listing agreement is a bilateral contract obligating the broker to market the property, revocation of the listing agreement terminates the agency relationship, and can expose the owner to breach of contract damages. See *Century 21 Butler Realty, Inc. v Vasquez* (1995) 41 CA4th 888, 49 CR2d 1.

PRACTICE TIP: When negotiating and drafting an exclusive right-to-sell or right-to-lease listing agreement, counsel should be wary of deleting the "withdrawal-from-market" clause because the deletion in effect allows the property owner to cancel the listing at any time and without cause, with no alternative performance option or penalty clause for withdrawal of the property.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.22 B. Providing for Payment of Commission

§7.22 B. Providing for Payment of Commission

The point at which a commission is earned is a separate issue from when it is to be paid. Standard form listing agreements provide that payment will be through escrow at the close of the transaction. A typical residential listing agreement may provide that compensation is payable:

- On close of escrow, but will be deemed earned even if escrow fails to close if that failure arose from the property owner's default or lack of good faith;
- If the buyer defaults, if and when the property owner collects damages from the buyer by suit or otherwise;
- If the owner withdraws the property from the market, encumbers it, leases it, or otherwise renders it unmarketable during the listing period; or
- If completion of the transaction is prevented by a party to the transaction other than the buyer, when the buyer collects damages by suit, settlement, or otherwise.

A commercial form listing agreement might require, among other things, that the resulting purchase or escrow agreement between the owner and buyer or tenant must provide that:

- The owner irrevocably instructs the escrow holder to pay the broker's agreed commission to the broker from the owner's proceeds in escrow;
- A contingency of the transaction is payment of the commission to the broker;
- The commission is due if the owner removes or withdraws the property from the transaction or acts as if the property is not available; and
- No changes may be made between the owner and the buyer or tenant with respect to the amount, timing, or other conditions of the broker's commission.

If a form agreement is not used or is revised to provide an express provision that the commission is only paid if the transaction is "consummated," then the failure of the transaction to close prevents the broker from earning the commission. See *Stromer v Browning* (1966) 65 C2d 421, 55 CR 18 (seller did not act in bad faith in changing terms and refusing to close).

PRACTICE TIP: If drafting a custom compensation clause, or tailoring that clause in a standardized form, be sure that the language clearly sets out whether the close of escrow is a condition precedent to payment or merely an indication of when payment is due. If closing is merely the time designated for payment of the commission, the failure to close does not defeat the broker's claim for a commission. See *Wallace v Zinman* (1927) 200 C 585, 254 P 946. See also *Schaffter v Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 83 CR3d 19 (buyer's refusal to close escrow because of change in market conditions). See also *RC Royal Dev't & Realty Corp. v Standard Pac. Corp.* (2009) 177 CA4th 1410, 100 CR3d 115 (commission was earned upon principal's entry into binding purchase contract, regardless of whether sale was consummated).

If the parties mutually agree to terminate the escrow, the result is less certain. A property owner's refusal to sue a defaulting buyer can be dictated by the economics of the transaction. In a rising real estate market, an owner who immediately markets and resells the property may have no real economic loss. Also, the owner may consider the cost of litigation and the likelihood of collection in deciding not to pursue such a claim. Absent a specific covenant in the listing agreement to the contrary, the seller is not obligated to pursue a claim against the defaulting buyer. *Lipton v Johansen* (1951) 105 CA2d 363, 233 P2d 648. The mere agreement between the buyer and seller to terminate the transaction is not dispositive of the broker's right to claim that the seller is in breach.

PRACTICE TIP: A broker can try to recover a commission by proving the "case within the case," that is, by proving that one of the parties breached and asserting that the mutual release was merely a matter of convenience and not an indication that neither party was at fault.

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§7.23 C. Interference With Prospective Business Advantage

The tort of interference with prospective business advantage can be established in real estate broker commission disputes. See §§4.48-4.51 for discussion of elements of the claim.

In *Buckaloo v Johnson* (1975) 14 C3d 815, 122 CR 745, the broker-plaintiff had an exclusive right to sell property owned by the seller. The property did not sell during the listing period. Four years later, the seller posted a for-sale sign on the property directing interested parties to contact the broker. A prospective buyer and a salesperson went to the broker's office and inquired about the property. The broker discussed this and other properties with them, but no further action was taken. The broker advised the seller that he had "procured" the prospective buyer and asked the seller to refer the buyer to the broker, if the seller heard from him directly. The seller ultimately sold the property to the prospective buyer and paid the salesperson a commission, but not the broker.

Although the broker could not recover from the seller because his listing agreement had long expired, the California Supreme Court upheld the cause of action against the prospective buyer and the salesperson on a theory of intentional interference with prospective economic advantage. The court outlined the elements of the cause of action as (*Buckaloo*, 14 C3d at 826):

> (1) an economic relationship between broker and vendor or broker and vendee containing the probability of future economic benefit to the broker, (2) knowledge by the defendant of the existence of the relationship, (3) intentional acts on the part of the defendant designed to disrupt the relationship, (4) actual disruption of the relationship, [and] (5) damages to the plaintiff proximately caused by the acts of the defendant.

The court noted that the advantageous business relationship does not have to have ripened into a formal contract. *Buckaloo*, 14 C3d at 827.

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§7.24 D. Recovery Under Safety Clauses

Standard form listing agreements often contain a provision commonly referred to as a "safety," "protection," or "sunset" clause. This clause entitles the broker to a commission if the property is sold or leased within a stated period (generally 30 to 60 days) after the listing expires to a party identified during the listing term. This type of clause is often contained in exclusive right-to-sell and right-to-lease listing agreements. See form clause and comment in §2.43.

To recover a commission under a safety clause, the broker must demonstrate sufficient efforts on the owner's behalf. The clause usually requires the broker to provide the owner with a list of the broker's prospective clients. The list must satisfy the specification of the safety clause, *e.g.,* "*under the foregoing clause, people who negotiated with or through the broker, physically viewed the property with the broker, or submitted a signed, written offer for the property.*" A list of people to whom the broker sent brochures as part of a blanket mailing would not qualify.

If the owner has entered into a new listing agreement, a sale or lease during the safety clause period could expose the owner to a double commission. See *Delbon v Brazil* (1955) 134 CA2d 461, 285 P2d 710.

PRACTICE TIP: The safety clause is probably the most common source of broker-versus-broker disputes, although the clause also creates many disputes between brokers and principals. A change in brokers has implications for all parties, and protective measures should be taken to avoid misunderstandings. For example, if the property owner enters into a listing agreement with a new broker, a sale or lease to the party procured by the broker under a prior exclusive listing would trigger a commission to both the prior and the new broker. To avoid this, the owner should make sure that the new broker is aware of the prior listing and agrees in writing to the list of names that the prior broker is deemed to have procured. The list of reserved names should be identified in the new listing agreement as "exclusions" or, alternatively, the list should be attached to the new listing and incorporated by reference.

On the broker's side, custom and practice dictate that before accepting a new listing, a broker should ask the owner whether the property has been previously listed in order to determine the terms of any unexpired safety clause and whether the names of any potential prospects have been reserved. In such a circumstance, it is also industry custom for the new broker to arrange to share the commission from a transaction to an excluded party, rather than expose the owner to a double commission. Once aware of the list of exclusions, the new listing broker may then elect to negotiate different compensation terms with the owner regarding the excluded prospects.

In a dispute in which a prior listing agreement exists, counsel should carefully review the prior listing agreement to verify that the prior broker (1) properly completed any blank space in the listing providing for the number of days within which the broker was required to deliver the list of excluded parties to the owner after the end of the listing period; and (2) timely delivered the list to the owner. If either of these failed to occur, the prior broker will likely be deemed to have waived his or her rights under the safety clause.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.25 IV. DISPUTES BETWEEN BROKERS

§7.25 IV. DISPUTES BETWEEN BROKERS

Most commission disputes related to real estate transactions are disputes between brokers. These disputes usually concern which broker procured the buyer or tenant and how to allocate the commission between (or among) brokers.

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A. Trade Association Policies and Regulations

§7.26 1. National Association of Realtors®

The National Association of Realtors® (NAR) and its state and local boards strongly encourage the resolution of disputes among members by mediation or arbitration under procedures established by their local real estate association. See §§1.6-1.7, 7.27, App A. The NAR code of ethics specifically requires members who are associated with different firms to submit disputes with one another to mediation or arbitration in accordance with the regulation of their local association, rather than litigate the dispute. Code of Ethics and Standards of Practice of the National Association of Realtors®, Article 17 (January 1, 2009). For additional information, visit the NAR website at the address listed in the Directory.

NOTE: The term Realtor® is a trademarked term connoting membership in the National Association of Realtors® (NAR) and, with that, membership in the California Association of Realtors® (CAR) and whichever local board the member selects as his or her principal board. It is not a generic term for a real estate licensee. Use of the term "Realtor" by one who is not a member of the NAR is a punishable offense under Bus & P C §10177(e). See §§1.6-1.8, 9.11.

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§7.27 2. California Association of Realtors® Dispute Resolution Procedures

The vast majority of residential real estate brokers in California belong to the California Association of Realtors® (CAR). See §1.8. CAR provides mediation and arbitration procedures and support to resolve disputes between its members, whether involving fee disputes or other matters. CAR's recommended arbitration procedures are set forth in its California Code of Ethics and Arbitration Manual (Arbitration Manual) and in standardized arbitration forms (see §7.34) which are available to and adopted by most local member associations. The Arbitration Manual sets out the procedures by which local panels conduct dispute hearings.

Most Multiple Listing Services (MLSs, see §§1.11-1.12, 7.29-7.30) also require all participants, whether CAR members or not, to arbitrate their disputes. The CAR Arbitration Manual provides that if a dispute involves an MLS that has adopted the Arbitration Manual, binding arbitration must be conducted in accordance with the procedures set forth in the Arbitration Manual. If, however, the brokers are party to an arbitration agreement that does not contemplate use of the CAR procedures, the disputants are not bound to follow the Arbitration Manual and CAR is not bound to provide facilities or other support for resolution of the dispute. California Code of Ethics and Arbitration Manual §43 (CAR 2008). The Arbitration Manual may be downloaded from the CAR website at the address listed in the Directory.

PRACTICE TIP: Most brokers are already aware when they contact an attorney over a commission dispute that the dispute must be arbitrated. Nevertheless, in the event that the broker is unaware of industry custom, counsel should confirm or make an initial determination whether the dispute is an arbitrable fee dispute. If the dispute is between or among participants in an MLS, then it almost certainly will be subject to a realty board arbitration.

PRACTICE TIP: When contacted by a client over a broker-versus-broker fee dispute, counsel should immediately determine the "collectibility" of the commission. If the commission is still in escrow and the prevailing broker can provide escrow with an award or judgment to get the commission released, then counsel can better evaluate whether the matter should be settled (and hence avoid attorney fees) or whether the merits of the claim are better served going forward with the arbitration.

Counsel should next evaluate whether it is in the broker's best interest to represent himself or herself at the local panel arbitration or whether the attorney should appear at the proceeding. Local association arbitration hearings are relatively informal; if the client is prepared and equipped to confront the other broker "one-on-one," without legal counsel, then it might be best that the broker not be represented at the arbitration. Not only will the client save money in attorney fees (which are not recoverable in association arbitrations), but when one broker gives notice to the association (as it must) that the broker will be represented at the hearing by legal counsel, then invariably the opposing broker will also retain an attorney, and thus convert an otherwise informal proceeding into a more tense and formal one.

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§7.28 3. Commercial Real Estate Trade Associations

Brokers who work in the area of commercial real estate tend not to join CAR and NAR, but instead join organizations focusing on particular property types, markets, and activities (*e.g.,* the AIR Commercial Real Estate Association (AIREA), the International Council of Shopping Centers (ICSC), and the Building Owners and Managers Association (BOMA)). These organizations provide oversight, education, and advocacy specific to the needs of their members. Unlike BOMA and ICSC, AIREA membership is made up exclusively of commercial brokers and, not surprisingly, requires that its members submit commission disputes to AIREA for arbitration. Further information is available at the AIREA, BOMA, and ICSC websites listed in the Directory.

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§7.29 4. Multiple Listing and Commercial Subscription Services

Today almost all residential properties are marketed through a multiple listing service (MLS). Commercial and industrial properties are often listed on commercial subscription services such as the Costar Group or LoopNet.

An MLS is a cooperative venture in which brokers place residential listings in a database so that other brokers looking for property may have access to information about those listings. The database includes the listing broker's percentage of the commission and the percentage to be paid to the broker who procures a buyer or tenant. Most, if not all, MLSs are run by local realtor® associations.

Commercial subscription services may be run by a private company that charges brokers a fee to advertise their listings. In addition, large national and regional brokerages maintain their own websites featuring properties for sale or lease.

In *Marin County Bd. of Realtors, Inc. v Palsson* (1976) 16 C3d 920, 130 CR 1, the California Supreme Court held that requiring membership in a board of realtors® as a condition precedent to membership or participation in an MLS was an illegal tying arrangement under California's antitrust law. As a result, MLSs now include both CAR members and nonmember participants.

PRACTICE TIP: Although the MLS must now include both CAR members and nonmember participants, there is no obligation on the part of an MLS member listing broker who offers a cooperating selling commission for a property for sale through the MLS to pay that cooperating commission to a nonmember broker, even though that nonmember broker may have successfully represented the buyer in the transaction. In such situations, prior to submitting the offer, the nonmember broker should ensure payment of its share of the commission by first requiring the listing broker to enter into a commission sharing agreement. See, *e.g.,* CAR's Cooperating Broker Compensation Agreement and Escrow Instructions (CAR form CBC).

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§7.30 5. Board Versus Inter-Board Disputes

When the dispute is between or among participants belonging to the same MLS, then the dispute is resolved by an arbitration under the aegis of the association of realtors® under whose jurisdiction the MLS operates. If the dispute, however, is between or among realtors® or participants who do not share a common association, then the dispute will be resolved as an inter-board arbitration. Inter-board arbitrations are held under the supervision of CAR, which processes the claim and assigns a neutral third association of realtors® to hear it. This is the only substantial difference between the two types of arbitration; the procedures are substantially the same for both. These procedures are set forth in the MLS membership agreement and the CAR Arbitration Manual. The Arbitration Manual may be downloaded from the CAR website at the address listed in the Directory. On MLS membership, see §§1.11-1.12.

NOTE: The requirement that MLS members arbitrate their disputes under the aegis of the local association of realtors® is not immune to challenge or interpretation. It has been argued that the operative language is ambiguous as to whether the association is the exclusive arbitration forum for such membership disputes or whether some other arbitration service (see §7.8) should or does have concurrent jurisdiction to hear the dispute. As a practical matter, members rarely object to the jurisdiction of the particular association to hear a commission dispute. When they do, however, either the disputing members agree to have their matter heard before an inter-board panel or some other arbitration tribunal, or the dispute is heard by the local association's panel over the protest of the objecting member. In those instances when the objecting member nonetheless arbitrates and then loses the arbitration, that member may petition the court as to the issue of whether the dispute was properly heard by the association or whether the dispute should have been heard in a different arbitration forum.

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§7.31 B. Nature of Disputes

The following are examples of how disputes over commissions can arise between brokers.

EXAMPLE 1: A buyer working with a broker attends an open house but neglects to tell the broker conducting the open house that she is working with another broker. Subsequently, the buyer makes an offer prepared by the broker with whom she has been working. The broker who held the open house asserts that he introduced the buyer to the property and was therefore the procuring cause.

EXAMPLE 2: A commercial tenant works with a broker for several months looking at numerous properties. The tenant switches brokers and, with the new broker, visits a property he previously saw with the original broker (neglecting to tell the new broker this). The new broker presents an offer to lease the property. The original broker asserts that she is entitled to the commission because she first introduced the property to the buyer.

EXAMPLE 3: A seller lists her property with a broker, who markets the property to a number of buyers, but no sale results. After the listing agreement expires, the seller lists the property with a new broker who arranges a sale to a buyer who was introduced to the property by the original broker. Both brokers assert a claim to the commission.

Often the original broker could assert a potential cause of action against the principals as well. However, custom and practice in the real estate brokerage industry dictates that whenever possible, the brokers try to avoid involving either of the principals in the dispute. Instead, the brokers limit the dispute to allocation of the commission rather than asserting a right to multiple commissions, although legally they might be entitled to do so. See discussions of procuring cause in §§7.16-7.20 and of safety clauses in §7.24.

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§7.32 C. Disputes Not Relating to Fees

Although most broker disputes are over commissions or fees, disputes between brokers may encompass other matters. For example, a broker may accuse another of unfair competition in advertising market share or the number of homes sold, or a broker may complain that another brokerage used unfair tactics to recruit away its salespersons.

These matters may fall outside the scope of the MLS and realtor® association mediation or arbitration procedures. In such cases, the local arbitration panel (or the court deciding the petition or motion to compel) may determine that the nature of the dispute, the magnitude of the amount involved, or the legal complexity of the issues is outside the scope of the local association's arbitration provisions. The arbitration panel reports its recommendation to the local association's board of directors. If the board of directors concurs, the arbitration terminates and the parties are relieved of their obligation to arbitrate. CAR has established detailed procedures for initiating and conducting arbitrations, which in turn are adopted by the local affiliates. See §7.27.

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D. Alternative Resolution of Commission Disputes

§7.33 1. Mediation of Broker-Versus-Broker Commission Disputes

As in virtually every other area of litigation, mediation of commission disputes has become a popular alternative to going to trial. On mediation procedures generally, see §§6.13-6.27. If the brokers are members of CAR, they are encouraged to seek initially to resolve the dispute by mediation. The following CAR forms are available, but not required, for this purpose:

- Request for Mediation Form (CAR form M-1);
- Notice of Mediation Conference (CAR form M-2) (sent by the local association);
- Mediation Confidentiality Agreement (CAR form M-3); and
- Mediation Agreement and Stipulated Arbitration Award (CAR form M-4).

These CAR mediation forms are accessible to CAR members on the CAR website at the address listed in the Directory. The CAR Residential Purchase Agreement and Joint Escrow Instructions (CAR Form RPA-CA) also requires mediation as a prerequisite to litigation of disputes between brokers and principals. Mediation is voluntary, so if one of the disputing brokers is not a member of CAR, he or she cannot be compelled to mediate the dispute.

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§7.34 2. Arbitration of Broker-Versus-Broker Commission Disputes

If mediation is not successful or the parties do not choose to use mediation, an arbitration may proceed using the following CAR forms:

- Arbitration Complaint (CAR form A-1);
- Notice to Respondent Arbitration (CAR form A-2); and
- Arbitration Response (CAR form A-3).

The CAR arbitration procedures include a right to challenge panel members:

- Notice of Right to Challenge Panel Members and Availability for Hearing Arbitration (CAR form A-4); and
- Reasons for Challenge Qualification of Panel Member Arbitration (CAR form A-5).

Once the arbitrators have been selected, the local association gives notice of the hearing and requests panel members to certify their qualifications using the following forms:

- Notice of Hearing Arbitration (CAR form A-6); and
- Certificate of Qualification Arbitration (CAR form A-7).

Since arbitration is contractual in nature, if one of the disputing brokers is not a member of CAR, he or she cannot be compelled to arbitrate the dispute unless he or she explicitly agreed to do so. These CAR arbitration forms are accessible to CAR members on the CAR website at the address listed in the Directory. On arbitration procedures generally, see §§6.28-6.39, 7.27.

PRACTICE TIP: The CAR Code of Ethics and Arbitration Manual (see §§7.27, 7.30) provides a relatively short "statute of limitations" on arbitration of disputes. The Arbitration Manual states that a complaint must be filed with the local association within 180 calendar days after "the facts constituting the matter complained of could have been known in the exercise of reasonable diligence." California Code of Ethics and Arbitration Manual §20 (CAR 2008). However, litigation tolls the time for commencing arbitration even if the arbitration agreement provides that proceedings must be commenced within a particular time. CCP §1281.12.

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§7.35 3. Refusal to Arbitrate

If the respondent refuses to arbitrate or if the broker seeking the commission has filed a legal complaint ignoring the arbitration requirements, an appropriate response is to file a petition (or, in a pending action, a motion) to compel arbitration (see §7.36) supported by a memorandum of points and authorities (see §7.37). The petition should be accompanied by a declaration from an authorized official of the local association or Multiple Listing Service under whom arbitration was sought, identifying the arbitration provisions of its bylaws and attaching an authenticated copy of the bylaws. See §7.38. Counsel should also review local court rules for any additional procedural requirements (*e.g.,* "meet and confer" requirements) prior to filing.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.36 4. Form: Petition to Compel Arbitration

§7.36 4. Form: Petition to Compel Arbitration

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No. _ _ _ _ _ _**
_ _[*Name(s)*]_ _, **doing business as** _____, **Petitioner(s)**	)	**PETITION TO COMPEL ARBITRATION** [*cite applicable statute, e.g., CCP §1281.2*]
and	)	**Hearing:** _ _[*date; time*]_ _
	)	**Dep't:** _ _[*number*]_ _
_ _[*Name(s)*]_ _, **doing business as** _____, **Respondent(s)**	)	**Hearing judge:** _ _[*if known*]_ _ **Action filed:** _ _[*date*]_ _ **Trial date:** _ _[*if set*]_ _

1. Petitioner, _ _[*name*]_ _, is and was at all times herein concerned a duly licensed and acting real estate broker, doing business as _ _[*name*]_ _, and was and is authorized to conduct said real estate business in the State of California.

2. Respondent, _ _[*name*]_ _, is and was at all times herein concerned a duly licensed real estate broker, doing business as _ _[*name*]_ _, and was and is authorized to conduct said real estate business in the State of California.

3. The _ _[*name*]_ _ Board of Realtors is and was at all times herein concerned a duly formed and existing _ _[*state of incorporation*]_ _ corporation, affiliated with the _ _[*name*]_ _ Association of Realtors, having its principal place of business in the County of _ _[*name of county*]_ _, State of California.

4. At the time of the controversy, Petitioner and Respondent were active Broker Members of the _ _[*name*]_ _ Board of Realtors, and as such, were and still are bound by the Bylaws of the _ _[*name*]_ _ Board of Realtors, a copy of which is attached hereto, marked Exhibit _ _[*e.g., A*]_ _ and incorporated herein by reference.

5. The Bylaws require every member to submit any controversy with another member to arbitration before the _ _[*name*]_ _ Board of Realtors according to the procedure provided in the Bylaws.

6. A controversy and dispute has existed and now does exist between Petitioner and Respondent relating to the division and amount of commission owing to Petitioner and Respondent (if any) arising out of the sale of _ _[*identify property*]_ _, pursuant to a written purchase agreement dated _ _[*date*]_ _, a copy of which is attached hereto, marked Exhibit _ _[*e.g., B*]_ _ and incorporated herein by reference, and two Commission Agreements dated _ _[*date*]_ _, and _ _[*date*]_ _, respectively, and attached hereto, marked Exhibits _ _[*e.g., C*]_ _ and _ _[*e.g., D*]_ _, respectively.

7. Petitioner has requested that Respondent arbitrate this dispute in accordance with the provisions of the Bylaws of the _ _[*name*]_ _Board of Realtors, but Respondent has refused and continues to refuse to submit the dispute to arbitration.

WHEREFORE, Petitioner prays for an Order of the court compelling the parties to arbitrate the dispute in accordance with the Bylaws of the _ _[*name*]_ _ Board of Realtors, for costs of suit, and for such other and further relief as the court may deem proper.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

[*Verification*]

Comment: The petition should be filed in the court having jurisdiction in (1) the county in which the agreement is to be performed or was made; (2) the county in which a party resides or has a place of business if the agreement was not made in a California county and does not specify a place for performance; or (3) in cases not covered by (1) or (2), then any county in the state. CCP §1292.

If one of the disputants has already filed a legal complaint seeking commissions, the petition to compel arbitration must be filed in that action (CCP §1292.4) concurrently with a motion to stay the action pending the arbitration (see forms in California Construction Contracts, Defects, and Litigation §§7.149-7.151 (Cal CEB 2008)). A petition under CCP §1281.2 may be filed instead of an answer to a complaint, and the petitioning defendant has 15 days after denial of the petition to file a response to the complaint. CCP §1281.7. If the association bylaws or the arbitration agreement include an attorney fee provision awarding fees to the prevailing party, the petition should include a claim for attorney fees and costs. See *Otay River Constr. v San Diego Expressway* (2008) 158 CA4th 796, 70 CR3d 434 (party who successfully resists petition to compel arbitration may be entitled to recover attorney fees incurred in that effort).

If the court concludes that there are other issues between the petitioner and the respondent that are not subject to arbitration and that are the subject of the pending action or special proceeding, and that a determination of those issues may make the arbitration unnecessary, the court may delay its order to arbitrate until those other issues are decided or until such earlier time as the court specifies. CCP §1281.2.

Under CCP §1281.3, the court may also consolidate separate arbitration proceedings in certain instances.

The petition must be filed with a notice of hearing and a memorandum of points and authorities (which may be separately stated (see §7.37) or combined with the petition), and a declaration of the petitioner or its agent (affirming under oath facts in the petition and authenticating contract exhibits (see §7.38)).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.37 5. Form: Memorandum of Points and Authorities in Support of Petition to Compel Arbitration

§7.37 5. Form: Memorandum of Points and Authorities in Support of Petition to Compel Arbitration

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No. _ _ _ _ _ _**
_ _[*Name(s)*]_ _, **doing business as** _____, **Petitioner(s)**	)	**MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF PETITION TO COMPEL ARBITRATION AND FOR ORDER TO SHOW CAUSE AND PETITION TO ORDER ARBITRATION**
and	)	
_ _[*Name(s)*]_ _, **doing business as** _____, **Respondent(s)**	)	**Hearing:** _ _[*date; time*]_ _ **Dep't:** _ _[*number*]_ _ **Hearing judge:** _ _[*if known*]_ _ **Action filed:** _ _[*date*]_ _ **Trial date:** _ _[*if set*]_ _
_____	)	

1. The Bylaws of the _ _[*name*]_ _ Board of Realtors require every Board member to submit any dispute with another member to arbitration through the Board's facilities, if either member requests it. _ _[*Cite Bylaw provision*]_ _.

2. The arbitration procedure is set forth in the Bylaws. _ _[*cite Bylaw provision*]_ _.

3. A written agreement to submit to arbitration, a controversy thereafter arising is valid, enforceable, and irrevocable. _ _[*Cite applicable statutory provision, e.g., CCP §1281*]_ _. A party to an arbitration agreement may petition for a court order to compel arbitration if s/he alleges: (1) The existence of a written agreement to arbitrate a controversy; and, (2) the other party's refusal to arbitrate. The court may not consider whether or not the Petitioner's contentions lack substantive merit. _ _[*Cite applicable statutory provisions, e.g., CCP §1281.2*]_ _.

4. The hearing of the petition is entitled to preference over all other civil actions and proceedings, except for other preference hearings. _ _[*Cite applicable statutory provision, e.g., CCP §1291.2*]_ _.

5. The court has the authority to award costs at the time of hearing this Petition. _ _[*Cite applicable statutory provision, e.g., CCP §1293.2*]_ _.

Respectfully submitted,

By: _____
Attorneys for Petitioner

Comment: A party filing a motion must also file a memorandum of points and authorities in support of the motion. Cal Rules of Ct 3.1112(a)(3), 3.1113. Requirements for the contents and format of the memorandum are in Cal Rules of Ct

3.1110-3.1116.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.38 a. Form: Declaration in Support of Petition to Compel Arbitration

§7.38 a. Form: Declaration in Support of Petition to Compel Arbitration

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No. _ _ _ _ _ _**
_ _[*Name(s)*]_ _, **doing business as** _____, **Petitioner(s)**	)	**DECLARATION OF _ _[*name*]_ _ IN SUPPORT OF PETITION TO COMPEL ARBITRATION**
and	)	
_ _[*Name(s)*]_ _, **doing business as** _____, **Respondent(s)**	)	**Hearing:** _ _[*date; time*]_ _ **Dep't:** _ _[*number*]_ _ **Hearing judge:** _ _[*if known*]_ _ **Action filed:** _ _[*date*]_ _ **Trial date:** _ _[*if set*]_ _

I, _ _[*name*]_ _, being over the age of majority, make this Declaration under penalty of perjury under the laws of the State of California:

1. If called as a witness in the above-entitled matter, I would testify as follows:

2. I am the _ _[*e.g., Executive Vice President/Executive Officer*]_ _ of the _ _[*name*]_ _ Board of Realtors, a _ _[*state of incorporation*]_ _ corporation, having its principal place of business in the County of _ _[*name of county*]_ _.

3. A true and correct copy of the Bylaws of the _ _[*name*]_ _ Board of Realtors is attached to the Petition _ _[*e.g., to Compel Arbitration*]_ _ and incorporated by reference. Said Bylaws have been and now are in full force and effect.

4. The Bylaws require every member of the _ _[*name*]_ _ Board of Realtors to submit any controversy or dispute with any other member of the Board to the arbitration procedure established by the Bylaws, on the request of either member.

5. The procedure for arbitration set forth in the Bylaws provides a complete procedure for handling the subject controversies or disputes between members of the Board. I have personal knowledge that this procedure has been used successfully in many similar commission dispute matters between members of the _ _[*name*]_ _ Board of Realtors in the past.

6. At all times pertinent to this dispute, both _ _[*name*]_ _, doing business as _ _[*name*]_ _, since _ _[*date*]_ _. and _ _[*name*]_ _ doing business as _ _[*name*]_ _, since _ _[*date*]_ _, have been active members of the _ _[*name*]_ _ Board of Realtors.

7. On _ _[*date*]_ _, Member _ _[*name*]_ _, by written request, a copy of which is attached and marked Exhibit _ _[*e.g., A-1*]_ _, requested arbitration of a dispute with _ _[*name*]_ _ arising out of the amount and division of commission for the sale of _ _[*identify property*]_ _. _ _[*Name*]_ _ again requested arbitration by letter dated _ _[*date*]_ _, a copy of which is attached and marked Exhibit _ _[*e.g., A-2*]_ _. _ _[*Name*]_ _ replied by letter

dated _ _[*date*]_ _, a copy of which is attached and marked Exhibit _ _[*e.g., A-3*]_ _, claiming that the dispute is outside of the jurisdiction of the _ _[*name*]_ _ Board of Realtors.

8. I worked for many months to try and resolve this dispute or controversy between the parties. To date, this has been unsuccessful.

9. The _ _[*name*]_ _ Board of Realtors has requested that _ _[*name*]_ _ submit to arbitration as provided in the Bylaws, and s/he refuses to participate.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: A party filing a motion may also file a declaration in support of the motion. Cal Rules of Ct 3.1112(b).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.39 b. Form: Order Compelling Arbitration

§7.39 b. Form: Order Compelling Arbitration

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No. _ _ _ _ _ _**
_ _[*Name(s)*]_ _,	)	**MEMORANDUM OF POINTS**
doing business as	)	**AND AUTHORITIES IN**
_____,	)	**SUPPORT OF PETITION TO**
Petitioner(s)	)	**COMPEL ARBITRATION AND**
	)	**FOR ORDER TO SHOW**
and	)	**CAUSE AND PETITION TO**
	)	**ORDER ARBITRATION**
_ _[*Name(s)*]_ _,	)	
doing business as	)	**Hearing: _ _[*date; time*]_ _**
_____,	)	**Dep't: _ _[*number*]_ _**
Respondent(s)	)	**Hearing judge: _ _[*if known*]_ _**
	)	**Action filed: _ _[*date*]_ _**
_____)		**Trial date: _ _[*if set*]_ _**

The petition of _ _[*name of petitioner*]_ _ for an order compelling arbitration was heard on _ _[*date*]_ _. _ _[*Name*]_ _ appeared as attorney for petitioner, and _ _[*name*]_ _ appeared as attorney for respondent _ _[*name*]_ _. Satisfactory proof of the existence of an arbitration agreement between petitioner and respondent having been made to the court, and good cause appearing,

IT IS ORDERED that the dispute concerning the division and amount of commissions owing to Petitioner and Respondent (if any) arising out of the sale of _ _[identify property]_ _, pursuant to a written purchase agreement dated _ _[*date*]_ _, be arbitrated in accordance with the arbitration procedures set forth in the Bylaws of the _ _[*name*]_ _ Board of Realtors, and that respondent pay petitioner's attorney fees and costs incurred in this proceeding.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the _ _[*title of court*]_ _

Comment: Generally, counsel for the prevailing party prepares a proposed order which the opposing party must receive prior to submitting it to the court for execution. Cal Rules of Ct 3.1312.

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§7.40 E. Discovery

Arbitration is an informal proceeding; therefore, discovery is seldom sought or used. When discovery is used in any arbitration, it is more limited than it is in a matter being tried before a court. Nevertheless, there are provisions for requiring the attendance of witnesses and the production of documents using a subpoena. See, *e.g.,* CCP §§1282.6, 1283. For more on discovery in arbitration proceedings, see §6.37.

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§7.41 F. Conduct of the Hearing

Arbitration proceedings before a local association of realtors®, unlike proceedings involving brokers and clients, are informal. The hearing panel generally consists of three arbitrators: brokers or salespersons selected from a local panel. The participants have a right to challenge a panel member for cause. Although the parties may be represented by legal counsel, in most cases only principals attend the hearing. The members of the arbitration panel receive training in how to conduct the hearing and are very familiar with local custom and practice. The goal is a resolution of a dispute among peers by other members of the peer group.

PRACTICE TIP: Attorneys representing clients in a local association arbitration should be politic and careful not to alienate the panel by attempting to control the proceeding or by interrupting with objections not critical to the decision of the arbitrators. In general, objections are not allowed, and panelists prefer that each side be allowed to present his or her side of the story without interruption. The other side then has a limited opportunity to ask questions, and the panel may ask direct questions as well. Counsel should be prepared for the routine admission of hearsay, including, but not limited to, declarations of third parties who are not in attendance and for whom no opportunity to cross-examine is given. Arbitration hearings are usually tape-recorded, so that a record of the proceeding is available should the panelists need to revisit the testimony or either party elect to appeal the result.

A typical arbitration hearing is very brief and may last only a couple of hours. The hearing usually commences with the presiding officer reading the procedure of the hearing comparable to that suggested by the CAR's Outline of Procedure for Hearing Arbitration (CAR form A-8). The Outline states that the panel is not bound by formal rules of evidence and has broad discretion regarding the evidence and testimony it allows to be presented. The panel adjourns immediately after the arbitration hearing, makes its decision, and usually advises the parties of its decision within a few days after the hearing. The panel usually prepares its award in the form suggested by CAR in its form, Award of Arbitrators (CAR form A-12). The Outline and the Award of Arbitrators form may be downloaded from the CAR website at the address listed in the Directory.

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§7.42 G. CAR Procuring Cause Guidelines

Although the courts had pretty much settled on a definition of "procuring cause" (see §7.16), for many years this term was confusing. Courts, local associations, and brokers often came to disparate results. Finally, in 2006, CAR released a Procuring Cause Guidelines chart to assist the real estate brokerage community in establishing factors to determine the issue of "procuring cause" between brokers. Because procuring cause is the most common issue leading to broker-versus-broker commission disputes, the Guidelines help bring certainty to practitioners who must evaluate their broker client's claim and provide consistency in results among the multitude of associations that arbitrate disputes between member brokers. For a copy of the Guidelines, see App D.

PRACTICE TIP: Procuring cause is not a single fact or event, but a combination of factors. In reviewing the Guidelines, counsel should focus on the totality of effort by the broker, whether asserting or contesting a compensation claim. The extent of use of the Guidelines varies from panel to panel, but virtually every local association arbitration panel in California applies the factors contained in the Guidelines to their deliberations of "procuring cause" disputes.

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§7.43 H. Review of Award

There is a very limited right to appeal or review of an award by the arbitration panel. A party seeking review must submit a request for review to the local association's board of directors in the format noted in CAR's Request for Review Arbitration (CAR form A-15). The only basis to seek a reversal or correction of the award is a procedural error. The appeals panel will *not* review or reconsider the existing facts or new facts.

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§7.44 I. Confirmation of Award

The arbitrator's award is not self-executing. Any arbitration award, including an award by a local association arbitration panel, represents a contract obligation. To obtain an enforceable judgment, the prevailing party may petition for confirmation of the award by the superior court. CCP §§1285, 1287.4. If the award is challenged, and the parties have not expressly agreed otherwise, the court gives limited review to the arbitrator's award and considers any evidence of arbitrator misconduct, but the court does not review the award for errors of fact or law. See *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 10 CR2d 183. The court then either confirms the award and enters a judgment or vacates the award. See CCP §§1285-1286. However, in *Cable Connection, Inc. v DIRECTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229, the California Supreme Court has extended the rule of limited judicial review of arbitrator error. See discussion and Warning in §6.30.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.45 1. Form: Petition for Confirmation of Arbitration Award

§7.45 1. Form: Petition for Confirmation of Arbitration Award

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No. _ _ _ _ _ _**
_ _[*name(s)*]_ _, doing business as _____, Petitioner(s)	)	**PETITION FOR CONFIRMATION OF ARBITRATION AWARD**
and	)	**Hearing: _ _[*date; time*]_ _** **Dep't: _ _[*number*]_ _** **Hearing judge: _ _[*if known*]_ _** **Action filed: _ _[*date*]_ _** **Trial date: _ _[*if set*]_ _**
_ _[*Name(s)*]_ _, doing business as _____, Respondent(s)	)	

Petitioner, _ _[*name*]_ _ , alleges:

1. Petitioner is, and was at all times herein concerned, a duly licensed and acting real estate broker, doing business as _ _[*name*]_ _, and was and is licensed to conduct said real estate business in the State of California.

2. Respondent, _ _[*name*]_ _, is, and was at all times herein concerned, a duly licensed and acting real estate broker, doing business as _ _[*name*]_ _, and was and is authorized to conduct said real estate business in the State of California.

3. The _ _[*name*]_ _ Board of Realtors® is and was at all times herein concerned a duly formed and existing _ _[*state of incorporation*]_ _ corporation, affiliated with the _ _[*name*]_ _ Association of Realtors and having its principal place of business in the County of _ _[*name of county*]_ _, State of California.

4. At the time of the controversy, Petitioner and Respondent were active Broker Members of the _ _[*name*]_ _ Board of Realtors®, and as such, were and still are bound by the Bylaws of the _ _[*name*]_ _ Board of Realtors®, a copy of which is attached hereto, marked Exhibit _ _[*e.g., A*]_ _ and incorporated herein by reference.

5. In accordance with the Bylaws, Petitioner submitted a dispute with Respondent relating to a commission arising from the sale of residential property located at _ _[*identify property*]_ _ , to the _ _[*name*]_ _ Board of Realtors® for binding arbitration in accordance with the Bylaws.

6. Under the Bylaws, members are deemed to have agreed to be bound by the decision and award of the arbitrators.

7. In accordance with the Bylaws, the arbitration was held on _ _[*date*]_ _. Petitioner and Respondent submitted all evidence relating to the dispute to the arbitrators as set forth in Exhibit _ _[*e.g., B*]_ _ attached hereto.

8. After submission of the evidence, the arbitrators rendered their decision and awarded to Petitioner _ _[*amount*]_ _ of _ _ _ percent (_ _%) of the sales price, that amount being $_ _[*amount*]_ _, and directed Respondent to pay that sum to Petitioner within _ _[*number*]_ _ days from the date of the decision, or before _ _[*date*]_ _.

9. A copy of the arbitrators' decision as mailed by registered mail to Petitioner and Respondent is attached to this Petition as Exhibit _ _[*e.g., C*]_ _.

10. Notwithstanding the provisions of the Bylaws and the decision and award of the arbitrators, Respondent has refused and continues to refuse to pay to Petitioner the full amount of the award due Petitioner from Respondent, with interest thereon from _ _[*date*]_ _.

WHEREFORE, Petitioner prays for an Order confirming the arbitration award, for entry of judgment in conformity therewith, including interest, and for costs of suit and for such other and further relief as the court may deem just and proper in the premises.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Comment: This petition requests that the award be confirmed as made. In a petition requesting that the award be corrected and then confirmed as corrected, counsel should add one or more paragraphs as necessary, after paragraph 3, stating the facts and the statutory grounds for correction. The prayer should then ask the court to correct and confirm the award and to enter judgment in conformity with it.

If a party seeks to vacate an arbitration award, this form can be adapted to set forth grounds for objecting to the award. A party may also seek to vacate an award in its response to a petition to confirm the award. CCP §1285.2.

Interest on the amount of the award from the date of judgment is automatically included in the judgment, even in the absence of a demand. Cal Rules of Ct 3.1802. See *Budget Fin. Plan v Sav-On Food Club* (1955) 44 C2d 565, 572 n6, 283 P2d 694. If a petitioner seeks to recover interest from an earlier date, such as the date the award was made or was payable under the parties' agreement (see *Precision Automotive v Northern Ins. Co.* (1967) 252 CA2d 1036, 1043, 61 CR 200), the prayer should specify the applicable date. Because an (unconfirmed) arbitration award has the effect of a written contract between the parties (CCP §1287.6), the award should accrue interest at the legal rate of 10 percent per annum unless the award states otherwise. CC §3289(b). See *Budget Fin. Plan v Sav-On Food Club, supra*. Recovery of prejudgment interest is generally governed by CC §3287. See *Esgro Cent., Inc. v General Ins. Co. of Am.* (1971) 20 CA3d 1054, 98 CR 153. For additional discussion of prejudgment interest, see §4.10.

The petition, together with a notice of hearing on the petition and all papers on which the petition is based, must be served in the manner and within the time limits specified in CCP §§1288, 1288.4, and 1290.4.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.46 2. Form: Memorandum of Points and Authorities in Support of Petition for Confirmation of Arbitration Award

§7.46 2. Form: Memorandum of Points and Authorities in Support of Petition for Confirmation of Arbitration Award

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No.** _ _ _ _ _ _
_ _[*Name(s)*]_ _, **doing business as** _____, **Petitioner(s)**	)	**MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF PETITION FOR CONFIRMATION OF ARBITRATION AWARD** [*cite applicable statute*]
and	)	
_ _[*Name(s)*]_ _, **doing business as** _____, **Respondent(s)**	)	**Hearing:** _ _[*date; time*]_ _ **Dep't:** _ _[*number*]_ _ **Hearing judge:** _ _[*if known*]_ _ **Action filed:** _ _[*date*]_ _ **Trial date:** _ _[*if set*]_ _

Petitioner submits the following Memorandum of Points and Authorities in Support of Petition for Confirmation of Arbitration Award.

1. The Bylaws of the _ _[*name*]_ _ Board of Realtors require arbitration of member disputes:

_ _[*Identify applicable section or article number*]_ _ **of the Bylaws requires all members of the _ _[*name*]_ _ Board of Realtors® to submit their disputes with other members to arbitration and to abide by the arbitrators' award.**

_ _[*Identify applicable section or article number*]_ _ **provides that every member of the Board is entitled to invoke the arbitration facilities in any dispute with another member. By becoming and remaining a member of the Board, every member binds himself or herself and agrees to submit to arbitration.** _ _[*Identify applicable section or article number*]_ _**. The Arbitration Agreement referred to in the Bylaws is expressly deemed to be an Arbitration Agreement meeting the provisions of the** _ _[*cite applicable statute, e.g., Part 3, Title 9 of the California Code of Civil Procedure*]_ _**. The manner of invoking the arbitration hearing set forth in** _ _[*identify applicable section or article number*]_ _ **states that the award shall be valid and binding and not subject to review or appeal. In** _ _[*identify applicable section or article number*]_ _**, the Bylaws state that a judgment of any competent court of record in** _ _[*identify location*]_ _ **may be rendered on the award.**

2. The arbitration held by the _ _[*name*]_ _ Board of Realtors® rendered a decision and award in favor of Petitioner:

The arbitration by the _ _[*name*]_ _ Board of Realtors® was held on _ _[*date*]_ _. After submission of the evidence, the arbitrators rendered their decision and awarded to Petitioner _ _[*amount*]_ _ and directed Respondent to pay that sum to Petitioner within _ _[*number*]_ _ days from the date of the decision, or before _ _[*date*]_ _. Respondent has failed to comply with the decision of the arbitrators.

3. This Court is empowered to confirm the arbitration award and to enter judgment thereon _ _[*designate applicable statute, e.g., CCP §1285*]**_ _:**

_ _[*Cite applicable statutory provision, e.g., CCP §1285*]**_ _ provides that any party to an arbitration in which an award has been made may petition the court to confirm the award. The Petition meets the requirements of _ _**[*cite applicable statutory provision, e.g., CCP §1285*]**_ _. Therefore the court has the power to confirm the award and to enter judgment in conformity with the award, as provided in _ _**[*cite applicable statutory provision, e.g., CCP §1285*]**_ _. Petitioner is entitled to receive its costs as provided in _ _**[*cite applicable statute, e.g., CCP §1293.2*]**_ _.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Comment: A party filing a motion must also file a memorandum of points and authorities in support of the motion. Cal Rules of Ct 31112(a)(3), 3.1113. Requirements for the contents and format of the memorandum are in Cal Rules of Ct 3.1110-3.1116.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/7 Broker Compensation and Claims/§7.47 3. Form: Declaration in Support of Petition for Confirmation of Arbitration Award

§7.47 3. Form: Declaration in Support of Petition for Confirmation of Arbitration Award

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
_ _[*Fax number*]_ _
_ _[*E-mail address*]_ _
Attorney for Petitioner, _ _[*name*]_ _

SUPERIOR COURT, COUNTY OF _ _ _ _ _

In The Matter of The Arbitration Between	)	**No. _ _ _ _ _ _**
_ _[*Name(s)*]_ _,	)	**DECLARATION OF**
doing business as	)	_ _[*name*]_ _
_____,	)	**IN SUPPORT OF PETITION**
Petitioner(s)	)	**FOR CONFIRMATION OF**
	)	**ARBITRATION AWARD**
and	)	
	)	**Hearing:** _ _[*date; time*]_ _
_ _[*Name(s)*]_ _,	)	**Dep't:** _ _[*number*]_ _
doing business as	)	**Hearing judge:** _ _[*if known*]_ _
_____,	)	**Action filed:** _ _[*date*]_ _
Respondent(s)	)	**Trial date:** _ _[*if set*]_ _
_____	)	

_ _[*Name*]_ _**, declares under penalty of perjury under the laws of the State of California:**

1. I am over the age of majority.

2. If called as a witness in the above entitled matter, I would testify as follows:

3. I am the _ _[*e.g., Executive Vice President (Executive Officer)*]_ _ **of the** _ _[*name*]_ _ **Board of Realtors®, a** _ _[*state of incorporation*]_ _ **corporation, having its principal place of business in the County of** _ _[*name of county*]_ _**.**

4. The _ _[*name*]_ _ **Board of Realtors®, a** _ _[*state of incorporation*]_ _ **corporation, is a member of the** _ _[*name*]_ _ **Association of Realtors® and the National Association of Realtors®.**

5. A true and correct copy of the Bylaws of the _ _[*name*]_ _ **Board of Realtors®, a corporation, is attached to the Petition** _ _[*e.g., for Confirmation of Arbitration Award*]_ _ **and incorporated by reference. With respect to the provisions thereof herein concerned, the Bylaws that relate to the arbitration of this dispute have been and now are in full force and effect.**

6. The Bylaws require every member of the _ _[*name*]_ _ **Board of Realtors® to submit any controversy or dispute with any other member of the Board to the arbitration procedure established by the Bylaws, on the request of either member.**

7. The procedure for arbitration set forth in the Bylaws provides a complete procedure for handling controversies or disputes between members of the Board. I have personal knowledge that this procedure has been used successfully in many similar commission dispute matters between members of the _ _[*name*]_ _ **Board of Realtors® in the past.**

8. At all times pertinent to this dispute both _ _[*name*]_ _**, doing business as** _ _[*name*]_ _**, since** _ _[*date*]_ _**,**

and _ _[*name*]_ _, doing business as _ _[*name*]_ _, since _ _[*date*]_ _, have been active Broker Members of the _ _[*name*]_ _ Board of Realtors®.

9. In accordance with the procedures in the Bylaws, the _ _[*name*]_ _ Board of Realtors® conducted an arbitration hearing between _ _[*name*]_ _ and _ _[*name*]_ _ on _ _[*date*]_ _.

10. Both _ _[*name*]_ _ and _ _[*name*]_ _ executed a written agreement prior to the date of the arbitration hearing in which they agreed to the arbitration and to abide by the decision and award of the arbitrators. A copy of the written agreement is attached to the petition on file herein.

11. All of the procedures and requirements of the Bylaws with respect to the arbitration have been met. Both _ _[*name*]_ _ and _ _[*name*]_ _ were present at the hearing and were given a full and complete opportunity to present all evidence to the arbitrators.

12. The decision of the arbitrators was made only after presentation of all evidence and based solely on their assessment of the merits of the controversy.

Executed at _ _[*location*]_ _, on _ _[*date*]_ _.

__[*Signature*]__

Comment: A party filing a motion may also file a declaration in support of the motion. Cal Rules of Ct 3.1112(b).

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§7.48 J. Correcting or Vacating an Arbitration Award

An appeal from an award of a local association arbitration panel must address the same issues that arise in an appeal of any arbitration award. The court may correct an award if it determines that (CCP §1286.6):

- There has been an evident miscalculation of figures or an evident mistake in the description of any person, thing, or property referred to in the award;
- The award is imperfect as a matter of form not affecting the merits of the dispute; or
- The arbitrators exceeded their powers and the award may be corrected without affecting the merits of the decision.

An award may be vacated if the court determines that (CCP §1286.2):

- It was procured by corruption, fraud, or other undue means;
- There was corruption in the arbitrators;
- A party suffered substantial prejudice from misconduct of a neutral arbitrator;
- The arbitrators exceeded their powers;
- A party's rights were substantially prejudiced by a refusal to postpone a hearing when sufficient cause was shown or by a refusal to hear material evidence; or
- An arbitrator failed to timely disclose a ground for disqualification of which the arbitrator was aware.

Errors of law or fact do not form the basis for the vacation of an award. For an analysis of judicial review of arbitration awards, see California Real Property Remedies and Damages §§14.40-14.52 (2d ed Cal CEB 2002).

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8

Regulation of Brokers

Paula Reddish Zinnemann
Mary E. Work

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§8.1 I. REGULATION OF BROKERS

California's real estate license laws date to 1919; however, the California State Legislature did not codify the statutory authority of the Department of Real Estate (DRE) until 1943. Now, in California, the real estate brokerage industry is regulated by statute (Bus & P C §§10000-10580, commonly known as the Real Estate Law) and by administrative regulations adopted by the Real Estate Commissioner (10 Cal Code Regs §§2705-2781, 2830.1-3109). Under this regulatory scheme, it is unlawful for anyone to act as a real estate broker or salesperson unless he or she is licensed by the DRE. Bus & P C §10130. For more information about the DRE, see the DRE website listed in the Directory.

Violators of these licensing requirements can be prosecuted by the district attorney of the county in which the violation occurred (Bus & P C §10130) and may be punished by a fine of up to $20,000 ($60,000 for a corporation), a jail term of up to 6 months, or both (Bus & P C §10139). In addition, a person seeking to recover compensation for services as a broker must plead and prove the existence of a valid license at the time the services were rendered. Bus & P C §10136; *Fellom v Adams* (1969) 274 CA2d 855, 862, 79 CR 633. See §§7.10-7.13 for discussion of licensing as a prerequisite to recovering a broker's commission.

In response to the financial crisis brought on in part by the growth in housing prices and the sometimes indiscriminate lending of mortgage funds, the federal government entered the broker regulatory scheme with the creation of the Nationwide Mortgage Licensing System and Registry (NMLS) under the Secure and Fair Enforcement Mortgage Licensing Act of 2008 (SAFE Act) (12 USC 5101-5116). Finance lenders and residential mortgage lenders under the Department of Corporation must register in the nationwide system by July 1, 2010. Real estate brokers who originate mortgages must comply by December 1, 2010. In addition, if a real estate broker or the broker's salesperson makes, arranges, or services loans secured by residential property containing one to four units, the broker must notify the DRE by January 31, 2010 or within 30 days of commencing such loan activity, whichever is later. In connection with SAFE and the creation of the NMLS, California law now requires brokers and salespersons to obtain a real estate license endorsement in order to act as a mortgage loan originator. Fin C §22100. Mortgage loan brokers' activities are regulated under both the Real Property Loan Law (Bus & P C §§10240-10248.3) and regulations adopted by the Real Estate Commissioner (10 Cal Code Regs §§2840-2849.01). Specifically, the mortgage loan originator license endorsement requirement entails additional education, written testing, and reporting duties. See §8.24 for additional discussion.

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§8.2 A. Activities Requiring a License

According to the licensing provisions of the Real Estate Law, a real estate broker is someone who performs any of the following acts for another person and for compensation:

- Sells or offers to sell, or buys or offers to buy, real property (Bus & P C §10131(a));
- Solicits prospective sellers or buyers, solicits or obtains listings, or negotiates for the purchase, sale, or exchange of real property or a business opportunity (Bus & P C §10131(a));
- Leases or rents, offers to lease or rent, solicits listings of places for rent, solicits for prospective tenants, or negotiates the sale, purchase, or exchange of leases of real property (Bus & P C §10131(b));
- Collects rent from real property, improvements, or business opportunities (Bus & P C §10131(b));
- Assists or offers to assist in filing an application for purchase, lease, or entrance to lands owned by the state or federal government (Bus & P C §10131(c));
- Charges an advance fee in connection with various specified activities relating to the sale or lease of real property, including obtaining a loan or loans (Bus & P C §10131.2); all advance fee agreements must first be reviewed by the DRE and a no objection letter issued prior to the use of the agreement (see Bus & P C §10085, 10 Cal Code Regs §2970; see also §8.20 on DRE regulation of loan modifications);
- Engages in various activities relating to the sale, lease, exchange, or financing of mineral, oil, or gas rights (Bus & P C §10131.4);
- Engages in various categories of activities relating to the sale of certain mobilehomes (Bus & P C §§10131.6-10131.7);
- Negotiates loans, collects payments, or performs other services for borrowers, lenders, or note owners in connection with loans secured by liens on real property (Bus & P C §10131(d); see also Bus & P C §10133.1(b) for certain exemptions on collection of loan payments and §§8.24-8.25 on loan brokering activities and licensing requirements for brokers engaging in residential mortgage loan origination);
- Sells or offers to sell, buys or offers to buy, or exchanges or offers to exchange real property sales contracts or promissory notes secured by a lien on real property, as either an agent or the principal (Bus & P C §§10131(e), 10131.1); or
- Engages in transactions involving any real property interest owned beneficially by no more than 100 persons, as specified in Corp C §25206 (Bus & P C §10131.3; see "Regulatory Control of Real Estate Syndicate Offerings" in The DRE Reference Book, which can be viewed or purchased on the DRE website listed in the Directory).

It is important to note that the definition of brokerage activity requires that, in most cases, the activity be performed (1) on behalf of another person and (2) in expectation of compensation. The compensation expected need not be a commission; nonmonetary consideration also constitutes compensation. A number of additional real estate related activities also require a broker license. These activities are discussed in §§8.24-8.28. In addition, certain business activities require a real estate broker license, even when the person engaged in the activity acts solely as a principal. See Bus & P C §§10131(e), 10131.1. See chap 7 on compensation.

NOTE: The DRE has issued guidelines on activities that may be undertaken by unlicensed assistants. These guidelines, covering such topics as cold calling, open houses, and document preparation, are intended to provide a safe harbor for certain activities. The DRE guidelines are not, however, regulations that are binding on licensees or courts. The guidelines are set forth in *Guidelines for Unlicensed Assistants*, available on the DRE website listed in the Directory.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/8 Regulation of Brokers/§8.3 B. Real Estate Advertising

§8.3 B. Real Estate Advertising

Under California law, real estate brokers who advertise services for which a license is required must use terms such as "broker," "bro.," "agent," "agt.," "licensee," or "REALTOR®" to indicate advertising by a real estate licensee. Bus & P C §10140.6; 10 Cal Code Regs §2770.1. All "solicitation materials intended to be the first point of contact with consumers" must include the DRE license number of the broker or salesperson. These materials include "business cards, stationery, advertising fliers, and other materials designed to solicit the creation of a professional relationship between the licensee and a consumer, and excludes an advertisement in print or electronic media and 'for sale' signs." Bus & P C §10140.6; 10 Cal Code Regs §2773.

Any real estate licensee acting in the capacity of a "mortgage loan originator" (as defined in Bus & P C §10166.01) must include in its solicitation materials the "unique identifier assigned to that licensee" by the Nationwide Mortgage Licensing System and Registry (see §§8.1, 8.24). Bus & P C §10140.6(b)(1). See also Bus & P C §§10235.5, 10236.4 regarding additional disclosures required when advertising loan products.

Previously, real estate salespersons who put their own names in the advertisement had to include the name of the supervising broker. Former 10 Cal Code Regs §2770. Although the supervisory broker name is no longer required, the broker must supervise all activities, including the advertisements of his or her salespersons. See 10 Cal Code Regs §2725(e). On a broker's duty to supervise salespersons, see §§3.56-3.58, 8.32-8.42.

NOTE: The term "REALTOR®" is a registered trademark of the National Association of REALTORS® (NAR), a private real estate trade association that represents and advocates for the interests of the organized real estate industry. The designation is used to denote membership in the organization's national, state, and local associations, and should not be used interchangeably with mere status as a real estate licensee. For further discussion of the NAR and other private broker associations, see §§1.6-1.9.

Brokers who join the NAR are subject to additional ethical requirements under the NAR Code of Ethics and Standards of Practice, a copy of which may be found in Appendix A. The California Association of Realtors® (CAR) also promulgates a California Code of Ethics and Arbitration Manual. Each of these publications may be found on the NAR and CAR websites listed in the Directory. See §§3.14-3.16.

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§8.4 1. False Advertising

Advertisements published by real estate licensees who assist clients in the purchase, lease, or entering of California or federal lands must include the name of the broker and the fact that he or she is licensed as a California real estate broker. Bus & P C §10140.5; 10 Cal Code of Regs 2848.

Loan advertising has additional requirements. See Bus & P C §§10140.6, 10235.5, 10236.4, 17539.4 (requiring broker license number and National Mortgage Licensing System identifier).

Under existing laws, the advertisements must not be false or misleading. Bus & P C §§10140, 17500. The DRE has not issued general guidelines for what constitutes false and misleading advertising in all cases. See DRE advertising guidelines for subdivision interests (10 Cal Code Regs §2799.1) and mortgage loans (10 Cal Code Regs §2848). A violation of the false advertising laws may result in a civil penalty of not more than $2500 for each violation (Bus & P C §17536(a)) and/or imprisonment (not exceeding 6 months in county jail (Bus & P C §17500)). Under 10 Cal Code Regs 2731, a licensee may not use a fictitious name unless it is a "dba" licensed to the broker in compliance with Bus & P C §17910 and 17917. See also 10 Cal Code of Regs §2731(d) regarding restrictions on the use of the term "escrow" in a fictitious business name.

No licensee may advertise or otherwise disseminate rates, terms, or conditions for making, purchasing, or negotiating loans or real property sales contracts that are false, misleading, or deceptive. Bus & P C §10235.

Advertisements for investments in trust deeds must include a statement that such investments are "subject to a risk of loss." 10 Cal Code of Regs §2848(a)(19).

Licensees must include in all loan advertisements, the license number under which the loan will be made or arranged. Bus & P C §10235.5. The Real Estate Commissioner has the authority to issue interpretive opinions regarding these provisions. See Bus & P C §10236.

For limitations regarding advertising that contains a seal, insignia, trade or brand name, or any other symbol that could be interpreted as implying a connection to state or local government, see Bus & P C §17533.6.

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§8.5 2. Internet and Fax Advertising

The Internet has become a popular advertising medium in the real estate industry. Existing statutes have been amended to clarify that false and misleading advertisement laws also apply to Internet activities. Bus & P C §§17500, 17530. The DRE has also adopted a rule regulating Internet advertising, which requires that the advertisement provide for direct contact between prospective parties and a licensed California real estate broker. 10 Cal Code Regs §2770.

Unsolicited commercial e-mail advertisements are prohibited. See Bus & P C §§17529-17529.9, 17538.45. Similar provisions also apply to unsolicited faxes. For federal restrictions on unsolicited faxes, see 47 USC §227 (Telephone Consumer Protection Act of 1991) and 47 CFR §68.318(d). For restrictions on solicitations using telephone auto-dialers, see 47 USC §227; Bus & P C §§17511-17513; Pub Util C §§2871-2876; CC §1770(a)(22).

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§8.6 3. Fair Housing Act

The Fair Housing Act (FHA) (42 USC §§3601-3631; commonly referred to as Title VIII of the Civil Rights Act of 1968) prohibits discriminatory practices in the sale or rental of a dwelling. The FHA applies to selling, renting, making loans secured by residential property, making appraisals, enforcing age discrimination covenants in common interest developments, and advertising residential properties. For further discussion of federal and state laws (and exemptions) covering housing discrimination, see §§3.83-3.87.

The United States Department of Housing and Urban Development (HUD) has issued general guidelines for enforcement of advertisements under the FHA. See 24 CFR Part 109. See also *Guidance Regarding Advertisements Under §804(c) of the Fair Housing Act*, HUD Memorandum (Jan. 9, 1995), available on the HUD website listed in the Directory. The FHA is discussed in greater detail in the following CEB titles: Advising California Common Interest Communities, chap 8 (Cal CEB 2003); California Land Use Practice §4.17 (Cal CEB 2006); California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009) §12.84; California Real Property Sales Transactions §§6.67, 6.100, 9.54 (4th ed Cal CEB 2007); Forming California Common Interest Developments, chap 8 (Cal CEB 2004).

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§8.7 4. Unruh Act; FEHA

The Unruh Civil Rights Act of 1959 (CC §51) prohibits business establishments—including real estate offices—from arbitrarily discriminating against people based on "sex, race, color, religion, ancestry, national origin, disability, or medical condition." CC §51(b). See also CC §§51.2-51.4. This list of particular categories is illustrative only and has been extended substantially by court decisions. The California Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996), adopted in 1980, prohibits discrimination or harassment based on race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income, or disability in housing accommodations. See Govt C §§12955-12955.9. For further discussion of the Unruh Act and FEHA, see §§3.83-3.84. California antidiscrimination laws affecting brokers and real property are discussed in the following CEB titles: Advising California Common Interest Communities, chap 8 (Cal CEB 2003); California Eviction Defense Manual, chap 14 (2d ed Cal CEB 1993); California Landlord-Tenant Practice, chaps 2, 8 (2d ed Cal CEB 1997); California Real Property Sales Transactions, chap 6 (4th ed Cal CEB 2007).

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C. Telephone Solicitations

1. Federal and State Regulations

§8.8 a. Do-Not-Call Laws

Brokers and salespersons who use the telephone to solicit business must comply with federal and state do-not-call laws. The Federal Trade Commission (FTC), under the Telemarketing and Consumer Fraud and Abuse Prevention Act (15 USC §§6101-6108), has established a national do-not-call registry, deeming it an "abusive telemarketing act or practice" for a seller or telemarketer to call a person whose telephone number is on the registry, subject to few exceptions. 16 CFR §310.4(b)(1)(iii). The FTC rules apply to telemarketing that involves more than one interstate call. 16 CFR §310.2(cc). The Federal Communications Commission (FCC) coordinates with the FTC on the national do-not-call registry and prohibits most sales calls to numbers on the registry. 47 CFR §64.1200(c)(2). Consequently, California-based telemarketers must comply with federal do-not-call rules whether their sales calls include out-of-state numbers or are limited to California numbers. California has its own do-not-call legislation (Bus & P C §§17590-17594), which is enforceable with respect to intrastate calls, at least to the extent that it is more stringent than the FCC rules. See 47 USC §227(e)(1). The California law adopts the California portion of the national database as California's do-not-call list. Bus & P C §17592(a)(2).

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§8.9 b. When Laws Apply; Cost to Access

Brokers and salespersons must comply with the do-not-call list rules if they initiate or cause someone else to initiate any telephone calls or messages to residential or wireless telephone numbers for the purpose of encouraging the purchase or rental of property, investment in property, or the purchase of services. 16 CFR §§310.2(u), (z), §310.4(b)(1)(iii); 47 CFR §64.1200(c), (f)(6), (f)(7), (f)(9). This does not apply to calls by brokers to someone who has listed property for sale, if the purpose of the call is to discuss a potential sale of the property to a buyer represented by the broker. 70 Fed Reg 19331 (2005). In California, this includes any calls offering a prize or offering to give away goods, services, or documents that can be used to obtain goods or services, offering or soliciting any extension of credit for personal, family, or household purposes, promoting any investment, insurance, or financial services, or seeking marketing information that may be used for direct sales solicitations. Bus & P C §17592.

Information about and links to the registry are available at the FTC website provided in the Directory. The registry is organized by area code. A business may download the first five area codes for free, for a 1-year period. Information about fees for additional area codes may be found on the FTC website. It is unlawful to participate in any arrangement to share the cost of accessing the database. 16 CFR §310.8(c).

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§8.10 c. Recordkeeping

Any for-profit business that engages in telemarketing remains obligated under existing federal laws to maintain and honor a list of consumers who have asked not to receive any further calls from that company. See 16 CFR §310.4(b)(1)(iii)(A); 47 CFR §64.1200(d). A consumer's do-not-call request must be honored for 5 years from the date the request is made, under FCC rules. 47 CFR §64.1200(d)(6). The national do-not-call list does not replace these company-specific do-not-call lists. FTC rules require businesses to keep detailed records of telemarketing activities for at least 2 years (16 CFR §310.5); however, records of consumers' do-not-call requests should be kept for at least 5 years in order to comply with 47 CFR §64.1200(d)(6).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/8 Regulation of Brokers/§8.11 2. Federal and State Safe Harbors

§8.11 2. Federal and State Safe Harbors

The FTC and FCC rules (16 CFR §310.4(b)(3); 47 CFR §64.1200(c)(2), (d)) provide a safe harbor for businesses that:

- Maintain a list of consumers who have asked to receive no further calls from that business;
- Establish and implement written procedures to avoid calls to numbers on that company-specific list and numbers on the national do-not-call list, updated at least every 31 days;
- Train the individuals who make the calls in these procedures; and
- Use a process to prevent telemarketing calls to numbers on the lists.

California provides a similar safe harbor in Bus & P C §17593(d). A business will not be liable for calling a number on the national list or its company-specific list if it can show that these procedures and records were in place and that the call was the result of error.

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§8.12 3. Exceptions

The national do-not-call list was established for residential and wireless numbers only, and the rules do not apply to business-to-business calls. 16 CFR §310.6(b)(7); 47 CFR §64.1200(c)(2), (e). See 68 Fed Reg 4580, 4632 (2003). There are a number of other exemptions, but not all are available under each set of laws. The federal rules and the California law each exempt calls made pursuant to an established business relationship, unless the recipient of the call has asked not to receive further calls (16 CFR §310.4(b)(1)(iii)(B)(ii); 47 CFR §64.1200(a)(2)(iv), (c)(2), (f)(9); Bus & P C §17592(e)(4)), and calls to consumers pursuant to their express, written permission or agreement. 16 CFR §310.4(b)(1)(iii)(B)(i); 47 CFR §64.1200(c)(2)(ii); Bus & P C §17592(e). The FCC rules permit telemarketing calls to family members, friends, and acquaintances, even if their numbers are on the registry (47 CFR §64.1200(c)(2)(iii)), but the FTC rules and California legislation do not.

California's law exempts calls made by small businesses under specified circumstances (Bus & P C §17592(e)(5)); however, that exemption is probably preempted by the federal statute and regulations. See 47 USC §227(e)(1); FCC Report and Order adopted June 26, 2003, CG Docket No. 02-278 (FCC 03-153) Rules and Regulations Implementing the Telephone Consumers Protection Act 68 Fed Reg 44144 (2003).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/8 Regulation of Brokers/§8.13 4. Remedies for Failure to Comply

§8.13 4. Remedies for Failure to Comply

State and federal authorities may obtain injunctive relief against those who violate the do-not-call list rules, and civil penalties of up to $16,000 for each violation. 15 USC §§45(m)(1)(A), 57a(a), 6102(c), 6103; 47 USC §227(e); 16 CFR §1.98(d); Bus & P C §17593(a). In addition, violators may be required to pay civil penalties to injured consumers. 15 USC §6104; 47 USC §227(c)(5); Bus & P C §17593(b).

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§8.14 5. Enforceability of Do-Not-Call List

The United States Court of Appeals for the Tenth Circuit has held that the federal do-not-call registry is a valid commercial speech regulation, which directly advances the government's interests in safeguarding personal privacy and reducing the danger of telemarketing abuse without burdening an excessive amount of speech. *Mainstream Mktg. Svcs., Inc. v FTC* (10th Cir 2004) 358 F3d 1228.

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§8.15 D. Brokers Distinguished From Finders

California courts have long recognized the distinction between a person acting as a real estate broker and a person acting merely as a "finder" and have ruled that a finder is not subject to the licensing requirements of the Real Estate Law. Also, a person acting as a finder without having a broker license may be able to recover a fee (*Tenzer v Superscope, Inc.* (1985) 39 C3d 18, 216 CR 130; *Tyrone v Kelley* (1973) 9 C3d 1, 106 CR 761), but a person acting as a broker without a license will not (*Hasekian v Krotz* (1968) 268 CA2d 311, 74 CR 410). A lawyer, not licensed as a real estate broker, who engages in licensed activities, however, is not protected by the finder's exception. *Preach v Monter Rainbow* (1993) 12 CA4th 1441, 16 CR2d 320 (*Preach I*). On a license as a prerequisite to compensation, see §§7.10-7.13.

The terms "finder" and "middleman" are used interchangeably to refer to one whose role in a transaction is limited to introducing the principals and leaving it to them to negotiate the terms of their contract. *Tyrone v Kelley, supra; McConnell v Cowan* (1955) 44 C2d 805, 285 P2d 261. A broker, on the other hand, actually plays a role in bringing about a meeting of the minds between the parties. An intermediary who engages in any activity beyond merely arranging an introduction of seller and buyer will be classified as engaging in an activity requiring a license as a broker. *Zappas v King Williams Press, Inc.* (1970) 10 CA3d 768, 89 CR 307; *Hasekian v Krotz, supra*; *Abrams v Guston* (1952) 110 CA2d 556, 243 P2d 109.

The distinction between broker and finder is important not only because a finder need not be licensed, but also because a finder does not owe the same fiduciary duty to the principal that a broker does. See *Batson v Strehlow* (1968) 68 C2d 662, 68 CR 589. See chaps 3-4 for discussion of brokers' fiduciary and other duties. Because a finder has no fiduciary obligations, courts are reluctant to find that an intermediary is merely a finder. See generally *Batson v Strehlow, supra*; *Zappas v King Williams Press, Inc., supra*.

PRACTICE TIP: As a practical matter, it is rare for an intermediary to sufficiently limit his or her activities so as to be deemed merely a finder, especially in large commercial transactions. An intermediary who expects compensation on consummation of the transaction will likely want to be involved in negotiation and performance of the contract in an effort to ensure completion of the transaction, rather than leaving the entire process in the hands of the principals. It is hazardous, therefore, to participate as an intermediary in a real property transaction expecting to be considered a finder rather than a broker. Nevertheless, finders are sometimes used in the area of business opportunity brokerage (see §8.27), in which salespersons and brokers often hear of potential clients by word of mouth and sometimes even use finders to canvass neighborhood businesses. These persons are rewarded (usually out of the broker's commission at close of escrow) if a purchase and sale results from information they have provided. See §§8.16-8.18 on the hazards of paying referral fees.

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§8.16 1. RESPA and Referral Fees

A further restriction on an intermediary's ability to collect a finder's fee is found in the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617; 24 CFR §§3500.1-3500.23, Appendices A-E, MS1-MS2 (Regulation X)). Referral fees and fee-splitting arrangements are barred in transactions involving four or fewer units that are financed by loans secured by first deeds of trust obtained from federally insured lending institutions. 12 USC §§2602, 2607; 24 CFR §3500.14. Fees for services actually performed, "affiliated business arrangements" (as long as certain advance notices are given to the person being referred), and payments under cooperative broker and referral arrangements or agreements between real estate salespersons and brokers are all exempt from this prohibition. See 12 USC §2607(c); 24 CFR §§3500.14(g)(1), 3500.15. The latter exemption has yet to be interpreted by the courts, and it is unclear whether it exempts any finder's fee paid to a licensed broker or exempts only referrals between brokers in different geographical areas. For further discussion of RESPA, see §1.22; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 12 (4th ed Cal CEB 2009).

Under California law, real estate brokers are prohibited from receiving a "commission, fee, or other consideration" for referral of clients to an "escrow agent, structural pest control firm, home protection company, title insurer, controlled escrow company, or underwritten title company," unless such compensation falls within an exception provided by the statute. See Bus & P C §10177.4.

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§8.17 2. Title Companies

An employee of a title insurer, underwritten title company, or controlled escrow company who "corruptly violates" the Insurance Code by paying "a commission, compensation, or other consideration" to a real estate licensee, or a real estate licensee who "corruptly violates" the Real Estate Law by receiving such compensation for the referral of title business is guilty of commercial bribery. Pen C §641.4(a). The penalties may include imprisonment in a county jail for not more than 1 year or a fine of $10,000 for each unlawful transaction, or both. Pen C §641.4(b). The Real Estate Commissioner is prohibited from disciplining a licensee for reporting that another licensee accepted illegal consideration unless the reporting licensee had guilty knowledge of, committed, or participated in the violation. Bus & P C §10177.4(a). For compensation restrictions on title companies, see Ins C §§12404-12413.5.

NOTE: The California Department of Insurance oversees a registration program for "title marketing representatives" whose primary duty is to market, offer, solicit, negotiate, or sell title insurance. Ins C §§12404, 12418-12418.4. The statutes clarify and significantly limit what may be spent in the marketing of title insurance products and services, and expand the list of "per se" inducements under the Insurance Code to include any expenditure for food, beverages, and entertainment regardless of the amount.

Although the inducements listed are per se violations for title insurance representatives, receipt of these inducements by a real estate licensee are not. In order to discipline a broker or salesperson, the DRE must prove that items received by the licensee were the inducement for the business given to the title company.

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§8.18 3. Disclosures Related to Residential Mortgages

The Real Estate Commissioner is not required to take action against a real estate licensee solely due to the licensee's acceptance of a fee for the referral of a client to a residential mortgage lender in violation of the federal Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617), provided that the licensee discloses the receipt of the referral fee and complies with all other applicable California laws. See 81 Ops Cal Atty Gen 177 (1997). However, 10 Cal Code Regs §2903 requires specific disclosures when a licensee acts as both the agent in a sale, lease, or exchange and also arranges financing for the transaction. A RESPA violation, however, still may be enforced by the Department of Housing and Urban Development. See §8.16.

Brokers seeking to engage in residential loan modification services must provide borrowers with a disclosure notice stating that it is not necessary to pay a third party for loan modification services and that such services are available for free from the U.S. Department of Housing and Urban Development. Bus & P C §10147.6; Civ C §2944.6.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/8 Regulation of Brokers/§8.19 E. When Is a License Required?

§8.19 E. When Is a License Required?

A person who performs any of the activities described in §8.2 with respect to his or her own property is exempt from the licensing requirements of the Real Estate Law. Generally, a broker license is required only for activities undertaken on behalf of others. Bus & P C §§10131, 10133(a). See, *e.g., Robinson v Murphy* (1979) 96 CA3d 763, 158 CR 246; *McGaughey v Fox* (1979) 94 CA3d 645, 156 CR 593. A few specifically enumerated activities, however, require a license even when the individual is acting as the principal.

EXAMPLE: A person who engages as a principal in the business of buying, selling, or exchanging with the public real property sale contracts or notes secured by liens on real property must be licensed as a real estate broker. "In the business" is defined as the acquisition for resale, or the sale or exchange with the public, of eight or more sale contracts or notes during a calendar year. Bus & P C §10131.1. See also §8.20 on loan modifications and §8.24 on mortgage brokers.

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§8.20 1. Loan Modifications

Under Bus & P C §10131(d), anyone who solicits borrowers or lenders for, or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with, loans secured directly or collaterally by liens on real property or on a business opportunity, must have a broker license. The DRE interprets this to include anyone soliciting, negotiating, or collecting payments under loan modifications, and has issued orders against nonlicensees who are engaged in loan modifications without the benefit of a real estate broker license, or an exemption to the licensing requirement, such as a licensed lawyer who is practicing law (see Bus & P C §§10133, 10133.5).

Effective October 11, 2009, a real estate licensee who performs residential loan modification services is prevented from collecting, claiming, charging, demanding, or receiving any compensation from a borrower until the licensee has performed every service that he, she, or it contracted to perform (so called "advance fees"). Bus & P C §§10026, 10085.6. The same restrictions apply to any person or entity (including attorneys) who offer loan modification services to borrowers. Civ C §2944.7. Both these statutes sunset on January 1, 2013 unless extended by the California legislature. In addition, Bus & P C §10085 has been amended to provide that the Real Estate Commissioner may require brokers to submit any and all materials used in obtaining advance fee agreements to the DRE at least 10 calendar days before use and to impose fines of up to $2500 and misdemeanor penalties for noncompliance.

Those seeking to engage in loan modification services on behalf of another must provide a disclosure notice stating that it is not necessary to pay a third party for loan modification services and that such services are available for free from the U.S. Department of Housing and Urban Development. Bus & P C §10147.6; Civ C §2944.6.

The California Foreclosure Prevention Act (CFPA) (Stats 2009, 2d Extra Sess, ch 4 §3) applies to the foreclosure process and may allow additional time for borrowers to work out loan modifications. All entities that service residential mortgage loans on properties located in California are subject to the CFPA. This includes those licensed by the DRE, the Department of Corporations, and the Department of Financial Institutions. See 10 Cal Regs §§2850.1-2850.10 for the regulations applying to real estate licensees. For more on the CFPA, see California Real Estate Finance Practice: Strategies and Forms §4.60B (Cal CEB 2000); California Mortgages, Deeds of Trust, and Foreclosure Litigation §2.62A (4th ed Cal CEB 2009).

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§8.21 2. Securities Dealers

Securities dealers are not required to be licensed as dealers unless they sell or offer for sale "a series of notes secured directly by interests in one or more parcels of real property, or… undivided interests in a note secured directly by one or more parcels of real property equivalent to a series transaction." In that case the securities dealer must obtain a real estate license, even for activities undertaken as the principal. See §8.28; Bus & P C §10237. The form and content of the statutory notice that the broker must file with the Real Estate Commissioner's Mortgage Loan Section is set forth in Bus & P C §10238.

Mortgage bankers, *i.e.,* those who act as the lender in originating loans secured by real property, do not need to be licensed as real estate brokers.

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§8.22 3. Exemptions Relating to Particular Persons

The following are also specifically exempt from the Real Estate Law's licensing requirements:

- A corporate officer who deals with real property owned or leased by the corporation without the expectation of special compensation (Bus & P C §10133(a)(1));
- A general partner of a partnership who, without expectation of special compensation, deals with real property owned or leased by the partnership (Bus & P C §10133(a)(1));
- An attorney rendering legal services to a client (Bus & P C §§10133(a)(3), 10133.1(a)(5)); but see Bus & P C §10085.6 prohibiting advance fees for loan modification services, discussed in §8.20;
- A receiver, a trustee in bankruptcy, or any person acting under a court order (Bus & P C §10133(a)(4));
- A trustee selling property under a deed of trust (Bus & P C §10133(a)(5));
- A person holding a power of attorney from the property owner (Bus & P C §10133(a)(2); but see *Sheetz v Edmonds* (1988) 201 CA3d 1432, 247 CR 776 (power of attorney exemption to be used when compelled by personal necessity or in isolated transactions only and cannot be used to evade licensing requirements));
- A broker's employee who "assists the broker in meeting the broker's obligations to its customers in residential mortgage loan transactions" involving institutional lenders, but who does not "participate in any negotiations between the principals" (Bus & P C §10133.1(c)(1));
- A resident manager of an apartment building and managers of hotels, motels, or trailer parks and their employees with respect to rentals (including vacation rentals) specified in Bus & P C §10131(b) (Bus & P C §10131.01(a));
- A stenographer, bookkeeper, receptionist, telephone operator, or other clerical worker while functioning as such (Bus & P C §10133.2);
- A film location representative in connection with a transaction that complies with the requirements of Bus & P C §10133.4; and
- Additional exemptions found in Bus & P C §§10133-10133.2 and 10133.15.

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§8.23 4. Exemptions Relating to Loans and Notes

The following are exempt from broker licensing requirements in connection with their activities in making, negotiating, or arranging mortgage loans; or in purchasing, servicing, and selling promissory notes secured by real property:

- Banks, trust companies, savings and loan companies, pension trusts, credit unions, insurance companies, and their employees (Bus & P C §10133.1(a)(1)-(8));
- Agricultural cooperatives and marketing entities (Bus & P C §10133.1(a)(2)-(3));
- A corporation securing credit or money from a federal intermediate credit bank (Bus & P C §10133.1(a)(4));
- A licensed finance lender acting within the scope of the license (Bus & P C §10133.1(a)(6));
- A cemetery authority (Bus & P C §10133.1(a)(7));
- A person licensed as a residential mortgage lender or servicer when acting under the authority of that license (Bus & P C §10133.1(a)(10)); and
- A licensed securities broker or securities dealer or employee acting within the scope of authority granted by the license in a transaction involving the offer, sale, purchase, or exchange of a security representing an ownership interest in a pool of promissory notes secured by liens on real property (Bus & P C §10133.1(a)(9)).

Note that any person soliciting or negotiating loan modifications must have a broker license. See §8.20.

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F. Specialized Licensees

§8.24 1. Mortgage Loan Brokers

In July 2008, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) (12 USC 5101-5116) was enacted by the United States Congress with the goal of encouraging states to establish minimum standards for licensing mortgage loan brokers. Among other things, the SAFE Act created a National Mortgage License System and Registry (NMLS) to which states can look for assistance in regulating "mortgage loan originators." In California, where mortgage brokers can be licensed by either the Department of Corporations (DOC) or the DRE, the California legislature enacted SB 36 (2009) to bring California's regulation of mortgage loan originators into compliance with the SAFE Act.

In general, the Real Estate Law provides that a real estate broker license is required for anyone who solicits borrowers or lenders for, or negotiates loans secured directly or collaterally by, liens on real property. Bus & P C §10131(d). Under SB 36, mortgage loan originators (as defined in Bus & P C §10166.01) licensed by the DRE are required to submit a license endorsement application through the NMLS by September 15, 2010. Endorsements will be issued through the DRE and must be obtained by January 1, 2011 in order for the real estate licensee to continue to act as a mortgage loan originator in California. The DRE requirements are described more fully at Bus & P C §§10150(c), 10151(e), 10166.01-10117. There are minimum education and testing requirements to qualify for the initial endorsement as well as for the yearly renewal of the endorsement. See Bus & P C §10166.06 for prerequisites for the mortgage loan originator endorsement. The DRE recently promulgated a regulation providing that the parallel disciplinary standards and processes that apply to real estate brokers and salespersons will also apply to those who apply for and receive a mortgage loan originator license endorsement. 10 Cal Code of Regs §2945.4. For further details on the license endorsement process, see the DRE website and the NMLS Resource Center website listed in the Directory.

The DOC issues mortgage loan originator (as defined in Fin C §§22013, 50003.5) licenses under two acts: the California Residential Mortgage Lending Act (CRMLA) (Fin C §§50000-50706) and the California Finance Lenders Law (CFLL) (Fin C §§22150-22780). The DOC website contains a description of these two types of licenses. The DOC requires any corporation holding either a CRMLA license or a CFLL license to complete and submit forms to the NMLS for the corporation and each controlling person of the corporation by May 28, 2010. The DOC expects to begin issuing mortgage loan originator licenses by July 2010. Additional information is available on the DOC website listed in the Directory.

A broker's employee assisting the broker in certain residential mortgage loan transactions may be exempt from the license requirement. See §8.22. For additional exemptions, see Fin C §50002(b)-(c).

A real estate licensee who represents a buyer or seller in a purchase and sale transaction and intends to receive compensation from a lender in connection with the securing of financing in connection with the property must provide a written disclosure of the form, amount, and source of the compensation to both parties prior to the closing of the transaction. See 10 Cal Code Regs §2904. Residential mortgage lenders are licensed and regulated by the Department of Corporations, but again do not need a separate real estate license. See Fin C §§50000-50129; 10 Cal Code Regs §1950.003.

The Real Estate Commissioner has jurisdiction over the operations of mortgage loan brokers because they must be licensed real estate brokers. Bus & P C §10131(d). The Commissioner may suspend or revoke a license for violations of the Real Estate Law or the regulations. The regulations also address the following:

- Advertising (Bus & P C §§10232.1, 10235, 10235.5, 10236.4, 10237.7; 10 Cal Code Regs §§2847-2848);
- For "Regulated Loans" (first trust deed loans of less than $30,000 and junior trust deed loans of less than $20,000):
- Interest rates (Bus & P C §10242(c));
- Prepayment rights (Bus & P C §10242.6);

- Balloon payments (Bus & P C §§10242.4, 10244-10244.1); and
- Brokers' commissions in regulated transactions (Bus & P C §10242(b)).

In addition, slightly different advertising disclosure requirements apply to brokers who solicit borrowers and brokers who solicit investors/lenders. Bus & P C §10236.4. Both types of solicitation advertising require the licensee's license number. Solicitations for borrowers must also include the identifier as described in 10 Cal Code Regs §2847.3. Brokers who make residential mortgage loans using or advancing their own funds and who qualify as approved lenders under certain federal loan programs must provide annual reports to the Commissioner. Bus & P C §10131.8.

NOTE: Unlike mortgage brokers, mortgage bankers lend, as principals, on the security of real property and need not be licensed as real estate brokers. See §8.19.

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§8.25 a. Disclosure Requirements and Limits on Charges

A mortgage loan broker owes a fiduciary duty to the borrower, including a duty to point out to an unsophisticated borrower any unfavorable loan provisions. *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 157 CR 392. In *Wyatt,* the broker failed to disclose unfavorable terms regarding interest, late charges, and the size of the balloon payment. In addition to compensatory damages, the borrowers were awarded punitive damages of $200,000 for fraud and breach of the broker's fiduciary duty. In *Realty Projects, Inc. v Smith* (1973) 32 CA3d 204, 108 CR 71, the borrowers sought loans within the coverage of the Real Property Loan Law (Bus & P C §§10240-10248.3) but were persuaded by the brokers to borrow above the applicable regulated loan limit. The court, in sustaining an order suspending and revoking the brokers' real estate licenses, held that they were required to disclose to the borrowers that the commissions and other charges would have been substantially lower if the loans had been within the coverage of the Real Property Loan Law.

The Real Property Loan Law protects borrowers by limiting the fees that may be charged on regulated loans and by requiring detailed and specific disclosure of loan charges. The law applies generally to loans made or negotiated by a real estate broker and secured by real property. Bus & P C §§10240(b), 10248.3. Most of its specific provisions, however (other than the disclosure requirement of Bus & P C §10240), apply only to loans secured by residential dwellings costing less than $30,000 (if secured by first deeds of trust) or less than $20,000 (if secured by junior liens). Bus & P C §§10240.1, 10245. For these purposes, a residential dwelling is defined as a single dwelling unit in a condominium or cooperative, or any parcel of one-to-four-unit residential real property that is owned by the signatory on the mortgage or deed of trust at the time of its execution. Bus & P C §10240.2.

The maximum charge that can be imposed for brokerage costs and expenses, including appraisal fees, escrow, title, notary, recording, and credit investigation fees (but exclusive of actual title and recording charges) in a mortgage loan subject to the Real Property Loan Law, is the greater of 5 percent of the principal amount of the loan, or $390, but in no event more than $700. Bus & P C §10242(a).

The Real Property Loan Law also requires that the broker deliver to the borrower a mortgage loan disclosure statement, in the form prescribed by the DRE, which discloses, among other things, the amount of commissions and all other costs charged to the borrower, for all broker-negotiated loans whether or not the loan is a regulated loan. Bus & P C §§10240-10241; 10 Cal Code Regs §§2840-2841. For a federally regulated residential mortgage loan of $30,000 or more in principal and secured by a first deed of trust (or $20,000 or more and secured by a junior deed of trust), the broker's disclosure obligations are satisfied if:

- The borrower receives a "good faith estimate" that satisfies the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) and that includes the broker's license number and a statement that it is not a loan commitment;
- The borrower receives applicable disclosures required by the Truth in Lending Act (15 USC §§1601-1693r); and
- If the loan provides for a balloon payment, the loan contains a balloon payment disclosure meeting specified standards. Bus & P C §§10240(c), 10245.

Before becoming obligated on any loan made or arranged by a broker, the borrower must acknowledge receipt of the required disclosures in writing. The broker must retain a copy of the disclosure documentation, acknowledged by the borrower, for a period of 3 years. Bus & P C §10240(a), (c). This requirement applies to all loans made or arranged by real estate brokers, not only those secured by a dwelling. Bus & P C §§10240.1, 10248.3.

When a licensee acts as both the agent in a sale, lease, or exchange and also arranges financing for the transaction must provide written disclosure of those roles to all parties to the transaction within 24 hours of undertaking the roles. 10 Cal Code Regs §2903.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/8 Regulation of Brokers/§8.26 b. Exemption From Usury for Loans Made or Arranged by Broker

§8.26 b. Exemption From Usury for Loans Made or Arranged by Broker

Under Cal Const art XV, §1, a loan secured by real property and made or arranged by a real estate broker is exempt from usury limitations. *Stoneridge Parkway Partners, LLC v MW Hous. Partners III LP* (2007) 153 CA4th 1373, 1379, 64 CR3d 61. The phrase "made or arranged" does not include a loan in which the broker was a borrower; it includes only loans in which the broker is either a lender or a third party acting for others for compensation. See *Winnett v Roberts* (1986) 179 CA3d 909, 225 CR 82; *Green v Future Two* (1986) 179 CA3d 738, 225 CR 3; CC §1916.1. However, a loan arranged by a broker acting in his capacity as the general partner of a borrower that is a limited partnership, does qualify for the exemption. See *Park Terrace Ltd. v Teasdale* (2002) 100 CA4th 802, 807, 122 CR2d 797; see also *Stickel v Harris* (1987) 196 CA3d 575, 242 CR 88 (broker did not lose exempt status by joining the borrowing joint venture). Similarly, a broker who is also an officer and employee of an affiliate of the lender will also qualify for the exemption. *Stoneridge Parkway Partners, LLC,* 153 CA4th at 1380.

The compensation expected by the broker may be the right to participate in the borrowing entity's anticipated profits. See *Park Terrace Ltd. v Teasdale, supra*. See CC §§2956-2967 on disclosure requirements that apply to brokers and other "arrangers of credit" (as defined in CC §2957) on purchase money liens on residential property.

Civil Code §1916.1 restricts the foregoing usury exemption to situations in which the broker:

- Acts for compensation or in expectation of compensation for soliciting, negotiating, or arranging the loan for another;
- Acts for compensation or in expectation of compensation for selling, buying, leasing, exchanging, or negotiating the sale, purchase, lease, or exchange of real property or a business for another and (1) arranges a loan to pay all or any portion of the purchase price of, or of an improvement to, that property or business, or (2) arranges a forbearance, extension, or refinancing of any loan in connection with that sale, purchase, lease, exchange of, or improvement to, real property or a business; or
- Arranges or negotiates for another a forbearance, extension, or refinancing of any loan secured by real property in connection with a past transaction in which the broker had acted for compensation or in expectation of compensation for selling, buying, leasing, exchanging, or negotiating the sale, purchase, lease, or exchange of real property or a business.

NOTE: The actions of simply preparing loan documents according to instructions and on terms provided by the parties, ordering title insurance, and dispersing funds do not constitute "arranging" a loan under Cal Const art XV, §1, or under CC §1916.1. See *Gibbo v Berger* (2004) 123 CA4th 396, 402, 19 CR3d 829 ("When viewed in the context of 'arranging a loan,' the phrase 'arranged by' must refer to some conduct by a real estate broker, acting as a third party intermediary rather than as a party to the loan, that causes a loan to be obtained or procured").

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§8.27 2. Business Opportunity Brokers

As defined in the Real Estate Law, the term "business opportunity" includes the sale or lease of the business and goodwill of an existing business enterprise or opportunity. Bus & P C §10030. A business opportunity broker is required to be licensed as a real estate broker. Bus & P C §§10130-10131. A sale of all or substantially all assets of a corporation, partnership, or sole proprietorship is considered a business opportunity, and the sale of all or substantially all the shares of a corporation may also be considered a business opportunity. *All Points Traders, Inc. v Barrington Assocs.* (1989) 211 CA3d 723, 259 CR 780. However, licensed security broker-dealers can broker the sale of certain business opportunities without a real estate license. Bus & P C §10008.5.

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§8.28 3. Real Estate Syndicate Securities Dealers

Real estate syndications may take many forms, but they are generally a means of pooling investors' funds for investment in real estate. They are most often formed to purchase, develop, or construct real property or to make loans secured by real property. Most syndications involve the offer and sale of a security within the meaning of the Corporate Securities Law of 1968 (Corp C §§25000-25707) and the federal Securities Act of 1933 (15 USC §§77a-77aa). For example, limited partnership interests, investment contracts, interests in an unincorporated association such as a trust, and multiple interests in promissory notes constitute securities. Corp C §25019 (definition of securities). See also *People v Woodson* (1947) 78 CA2d 132, 177 P2d 586 (limited partnership interests are securities).

Anyone who offers or sells securities as a principal or a broker must generally be licensed as a "broker-dealer" by the Department of Corporations. Corp C §§25210-25221. However, a person selling certain limited classes of securities (consisting primarily of interests in noncorporate entities) that are owned by no more than 100 persons and that represent interests in an entity that is formed for the sole purpose of investing in real property is exempt from the broker-dealer licensing requirement if he or she is licensed as a real estate broker. Corp C §25206; Bus & P C §10131.3. Conversely, a broker-dealer who is licensed under the Corporate Securities Law of 1968 need not obtain a real estate broker license when dealing in real estate syndicate securities. Bus & P C §10131.3.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/8 Regulation of Brokers/§8.29 G. Licensing Qualifications

§8.29 G. Licensing Qualifications

To obtain a real estate license, applicants must pass a written examination. Bus & P C §§10150-10153. An applicant for a broker license must also meet an experience requirement by having:

- A salesperson license for at least 2 years, having qualified for renewal of real estate salesperson status within the 5-year period preceding the application, and during such period, having been actively engaged as a real estate salesperson;
- The equivalent of at least 2 years of general real estate experience (and approval of the Commissioner); or
- A degree from a 4-year college or university, with a specialty in real estate (and approval of the Commissioner). Bus & P C §10150.6.

An applicant for a broker or a salesperson license must also meet specific educational requirements (Bus & P C §§10151, 10153.2, 10153.4-10153.5), must be fingerprinted (Bus & P C §10152; 10 Cal Code Regs §2712), and may be required to submit proof of honesty and truthfulness (Bus & P C §10152).

In addition to the general licensing requirements set forth above, licensed brokers or salespersons who engage in mortgage loan origination must obtain an endorsement to their license from the DRE. See discussion of qualifying for and renewing the endorsement in §8.24.

Even if all licensing qualifications are met, the Real Estate Commissioner may deny a license to anyone who:

- Attempted to procure the license by fraud, misrepresentation, or deceit or by making a material misstatement of fact in the application;
- Has been convicted of a felony or a crime that is substantially related to the qualifications, functions, or duties of a real estate licensee (Bus & P C §10177(b); see also §9.12 and 10 Cal Code of Regs §2910 regarding "criteria of substantial relationship"); or
- Is guilty of certain other dishonest activities (Bus & P C §10177; see *Harrington v Department of Real Estate* (1989) 214 CA3d 394, 263 CR 528).

PRACTICE TIP: Attorneys should advise clients applying for real estate licenses to disclose all convictions irrespective of the time such convictions occurred or the belief that they have been expunged. The fingerprinting process by the Department of Justice and the Federal Bureau of Investigation is quite thorough and reveals all convictions of record. When the fingerprinting process discloses a conviction that the applicant has failed to disclose on his or her application, it is the DRE position that the applicant has attempted to procure a real estate license by fraud. See Bus & P C §10177(a).

The Real Estate Commissioner may issue a restricted license to an applicant who has met the examination and education requirements, but who, after a hearing, is found by the Commissioner not to have met the other requirements. Bus & P C §10156.5. The license may be restricted as to term or employment by a particular broker, and may include other conditions. Bus & P C §10156.6. In addition, the Commissioner may suspend a restricted license without a hearing. Bus & P C §10156.7(b). If the license is conditioned on satisfaction of the education requirements in Bus & P C §10153.4 within 18 months, it will be automatically suspended on the licensee's failure to comply with that condition. Bus & P C §10156.7(c).

Licenses for both brokers and salespersons are issued for 4 years. Bus & P C §§10153.6-10153.7. An initial renewal of either license requires that the applicant successfully complete 45 hours of continuing education courses, seminars, or conferences every 4 years as prescribed in Bus & P §10170.5:

- A 3-hour course covering professional ethics and the legal aspects of being a real estate broker or salesperson (Bus & P C §10170.5(a)(1));
- A 3-hour course in agency relationships and duties in a real estate brokerage practice, including instruction in the disclosures to be made and the confidences to be kept in the various agency relationships between licensees and parties to real estate transactions (Bus & P C §10170.5(a)(2));

- A 3-hour course in trust fund accounting and handling (Bus & P C §10170.5(a)(3));
- A 3-hour course in fair housing (Bus & P C §10170.5(a)(4);
- A 3-hour course in risk management (Bus & P C §10170.5(a)(5)); and
- At least 18 hours of courses or programs related to consumer protection (Bus & P C §10170.5(a)(6)).

Successful completion of a course means passing its final examination. Bus & P C §10170.5(d).

On subsequent renewals, except as provided by Bus & P C §10170.8, the licensee must have completed in the last 4 years the 45 hours of continuing education set out in Bus & P C §10170.4, including an 8-hour update survey course of the subjects described in Bus & P C §10170.5.

NOTE: The Federal Personal Responsibility and Work Opportunity Reconciliation Act (8 USC §§1601-1646) requires states to eliminate a broad array of public benefits for illegal immigrants. The definition of a public benefit includes professional and occupational licenses issued to individuals by state agencies. 8 USC §1621. To implement the Act, the DRE adopted 10 Cal Code Regs §2718, which requires proof of legal presence in the United States from all applicants for both an initial and a renewal license.

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H. Corporations and Partners as Licensees

§8.30 1. Corporate Brokers

A corporation may be licensed as a real estate broker. The corporate license entitles one designated officer (who must individually hold a broker license) to act as a broker on behalf of the corporation without payment of any further licensing fee. Bus & P C §10211. If more than one officer of a corporation acts as a broker, the corporation must obtain additional licenses for each of them (Bus & P C §10158), and each officer through whom the corporation acts as a licensee must pass the DRE's written examination (Bus & P C §10151). An officer through whom a corporation is licensed may act as a broker as long as he or she is employed under the license, but only on behalf of the corporation. Bus & P C §10159. Acts for which a real estate license is required may be conducted by the corporation only if there is an officer licensed under Bus & P C §10158 or §10211. 10 Cal Code Regs §2740.

A corporation's real estate broker license may not be revoked if the offending officer, director, or controlling shareholder acted individually and not on behalf of the corporation, and had completely disassociated himself or herself from the corporation at the time of revocation. Bus & P C §10177(p). See *Amvest Mortgage Corp. v Antt* (1997) 58 CA4th 1239, 68 CR2d 457.

PRACTICE TIP: It is possible to be licensed only as a broker officer for a corporation. Such a license limits the licensee to performing broker acts only in conjunction with the corporation's broker license.

Corporations engaged in mortgage loan origination must register with the Nationwide Mortgage Licensing System and Registration (see §§8.1, 8.24) and obtain an endorsement for its corporate broker license. All employees of a corporation engaged in mortgage loan origination, unless exempt under Bus & P C §10166.03, must also obtain individual mortgage loan originator license endorsement. Bus & P C §§10166.01-10166.02. An independent contractor employed by the corporation may not engage in the activities of a loan processor or underwriter unless the independent contractor obtains and maintains an endorsement as a mortgage loan originator. Bus & P C §10166.03(c).

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§8.31 2. Partnerships

Although there is no provision for a broker license to be issued to a partnership per se, individual licensed brokers may form a partnership. Bus & P C §10137.1. The partnership can perform acts requiring a license provided that every partner through whom the partnership performs such acts is licensed as a real estate broker. With proper supervision and while working under a broker-salesperson agreement, a salesperson who is licensed to a broker of the partnership may perform licensee acts for and on behalf of the partnership. 10 Cal Code Regs §2728.

A broker license may be issued in a fictitious name (or "dba") as long as the broker has first qualified to do business under the fictitious name. Bus & P C §10159.5. A licensee cannot do business under a fictitious name unless the license was issued in that name. 10 Cal Code Regs §2731.

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II. BROKER'S RELATIONSHIP WITH SALESPERSONS

§8.32 A. Salesperson Licensing and Employment Requirements

A natural person employed by a licensed real estate broker to perform any act that requires a broker license is defined as a "salesman" by the Real Estate Law (Bus & P C §10132) and must be licensed by the DRE (Bus & P C §10130). "Salesman" means "salesperson" wherever it is used in the Real Estate Law, and a licensee may refer to the licensed status as salesman, saleswoman, or salesperson. Bus & P C §10017. In the residential real estate industry, salespersons are often referred to as "agents." A salesperson may be employed only by a licensed broker and may not perform licensed acts except through that broker. Bus & P C §§10132, 10137; *Grand v Griesinger* (1958) 160 CA2d 397, 325 P2d 475. For example, if a salesperson procures a listing of property, the listing agreement must be entered into between the property owner and the employing broker. Likewise, when a commission is paid, the broker must receive the commission and may agree to pay a part of the commission to the salesperson who handled the transaction. See discussion in §7.11.

A broker may not employ a person who is not a licensed broker or a licensed salesperson to perform acts that require a license. Bus & P C §10137. A salesperson cannot be employed by, or accept compensation from, anyone other than the broker under whom he or she is currently licensed. Bus & P C §10137; *Hoar v Tuley* (1970) 12 CA3d 344, 90 CR 559.

The DRE permits an employing broker to pay commissions or compensation directly to the validly formed corporation of its salespersons. However, the salesperson corporation may not obtain a salesperson license and may not perform acts for which a real estate license is required.

PRACTICE TIP: It is accepted DRE policy that the employing broker may pay his or her salesperson's commission through escrow as long as the broker has given written instructions to the escrow on a "transaction-to-transaction" basis.

It is also unlawful for a salesperson to pay compensation to any real estate licensee for acts requiring a license, except through the employing broker. Bus & P C §10137.

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§8.33 B. Character of Relationship and Corresponding Obligations

The statutory scheme of the Real Estate Law requires that a salesperson act only through and on behalf of a broker. Bus & P C §§10132, 10137, 10160. Likewise, a broker is required to supervise his or her salespersons and is subject to disciplinary action by the Real Estate Commissioner for failure to do so. Bus & P C §10177(h). The duty of supervision requires that the broker establish policies, rules, procedures, and systems to manage and review certain activities, including transactions for which a license is required, documents that may have a material effect on the rights or obligations of a party to the transaction, handling of trust funds, and advertising. 10 Cal Code Regs §2725. Despite the typical characterization of the relationship between the broker and a salesperson as an independent contractor arrangement, the statutory scheme of the Real Estate Law, particularly the broker's duty to supervise salespersons (see §§3.56-3.58), makes them agents and employees of the broker for purposes of the Real Estate Law (*Gipson v Davis Realty Co.* (1963) 215 CA2d 190, 30 CR 253), and it may make them employees for other purposes as well, such as application of workers' compensation laws (see §8.39), income tax and Social Security withholding (see §8.40), and tort liability (see §§8.41, 11.15-11.17).

In *Resnik v Anderson & Miles* (1980) 109 CA3d 569, 167 CR 340, the court held that a salesperson was an employee in deciding that the Labor Commissioner had jurisdiction under Lab C §98(a) to adjudicate the salesperson's claim for a commission owed him by the broker. The court reasoned that the strictures of the Real Estate Law effectively made the real estate salesperson an employee, as a matter of law. Although the parties' characterization of the relationship was not determinative, the significance of the context of the inquiry was not ruled out. 109 CA3d at 572. This does not mean, however, that a salesperson is an employee of the broker for all purposes.

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§8.34 1. Relationship Between Broker and Salesperson Under Bus & P C §10032: Employee or Contractor?

Whether a salesperson is the broker's employee or an independent contractor under the law varies depending on the context in which the inquiry is made. The parties' characterization of the relationship is not determinative. *Brown v IAC* (1917) 174 C 457, 163 P 664; *Anderson v Badger* (1948) 84 CA2d 736, 191 P2d 768. The enactment of Bus & P C §10032 clarified the legal obligations arising from the broker-salesperson relationship in some respects and left others undefined. Section 10032(a) provides that all obligations created under the Real Estate Law and the corresponding regulations regarding salespersons and the obligations of brokers and salespersons to the public are to be enforced without respect to whether the relationship of the salesperson to the broker is characterized as that of an independent contractor or employee. Section 10032(b) provides that the real estate broker, and the real estate salesperson licensed under that broker, may characterize their legal obligations to each other as that of independent contractors or of employer and employee. However, the character of that relationship for other purposes may be governed by other statutes, such as the statutes governing withholding taxes, unemployment compensation, and workers' compensation. Thus, whether a salesperson is the broker's employee or an independent contractor under the law depends on the context in which the inquiry is made.

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§8.35 2. As Against Third Parties

With respect to third parties, a supervising broker who also holds an ownership interest in a brokerage may be liable for the tortious acts of the salespersons working under the broker's supervision, under the Real Estate Law and DRE regulations, and based on the vicarious liability theory that a principal is responsible for the acts of its agent. In addition, a supervising broker who is also the sole owner of a brokerage may have personal liability if facts exist to justify piercing the company's corporate veil. See *Holley v Crank* (9th Cir 2004) 400 F3d 667 (broker held personally liable for actions of employee in violating Fair Housing Act). See also *California Real Estate Loans, Inc. v Wallace* (1993) 18 CA4th 1575, 23 CR2d 462. See generally Bus & P C §10032; CC §2079.13.

A broker's failure to properly supervise a salesperson may also result in a civil judgment against the broker on a theory of vicarious liability for the fraud, misrepresentation, or deceit, putting the broker's license in jeopardy under Bus & P C §10177.5. See *California Real Estate Loans, Inc. v Wallace, supra.* While Bus & P C §10179 requires that the broker-employer have guilty knowledge of any violation by its salesperson to be subject to suspension or revocation of his or her real estate license, Bus & P C §10177.5 in effect imposes strict liability on the broker for the salesperson's fraudulent acts. Thus, vicarious liability resulting in a fraud judgment against the broker may result in the suspension or revocation of the broker's real estate license. This aspect of broker liability may not be changed by contract or by characterizing the relationship with a salesperson as that of an independent contractor. Bus & P C §10032; *Gipson v Davis Realty Co.* (1963) 215 CA2d 190, 30 CR 253. The revocation of a broker license under Bus & P C §10177.5 does not require any guilty knowledge on the broker's part, only the fact of a judgment against the broker. Administrative discipline against the broker who suffers a judgment due to the misconduct of a salesperson provides a powerful incentive to guard against misconduct by salespersons in the future. See discussions of vicarious liability and the theory of respondeat superieur in §§3.58, 5.19, 11.15-11.17.

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§8.36 3. Relationship Between Broker and Salesperson Under Common Law and Other Statutory Schemes

In contexts not specifically addressed in Bus & P C §10032, analysis of the character of the relationship between broker and salesperson generally depends on the application of common law principles to the facts of a particular case. Under common law, the most important test of whether the relationship is that of employee or independent contractor is the degree to which the broker has the right to control the manner and means in which the salesperson's work is done. If the broker may control only the results to be achieved, an independent contractor relationship likely exists. If the broker's right of control extends over the details of how services are performed, however (whether or not such actual control is exercised), then an employer-employee relationship likely exists. See *Baugh v Rogers* (1944) 24 C2d 200, 148 P2d 633; *Burlingham v Gray* (1943) 22 C2d 87, 137 P2d 9, superseded by statute as stated in *Hendy v Lossee*, (1991) 54 C3d 723, 1 CR2d 543.

In addition to the common law test, the relationship between broker and salesperson must be considered in view of the purposes of any statutory scheme applicable to the context in which the inquiry arises. Absent an overriding public policy or the clearly expressed intent of another statutory scheme, the duty to supervise imposed by the Real Estate Law historically has been interpreted to favor a finding of an employee-employer relationship.

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§8.37 4. Impact on Case Law

The express pronouncement codified by the 1991 enactment of Bus & P C §10032 that the legal relationship between a salesperson and broker with respect to their legal obligations to each other may be that of independent contractor, places the ongoing validity of some judicial decisions in doubt. For example, in *Resnik v Anderson & Miles* (1980) 109 CA3d 569, 167 CR 340, the issue before the court was whether the Labor Commissioner had jurisdiction under Lab C §98(a) to adjudicate the salesperson's claim for a commission owed by the broker, a question that turned on the salesperson's status as an employee or independent contractor. On the strength of the agency relationship created by the Real Estate Law and the pronouncement in *Gipson v Davis Realty Co.* (1963) 215 CA2d 190, 30 CR 253, that the legislature had made the salesperson an employee of the broker as a matter of law, the *Resnik* court declared that the relationship of a salesman to a broker could not be classified as that of an independent contractor. Finding no compelling reason why the classification that the salesperson was an employee as a matter of law should not be applied, the court held that the Labor Commissioner had jurisdiction under Lab C §98(a) to adjudicate the salesperson's claim for a commission. 109 CA3d at 572. Because a material premise of the decision in *Resnik* was that the Real Estate Law precludes a salesperson's relationship vis-a-vis his or her broker from being classified as that of an independent contractor, and the Real Estate Law now expressly permits the legal obligations between a salesperson and broker to each other to be that of independent contractors, it is uncertain how this issue would be decided today. See *Grubb & Ellis Co. v Spengler* (1983) 143 CA3d 890, 896, 192 CR 637 (questioning *Resnik* in light of provisions of unemployment compensation law and Internal Revenue Code).

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§8.38 5. Unemployment Insurance

Brokers and real estate salespersons are excluded from coverage under California's unemployment insurance system if specified conditions are met. To be excluded, the salesperson must (1) be licensed, (2) derive substantially all remuneration from services directly related to sales or performance of services rather than the number of hours worked, and (3) perform services under a written contract with the broker providing that the salesperson will not be treated as an employee for state tax purposes. Un Ins C §650. If a salesperson is paid a salary, coverage turns on whether he or she is an independent contractor or an employee under Un Ins C §601, and this determination depends on the degree of control the broker is able to exercise. See, *e.g., Grant v Woods* (1977) 71 CA3d 647, 139 CR 533 (newspaper carriers are employees). To obtain helpful information and publications on this topic, see the California Employment Development Department's website, listed in the Directory.

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§8.39 6. Workers' Compensation

The status of a real estate salesperson under the California Workers' Compensation Act (Lab C §§3200-6149) remains a question of fact to be analyzed on a case-by-case basis, as governed by the definitions of employee and independent contractor set forth in the Act. Lab C §§3350-3351, 3353. The analysis underlying the common law test for employees (the right of control over the means of performing services) applies in this context. *Flickenger v IAC* (1919) 181 C 425, 184 P 851; *Esquer v Teresi* (1951) 105 CA2d 89, 232 P2d 895. In the cases decided before the enactment of Bus & P C §10177 (on suspension and revocation of licenses), the results were mixed. In *Brown v IAC* (1917) 174 C 457, 163 P 664, and *Cameron v Pillsbury* (1916) 173 C 83, 159 P 149, the courts held real estate salespersons to be employees for workers' compensation purposes under the facts presented. In each case, the salesperson was contractually obligated to devote all working hours to performance of his duties, and the broker had the right to control his means of performing these duties. Similarly, in *Hartford Acc. & Indem. Co v IAC* (1928) 93 CA 313, 269 P 733, the broker was held to have sufficient control over the salesperson to render him an employee. On the other hand, in *Royal Indem. Co. v IAC* (1930) 104 CA 290, 285 P 912, the court found no evidence that the broker controlled the means, manner, or mode of the salesperson's work, but was instead interested only in the results of the efforts of the agent, making classification of the salesperson as an independent contractor proper.

Since enactment of Bus & P C §10177, the court in *Payne v White House Props., Inc.* (1980) 112 CA3d 465, 169 CR 373, reaffirmed that whether the salesperson is an employee of the broker for workers' compensation purposes remains a question of fact to be determined at trial. In *Payne*, the court found sufficient evidence to support the conclusion that the salesperson was not an employee; however, the court observed that in most instances, the salesperson *is* likely to be an employee for workers' compensation purposes.

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§8.40 7. Withholding Income and Social Security Taxes

Income, employment, and Social Security taxes must be withheld from compensation paid to employees, but those taxes cannot be withheld from independent contractors. IRC §§3102(a), 3401-3403, 3501-3509. The Internal Revenue Code and the Department of Treasury Regulations have adopted essentially the same view that the common law test of an independent contractor is whether the broker controls only the results of the salesperson's work and not the specific means by which it is accomplished. Reg §31.3401(c)-1(b).

Moreover, real estate salespersons receive specific statutory treatment. A licensed salesperson will not be considered an employee if (1) compensation is based on sales or other output rather than number of hours worked and (2) the salesperson and the broker have a written contract that states that the salesperson will not be treated as an employee for withholding purposes. IRC §3508. California has a similar statutory exemption from state unemployment insurance withholding requirements. Un Ins C §13004.1. If the salesperson does not satisfy its specific requirements, however, the control test must be relied on to determine whether the salesperson is an employee or an independent contractor. See also 59 Ops Cal Atty Gen 369 (1976), which concluded that Bus & P C §10177(h) probably imposes a sufficient measure of control on the broker to make the salesperson an employee for income and Social Security tax purposes.

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§8.41 8. Tort Liability

As indicated in §8.33, for purposes of the Real Estate Law, salespersons are agents of their brokers as a matter of law. *Gipson v Davis Realty Co.* (1963) 215 CA2d 190, 30 CR 253. By virtue of both common law principles of agency and statutory law, brokers are liable as a matter of law for the torts committed by their salespersons within the course and scope of their agency. *California Real Estate Loans, Inc. v Wallace* (1993) 18 CA4th 1575, 23 CR2d 462; Bus & P C §10032; CC §2079.13. This is true without regard to whether the salesperson is otherwise classified as an employee or independent contractor. An employer is required by statute to indemnify an employee for all that the employee necessarily expends or loses in the performance of his or her job or while obeying the directions of the employer, whether or not lawful, unless the employee believed the acts to be unlawful at the time the directions were obeyed. Lab C §2802(a). Any contract made by an employee that purports to waive this right is null and void. Lab C §2804. Although independent contractors are not entitled to indemnification under Lab C §2802, a real estate salesperson who is an employee of a broker should be indemnified for any tort liability necessarily arising from services performed in the scope of employment. It is also possible that the indemnification right under Lab C §2802 could require an employing broker to cover the salesperson's attorney fees and defense costs if the salesperson is sued as an individual for acts performed in the scope of employment.

It is common for real estate salesperson independent contractor agreements to allocate defense costs (and sometimes judgments and settlements) between the broker and the salesperson. If the salesperson is an employee despite the contractual characterization of employment as an independent contractor, Lab C §2804 may render unenforceable any agreement by the salesperson to bear part of the judgment, settlement, or defense costs. Of course, if the theory of liability depends on conduct the salesperson knew to be unlawful at the time it was undertaken or which is outside the scope of employment, there is no right to indemnity in any event.

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§8.42 C. Documenting Relationship Between Broker and Salesperson

A broker must have a written agreement with each salesperson, whether licensed as a salesperson or as a broker. 10 Cal Code Regs §2726. The agreement must set forth the material terms of the agreement, including supervision of licensed activities, duties, and compensation. 10 Cal Code Regs §2726. The DRE must be notified of a broker's employment of a salesperson or of another broker. Bus & P C §10161.8; 10 Cal Code Regs §2752. A salesperson cannot accept compensation from anyone except the broker under whom the salesperson is licensed at the time. The salesperson's right to compensation is based solely on the agreement with the broker. Bus & P C §10137.

Increasingly, salespersons and their brokerage firms are hiring unlicensed assistants to aid in transactions. What the unlicensed assistants can and cannot do is subject to interpretation. The DRE has issued general guidelines to define their roles. See Note in §8.2. To obtain a sample agreement between the assistant and firm or salesperson (CAR form PAC-11), contact the California Association of Realtors® at the website listed in the Directory.

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III. BROKER AS ESCROW AGENT

§8.43 A. License Requirements

Escrow agents are regulated by California's Escrow Law (Fin C §§17000-17702) and must be licensed by the Corporations Commissioner (Fin C §17200). Real estate brokers are exempt from these requirements while they are acting in the course of or incidental to real estate transactions in which they are an agent or a party. Fin C §17006(a)(4). This exemption is "not available for any arrangement entered into for the purpose of performing escrows for more than one business." Fin C §17006(b). A broker may act as an escrow agent without an escrow license in a transaction in which he or she is also acting as a broker (54 Ops Cal Atty Gen 13 (1971)), but must obtain a license to act as an escrow agent in a transaction in which the broker is not providing brokerage services (43 Ops Cal Atty Gen 284 (1964)).

When acting under Fin C §17006(a)(4), the broker may charge a separate fee for escrow services. 44 Ops Cal Atty Gen 105 (1964). The Real Estate Commissioner has promulgated regulations on a broker's handling of funds as an escrow agent (10 Cal Code Regs §2951) and a broker's actions in handling an escrow (10 Cal Code Regs §2950).

A license may not be issued or renewed with a fictitious business name containing the term "escrow," or any other terms that implies that escrow services are provided, unless the fictitious business name also includes the term "a non-independent broker escrow" following the fictitious business name. 10 Cal Code of Regs §2731(d).

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§8.44 B. Decision to Use

The decision on whether to use a broker-affiliated escrow company must be carefully weighed. Generally, the escrow departments of banks or large title companies have greater resources and can provide a wider range of ancillary services than are available at a small, broker-owned escrow company. Counsel should generally advise against permitting brokers to act as both broker and escrow agent in the same transaction because of the difficulty in differentiating between the broker's fiduciary obligation and other duties to the principal (see chap 3) and because of the escrow holder's fiduciary duties to both parties (see *Colonial Sav. & Loan Ass'n v Redwood Empire Title Co.* (1965) 236 CA2d 186, 46 CR 16; *Spaziani v Millar* (1963) 215 CA2d 667, 30 CR 658). It is unclear whether a broker-affiliated escrow agent could function as a truly neutral escrow agent.

Attorneys with a bona fide relationship with a principal in a real estate or personal property transaction are also exempt from the licensing requirements of the Escrow Law (Fin C §17006(a)(2)), but they should be aware of the conflicting duties that would arise from acting as both escrow agent and attorney in the same transaction.

PRACTICE TIP: When choosing an escrow, consider that escrow agents licensed by the Department of Corporations are required to be bonded, while the DRE has no such requirements for broker escrows.

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IV. RECENT BROKER LEGISLATION

§8.45 A. Large Fines for Unlicensed Activity

Effective January 1, 2009, any unlicensed person acting as a real estate broker or salesperson is guilty of a public offense punishable by a fine of up to $20,000, imprisonment in the county jail for up to 6 months, or by both a fine and imprisonment. In addition, the law provides that if the unlicensed entity violating the law is a corporation, a fine of up to $60,000 may be imposed. Bus & P C §10139. See §8.1.

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§8.45A B. Advance Fees

Senate Bill 94 (2009), effective October 11, 2009, makes it illegal for a licensee to claim an advance fee for providing loan modification services. See discussion in §8.20.

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§8.45B C. Mortgage Origination or Modification

In conjunction with the federal Secure and Fair Enforcement Mortgage Licensing Act of 2008 (SAFE Act) (12 USC 5101-5116), California Senate Bill 36 (2009) requires a special "mortgage loan originator" endorsement for those who engage in loan modification or mortgage broker services. See §§8.1, 8.24.

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§8.46 D. Real Estate Fraud Protection Trust Fund

Counties may increase from $2 to $3 the amount they may impose on recording of real estate documents if the fee is used to fund a county-wide real estate fraud prosecution trust fund. The number of documents on which the $3 recording fee may be charged has also increased. Fines collected in excess of $10,000, and any fines collected from a corporation in excess of $50,000 are to be deposited into the county's trust fund, if such a fund exists in the county in which the person or corporation was prosecuted. Govt C §27388(a).

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§8.47 E. Bar Orders, Short Sales

Three distinct changes to the Real Estate Law were made by SB 1737, all operative January 1, 2009. First, the DRE has regulatory authority to issue an order barring any individual from real estate related activity who has been found guilty of an offense involving fraud, dishonesty, or deceit. Barred persons are also prohibited from participating in any business activity of a finance lender, residential mortgage lender, bank, credit union, escrow company, or title company for 36 months. Bus & P C §10087.

Second, the DRE has authority to discipline a licensee who generates an inaccurate opinion of value (a "broker price opinion" or BPO) requested in connection with a short sale in order to acquire a financial or business advantage. Bus & P C §10176(m).

Third, a licensee who represents a party in a purchase and sale transaction and who arranges the financing in connection with the purchase of the property must provide a written disclosure of his or her role as a mortgage broker to all parties to the transaction. Bus & P C §10177.6.

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§8.48 F. Recovery Account Payment Limits Increased

Under the Real Estate Law, the DRE administers a recovery account from which the DRE can pay victims of fraud their actual and direct losses, if the fraud was committed by a real estate licensee while performing acts for which a license is required. For applications received after January 1, 2009, the payout from the fund was increased to $50,000 for any one transaction and $250,000 for any one licensee. Bus & P C §10474(b). For more on the Recovery Account of the Real Estate Fund, see §§4.20, 9.37. The DRE website containing information about the Recovery Account is listed in the Directory.

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9

Disciplinary Procedures

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I. OVERVIEW

§9.1 A. Regulation of Brokers and Sales Associates

The Real Estate Law (Bus & P C §§10000-10580) on licensing and the Subdivided Lands Act (Bus & P C §§11000-11288) on regulation of subdivision transactions primarily focus on protection of the public in real estate transactions in which a real estate licensee represents a party or parties. The Real Estate Commissioner has the authority to adopt regulations to aid in the administration and enforcement of the Real Estate Law and the Subdivided Lands Act. The Regulations of the Commissioner have the force and effect of the law itself. See 10 Cal Code Regs §§2705-2781, 2830.1-3109; §§9.8-9.18.

PRACTICE TIP 1: Because the disciplinary powers of the Department of Real Estate (DRE) are derived from statute, counsel representing a licensee (a broker or salesperson) should always review the statutes and regulations governing the Department. A good place to find these provisions is in the DRE's accusation (see §§9.20, 9.29-9.33), statement of issues (see §9.21), or other charging documents, in which the DRE is required to state the relevant statutes or rules. See Govt C §§11503-11504; §9.30. The applicable sections of the Code and Regulations can also be found on the DRE's website listed in the Directory or purchased from the DRE in book form.

PRACTICE TIP 2: Representation of licensees before the DRE requires knowledge, expertise, and experience that cannot simply be derived from reviewing printed material. It is highly recommended that a neophyte representing brokers and salespersons in this context consult with knowledgeable, experienced defense counsel. In addition to understanding the statutes and regulations, it is important to know and understand the "value" of a case for settlement purposes. Understanding the administrative law environment, appellate rights, the law pertaining to writs of mandate: all these issues and more must be carefully considered in representing licensees.

The DRE recently promulgated a regulation providing that the parallel disciplinary standards and processes that apply to real estate brokers and salespersons will also apply to those who apply for and receive a mortgage loan originator license endorsement available under the National Mortgage Loan Service and Registry (see §§8.2, 8.24). 10 Cal Code of Regs §2945.4.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.2 B Duties of the California Real Estate Commissioner

§9.2 B Duties of the California Real Estate Commissioner

Foremost among the Real Estate Commissioner's specific duties are:

- Qualification of applicants and issuance of real estate licenses (see chap 8);
- Investigation of complaints and, when appropriate, pursuit of formal action against licensees and license applicants (see §§9.26-9.37); and
- Investigation of unlicensed persons alleged to be performing acts for which a real estate license is required (see §9.22).

Through real estate broker and other license requirements, the Commissioner also regulates dealings in mineral, oil, and gas property. See Bus & P C §§10500-10513.

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§9.3 C. California Department of Real Estate

The DRE website describes its mission as "To protect and serve the interests of the public in real estate transactions and provide related services to the real estate industry." The address for the DRE website is listed in the Directory. The DRE is part of the executive branch of the state government and derives its power from the statutory provisions that govern it. Within the scope of the laws authorizing the DRE, it is empowered to issue licenses and to take disciplinary action with respect to its licensees.

When a verified written complaint is filed against a licensee, the Real Estate Commissioner is required to investigate the matter. The Commissioner may also commence an investigation on its own motion. The investigation may include an audit of the broker's books and records. See Bus & P C §10148 for record retention requirements. The licensee is informed of the DRE's intention to take disciplinary action by service of an accusation (see §§9.20, 9.29-9.33) and is entitled to notice and an opportunity to be heard on the matter. See §§9.35-9.36.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.4 D. Criminal Referrals and Representation

§9.4 D. Criminal Referrals and Representation

The DRE does not criminally prosecute a licensee or persons violating the Real Estate Law. Instead, the DRE may refer matters, such as unlicensed activity or theft of funds, for criminal prosecution to appropriate law enforcement agencies, including the California Department of Justice. See Bus & P C §10135. The Attorney General acts as the attorney for the Real Estate Commissioner in all court actions and proceedings brought by or against the Commissioner. Bus & P C §10079. However, only the DRE has the authority to revoke or otherwise administratively discipline a real estate license. Bus & P C §10175.

PRACTICE TIP: At the inception of representation of a licensee or applicant for a license in these circumstances, counsel should consider consulting, or referring the licensee to, a criminal defense attorney to discuss any potential Fifth Amendment waiver implications to the client.

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§9.5 E. Prevention of Future Harm

Although administrative licensing cases are considered civil, as opposed to criminal, in nature (*Lam v Bureau of Sec. & Investigative Servs.* (1995) 34 CA4th 29, 38, 40 CR2d 137), they differ significantly from traditional tort and breach of contract cases. Unlike a traditional tort or other civil case, which is intended to redress an existing injury, licensing cases are intended to prevent future harm to the public. *Griffiths v Superior Court* (2002) 96 CA4th 757, 772, 117 CR2d 445.

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§9.6 F. Conduct Outside Practice

A licensee's conduct that occurs outside his or her practice of real estate may also be grounds for discipline. The most common example occurs when a licensee is convicted of a crime not connected to a real estate transaction or other activity for which a real estate license is required. The DRE may file a disciplinary action and suspend or revoke a license based on evidence of a criminal conviction. Bus & P C §§490, 10177(b). For example, a broker license was revoked by the Real Estate Commissioner after the broker pleaded guilty in criminal court to possession of marijuana for sale. *Golde v Fox* (1979) 98 CA3d 167, 159 CR 864.

Generally, an applicant may be denied a real estate license for any of the following reasons (Bus & P C §§480, 10177(b)):

- Conviction of a crime, whether by plea agreement, verdict of guilt, or plea of nolo contendere;
- Commission of any act involving dishonesty, fraud, or deceit with the intent to substantially benefit the applicant or another, or to substantially injure another; or
- Commission of any act which if done by a DRE licensee would be grounds for suspension or revocation of license.

Any crime on which a license denial, suspension, or revocation is based must be substantially related to the qualifications, functions, or duties of a real estate licensee. *Pieri v Fox* (1979) 96 CA3d 802, 158 CR 256. The DRE has articulated a set of guidelines in the "Criteria of Substantial Relationship." 10 Cal Code Regs §2910. See §9.12.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.7 G. Procedures Available in the Disciplinary Process

§9.7 G. Procedures Available in the Disciplinary Process

A license discipline case is intended to be an expedited proceeding, without the pretrial motions and extensive discovery of a civil litigation case. As with other administrative proceedings, the procedures are streamlined. For example:

- **Discovery.** Absent unusual circumstances, discovery is limited to document production and subpoenas. No particular form is required to request documents. See Govt C §§11507.5-11507.7. Depositions are permitted only on petition, on the ground that the witness is unavailable to testify at the hearing. See Govt C §11511.
- **Evidence.** The technical rules of evidence are not always followed. See Govt C §11513(c). Hearsay evidence may be used to supplement or explain other evidence. See Govt C §11513(d). Affidavits may be used in lieu of testimony. See Govt C §11514.
- **Notice and service of documents.** The content and manner of service of certain notices are specified by statute. See, *e.g.,* Govt C §§11505, 11509.
- **Appeals.** Judicial review is by petition for writ of mandate. See Govt C §11523.

There are special procedures for each step in the process from initiation of the proceeding to prehearing conference to the presentation of evidence. See §§9.26-9.37. For a detailed discussion of the procedural aspects of administrative license discipline law, see California Administrative Hearing Practice, chaps 5-7 (2d ed Cal CEB 1997).

PRACTICE TIP: Before handling a license discipline case for the first time, counsel should carefully review the administrative adjudication provisions of the Administrative Procedure Act (APA) (Govt C §§11400-11529). As part of that careful review, counsel should also take note of critical time periods contained in the APA. Those time periods include the time in which a respondent must file a notice of defense and the time in which a respondent must request discovery production from the agency.

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II. STATUTES AND REGULATIONS GOVERNING DRE DISCIPLINARY ACTIONS

§9.8 A. Business and Professions Code

On August 4, 1943, the California legislature organized the statutory authority of the DRE into the two parts of Division 4 of the Business and Professions Code. Part 1 (Bus & P C §§10000-10580) is titled Licensing of Persons and is often referred to as the Real Estate Law. Part 2 (Bus & P C §§11000-11288) is titled Regulation of Transactions and is often cited as the Subdivided Lands Act. These laws are different in purpose and operation from real property law, law of agency, contract law, or other aspects of real estate ownership and conveyancing.

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§9.9 1. Violation of the Business and Professions Code as Grounds for Discipline

The basis for most license suspensions or revocations is violation of Bus & P C §§10176-10177. See §§9.10-9.11. 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. In general, the licensee must have been acting as broker or salesperson in a real estate transaction before the section will apply.

Some provisions of Bus & P C §10177 apply to situations when the licensee or respondent was not necessarily acting as broker or salesperson. The most common violations alleged against applicants and licensees as a basis to deny or discipline a license relate to criminal convictions and the failure to disclose the criminal convictions of the licensee. The issue of procuring or attempting to procure a real estate license or license renewal by fraud or misrepresentation can arise in three different situations: when a new application is made, when a license is renewed, or when one petitions for the reinstatement of a license. The DRE considers the licensee's failure to reveal prior criminal history to be an attempt to procure a license by fraud. See also §9.6.

Business and Profession Code §10177.5 states:

> When a final judgment is obtained in a civil action against any real estate licensee upon grounds of fraud, misrepresentation, or deceit with reference to any transaction for which a license is required under this division, the Commissioner may, after hearing in accordance with the provisions of this part relating to hearings, suspend or revoke the license of such real estate licensee.

Attorneys defending licensees in civil actions in which there is exposure for liability on the basis of "fraud, misrepresentation, or deceit" must be aware that when an action is tried against a licensee, more than just money is at stake. This statute allows the Real Estate Commissioner to suspend or revoke a license based on a final judgment obtained in a civil action based on the referenced grounds. Licensees should be advised of the risks inherent to their licenses if such a case is tried against them. The Commissioner need not "retry" the action. A certified copy of the final judgment will suffice.

The downside to counsel suing licensees for fraud, misrepresentation, and deceit is the potential loss of insurance coverage for the licensee. Both plaintiff's and defendant's counsel in the civil case must take these matters into careful consideration. On broker insurance generally, see chap 10. On civil trial issues, see chaps 11-13.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.10 a. Business and Professions Code §10176

§9.10 a. Business and Professions Code §10176

The Real Estate Commissioner may temporarily suspend or permanently revoke a real estate license if the real estate licensee, in connection with matters subject to the Real Estate Law, has been guilty of any of the following, as set forth in Bus & P C §10176:

- A substantial misrepresentation;
- False promises of a character likely to influence, persuade, or induce;
- A continued and flagrant course of misrepresentation or making of false promises through real estate brokers or salespersons;
- Acting for more than one party in a transaction without the knowledge or consent of all the parties;
- Commingling money or other property of others with the licensee's own money or other property;
- Claiming, demanding, or receiving remuneration under an exclusive agreement authorizing or employing a licensee to act as a broker when the agreement does not contain a definite, specified date of final and complete termination;
- Claiming or taking of secret or undisclosed compensation, commission, or profit, or failing to reveal to the licensee's employer the full amount of compensation, commission, or profit received for services as a broker or salesperson under an agreement which either predates or is coincident with the signing of an agreement between the contracting parties;
- Using an option to purchase a real property or business opportunity when the licensee is also employed to sell, buy, or exchange the property or opportunity, without the knowledge and written consent of the licensee's principal and employer;
- Any conduct that constitutes fraud or dishonest dealing;
- Obtaining the signature of a prospective purchaser to an agreement that provides that the purchaser will buy, lease, rent, or exchange a business opportunity or real property through the broker, or pay a compensation to the broker, without first obtaining the written authorization of the owner of the property to offer the property for sale, lease, exchange, or rent;
- Failing to disburse funds in accordance with a commitment to make a mortgage loan that has been accepted by the applicant when the broker has represented to the applicant that the broker is the lender or is authorized to issue the commitment on behalf of the lender;
- Intentionally delaying the closing of a mortgage loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower; and
- Generating an inaccurate opinion of the value of residential property, requested in connection with a debt forgiveness sale, in order to either (1) manipulate the lienholder to reject the proposed sale or (2) acquire a financial or business advantage, including a listing agreement, that directly results from the inaccurate opinion.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.11 b. Business and Professions Code §10177

§9.11 b. Business and Professions Code §10177

The Real Estate Commissioner may (1) suspend or revoke the license of a licensee, (2) deny the issuance of a license to an applicant, and (3) suspend, revoke, or deny a license of a corporation if any officer, director, or person controlling at least 10 percent of the corporation has done any of the following:

- Procured, or attempted to procure, a real estate license or license renewal by fraud, misrepresentation, deceit, or material misstatement of fact;
- Entered a plea of guilty or nolo contendere to, or been found guilty of, a felony or a crime substantially related to the qualifications, functions, or duties of a real estate licensee, and the time for appeal has elapsed or the judgment of conviction has been affirmed on appeal, irrespective of an order granting probation, suspending the sentence, allowing the licensee to withdraw the guilty plea, or dismissing the accusation (see §9.20) or information;
- Knowingly authorized, directed, connived at, or aided in the publication, advertisement, distribution, or circulation of a material false statement or representation concerning the licensee's education, credential, trade organization membership, or business concerning a business opportunity or a land or subdivision offered for sale (see Bus & P C §§11000-11202);
- Willfully disregarded or violated the Real Estate Law (Bus & P C §§10000-10580), Bus & P C §§11000-11288, or 10 Cal Code Regs §§2705-3109;
- Willfully used the term "realtor" or a trade name or insignia of membership in a real estate organization of which the licensee is not a member;
- 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, revoked, or suspended by another agency of this state, another state, or the federal government for acts that, if done by a real estate licensee, would be grounds for the suspension or revocation of a California real estate license, but only if the denial, revocation, or suspension was 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 (APA) (Govt C §§11400-11529), and only on an express finding of a violation of law by the agency or entity;
- Demonstrated negligence or incompetence in performing an act for which he or she is required to hold a license;
- As a broker licensee, or as the officer designated by a corporate broker licensee, failed to exercise reasonable supervision and control over salespersons;
- Used employment by a governmental agency in a capacity giving access to private records in a manner violating the confidential nature of the records;
- Engaged in any other conduct that constitutes fraud or dishonest dealing;
- Violated any of the terms, conditions, restrictions, and limitations contained in an order granting restricted license;
- With specified exceptions, 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 having specified characteristics (see, *e.g.,* Govt C §§12926-12926.1, 12955, 12955.2, 12955.9; CC §§51, 51.2-51.4, 51.10-51.11);
- Violated the Franchise Investment Law (Corp C §§31000-31516) or 10 Cal Code Regs §§310.002-310.505;
- Violated the Corporate Securities Law of 1968 (Corp C §§25000-25707) or 10 Cal Code Regs §§260.000-260.617;
- As buyer's broker, failed to disclose to the buyer the nature and extent of the licensee's direct or indirect ownership interest in the real property concerned (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 is included in the disclosure requirement);

- Violated Bus & P C §§10237-10239.4 (claim of exemption from securities qualifications); or
- Violated any provision of, or regulation promulgated under (1) the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617); (2) the Truth in Lending Act (TILA) (15 USC §§1601-1667f); (3) Home Ownership and Equity Protection Act of 1994 (HOEPA) (15 USC §1639); or any of the federal acts related to mortgages cited in Civ C §§2920-2944.7.

If an offending officer, director, or stockholder acted individually and not on behalf of the corporation, and has been completely disassociated from any affiliation or ownership of the corporation and the corporation has not itself done any wrongful acts, either directly or through its other employees, agents, officers, directors, or stockholders, the Commissioner cannot suspend, revoke, or deny issuance of the real estate license of the corporation. Bus & P C §10177.

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§9.12 2. Substantial Relationship

In determining whether a license should be denied, suspended, or revoked on the basis of a criminal conviction (or on the basis of any act described in Bus & P C §480), whether the crime is "substantially related to the qualifications, functions, or duties" of a DRE licensee within the meaning of Bus & P C §§480 and 490 is critical. The "Criteria of Substantial Relationship" (10 Cal Code Regs §2910) used by the DRE in making this determination includes, *e.g.,* acts of fraud, counterfeiting, bribery, sexual misconduct, certain building code violations, and drug and alcohol crimes.

Under the Department's criteria, a substantial relationship was found to exist between a conviction for violating various municipal codes and the "qualifications, functions or duties" of a licensee. In *Robbins v Davi* (2009) 175 CA4th 118, 95 CR3d 792, a court upheld the DRE's revocation of a broker's real estate license, which was based on his criminal conviction for repeated violations of fire and safety codes arising out of his ownership and management of apartment buildings. The court held that because the unlawful acts were committed "with the intent of conferring a financial or economic benefit upon the perpetrator." (citing 10 Cal Regs §2910(a)(8)).

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§9.13 B. California Code of Regulations

The legislature has authorized the Real Estate Commissioner to promulgate regulations to assist with the DRE's licensing and enforcement work. These regulations are found at 10 Cal Code Regs §§2705-2781 and 2830.1-3109. The Real Estate Law and the regulations of the Commissioner are available online at the DRE's website listed in the Directory and can be purchased from the DRE in book form.

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§9.14 C. Statute of Limitations

Under Bus & P C §10101, the statute of limitations for an accusation of licensee malfeasance, including violations of various mortgage loan originator statutes and regulations (see §§8.1, 8.24) may vary:

- When no fraud, misrepresentation, or false promise is involved, 3 years from the occurrence of the alleged misconduct;
- When fraud, misrepresentation, or a false promise is involved, 1 year from the date of discovery of the misconduct by the aggrieved party or 3 years after the occurrence, whichever is later; and
- In no case may an accusation be filed more than 10 years after the occurrence of the alleged misconduct.

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§9.15 D. Mitigation and Rehabilitation Evidence

Mitigation evidence is used to temper the sanction for a violation of law. Mitigation evidence is not admissible to justify or excuse a violation: it is offered solely for the purpose of reducing the penalty. *Richards v Gordon* (1967) 254 CA2d 735, 742, 62 CR 466 (upholding Commissioner's revocation of salesperson license). Mitigation evidence may not be offered to deny a criminal conviction. The record of the conviction is conclusive evidence of the fact that the conviction occurred. *Arneson v Fox* (1980) 28 C3d 440, 170 CR 778 (upholding Commissioner's revocation of broker license).

As evidence of mitigation, an applicant or licensee may present evidence showing that he or she has made efforts at rehabilitation; that they have, in a positive manner, changed their behavior. The DRE has developed Criteria of Rehabilitation (10 Cal Code Regs §§2911-2912) used to evaluate rehabilitation of an applicant or licensee when considering the issuance or reinstatement of a license.

No one may be denied a license solely on the basis of a felony conviction if the applicant has received a certificate of rehabilitation under the California Penal Code. Bus & P C §480(b). If an applicant has a history of criminal convictions, the DRE may require that the applicant demonstrate a substantial period of exemplary conduct following the misdeeds. This can be demonstrated by the successful completion of a criminal sentence or probation and a further period of time free from any violation of law. See *In re Gossage* (2000) 23 C4th 1080, 99 CR2d 130 (rehabilitation not demonstrated).

In cases of applicants seeking a mortgage loan originator license endorsement (see §§8.1, 8.24), evidence of rehabilitation since a criminal conviction will be given no consideration if the applicant has been convicted of any felony within 7 years from the date of his or her application for the license endorsement. 10 Cal Code Regs §2911(o). Further, no endorsement will be issued to an applicant where the applicant has ever been convicted of a felony involving an act of fraud, dishonesty, a breach of trust, or money laundering. 10 Cal Code Regs §2911(p).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.16 E. Criminal Convictions

§9.16 E. Criminal Convictions

Prior to January 1, 2008, Bus & P C §10177(b) required the DRE to prove that a misdemeanor conviction alleged as a basis for discipline was for a crime of moral turpitude. See *Petropoulos v Department of Real Estate* (2006) 142 CA4th 554, 47 CR3d 812, modified and rehearing denied, 2006 Cal App Lexis 1448. Counsel should evaluate the date of conviction to determine which standard should apply.

A misdemeanor conviction can form the basis for the discipline of a real estate licensee if the conviction is substantially related to the qualifications, functions, and duties of a licensee. Bus & P C §10177(b); 10 Cal Code Regs §2910.

Under Bus & P C §10177(b), a misdemeanor or felony conviction can form the basis to impose discipline whether or not the criminal act occurred while the licensee was acting in the capacity of a broker or salesperson.

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§9.17 F. "Underground" Regulations and the Administrative Procedure Act

Unless authorized by the legislature, an agency may not issue regulations until they have been adopted under the Administrative Procedure Act (APA) (Govt C §§11400-11529). Govt C §11340.5. Any general rules not written into regulations or otherwise authorized by the legislature are invalid "underground" regulations. *Donaldson v Department of Real Estate* (2005) 134 CA4th 948, 967, 36 CR 3d 577; *Tidewater Marine W., Inc. v Bradshaw* (1996) 14 C4th 557, 563, 59 CR2d 186. On underground regulations, see California Administrative Mandamus §§6.58-6.59 (3d ed Cal CEB 2003). See also Practice Tip in §9.7.

The APA also contains an "Administrative Adjudication Bill of Rights." Govt C §11425.10. Most of these rights concern matters of procedure. This portion of the APA addresses the fact that the hearings are open to public observation except in certain limited circumstances; describes who may serve as a presiding officer in a proceeding conducted under the APA; discusses the issue of disqualification of the presiding officer; and sets forth the form in which the decision is to be prepared. There is a reference in this portion of the APA regarding the designation of agency decisions as "precedential." While the DRE has the authority to make certain of its decisions precedential, to date it has not elected to do so.

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§9.18 G. Out-of-State Laws and Decisions by Other Agencies

If a real estate licensee violates a sister-state or federal law, that violation may be a basis for discipline or the denial of an application for a real estate license. Further, the denial of a license or discipline of a license issued by another agency of this state may be grounds to discipline the real estate license. See Bus & P C §10177(f); *e.g., Windham v Board of Med. Quality Assur.* (1980) 104 CA3d 461, 163 CR 566.

PRACTICE TIP: If an applicant or licensee faces discipline by the DRE under Bus & P C §10177(f), counsel should carefully review the process afforded during the prosecution of the underlying action that led to discipline by another California agency or by an agency of another state or the federal government. If the process did not provide the same due process rights as those afforded by the APA, there may be no basis for DRE pursuit of an action under the statute.

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§9.19 III. TYPES OF LICENSING ACTIONS

The Real Estate Commissioner has the power to suspend or revoke a real estate license. The Commissioner also has the authority to deny a license if the applicant does not meet the full requirements of the law. Applicants go through a screening process (including the submission of fingerprints to the Department of Justice and the Federal Bureau of Investigation). If the process reveals a criminal record or some other record that calls the applicant or application into question, the application will be assigned to a deputy commissioner for further investigation. Applicants are encouraged to review the booklet produced by the DRE entitled *Instructions to License Applicant: How to Obtain and Maintain a Real Estate License*. The publication is available on the DRE website listed in the Directory.

PRACTICE TIP: Counsel assisting or advising applicants for a license should encourage the applicant to make full disclosure in response to each and every inquiry in the application. While an applicant may have a chance of receiving a license on the basis of an application that includes disclosure of a criminal conviction, the applicant's chances for receiving that license are substantially diminished if the applicant fails to disclose and the DRE discovers the conviction during its background check.

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A. Actions Initiated by DRE

§9.20 1. Action to Revoke or Suspend License

The DRE may initiate an investigation and disciplinary proceeding based either on a consumer complaint or on its own motion. An accused licensee is entitled to procedural protections consistent with a "vested" interest, but that does not give the licensee a "substantive vested right to continue to pursue his occupation." *Hughes v Board of Architectural Exam'rs* (1998) 17 C4th 763, 790, 72 CR2d 624. When the DRE seeks to revoke or suspend a license, the Department must file a document setting out the facts and law on which the discipline is sought. This charging document is known as an "accusation." Govt C §11503. The accusation must contain a written statement of charges that states in "ordinary and concise language" the acts or omissions with which the licensee is charged and the statutes and rules that the licensee is alleged to have violated. Govt C §11503. The DRE has the burden of proof under the standard of clear and convincing evidence to a reasonable certainty. On the requirements for drafting, filing, and serving an accusation, see California Administrative Hearing Practice, chap 3 (2d ed Cal CEB 1997).

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§9.21 2. Action to Deny License

An applicant for a real estate license is required to show that he or she has the knowledge and honesty to be licensed. If an applicant fails to show that he or she has the qualifications necessary to be licensed, the applicant is informed of the intention of the DRE to deny the application by service of a "statement of issues."

Before denying, suspending, or revoking a license or an endorsement to engage in mortgage loan origination activities (see §§8.1, 8.24), the DRE follows Govt C §§11500-11529. The DRE has all the powers granted to an agency by the Administrative Procedure Act (APA) (Govt C §§11400-11529). See Bus & P C §10100. The Real Estate Commissioner, in seeking to deny an application (if the applicant has filed a notice of defense (see §9.33)) or to discipline an existing licensee, uses the hearing procedures set out in the APA.

When the DRE seeks to deny a real estate license application based on either lack of qualifications or an applicant's prior misconduct, the Department must file a pleading (the statement of issues) and institute a formal administrative action. The statement of issues must specify the statutes and rules "with which the respondent must show compliance" and any "particular matters that have come to the attention of the initiating party and that would authorize a denial of the agency action sought." Govt C §11504.

The APA does not specify which party has the burden of proof in such cases, but case law has established that, in the absence of statutory law to the contrary, the applicant for the license or permit has the burden of proof. *Breakzone Billiards v City of Torrance* (2000) 81 CA4th 1205, 1245, 97 CR2d 467. The standard of proof is not entirely clear. *Ettinger v Board of Med. Quality Assur.* (1982) 135 CA3d 853, 185 CR 601, suggests that the standard of proof is clear and convincing proof to a reasonable certainty, while *San Benito Foods v Veneman* (1996) 50 CA4th 1889, 58 CR2d 571, and Evid C §115 suggest that the standard of proof is preponderance of evidence.

On the procedural aspects of the administrative hearing process, see California Administrative Hearing Practice (2d ed Cal CEB 1997). On issues related to appeals of license discipline cases, see California Administrative Mandamus (3d ed Cal CEB 2003).

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§9.22 3. Order to Desist and Refrain

The Real Estate Commissioner may investigate persons or firms who appear to be operating improperly, or without a license, or who subdivide land without complying with the subdivision laws enforced by the Commissioner. If sufficient evidence is obtained, the Commissioner may cause an order to desist and refrain issued. Special provisions apply, if the recipient requests a hearing. See Bus & P C §10086. The respondent to the order has 30 days to request a hearing. If the respondent also files a verification that the order precludes engaging in a substantial part of his or her business, then within 10 days the Commissioner is required to file an action in superior court for a restraining order pending the hearing. If the Commissioner fails to file the action or the court declines to issue the restraining order, the respondent may resume engaging in business. The hearing must be held within 30 days unless the respondent agrees to the postponement. Investigations involving the sale or lease of interests in subdivisions outside California are governed by Bus & P C §11019.

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§9.23 4. Debarment

Effective January 1, 2009, the Real Estate Commissioner may suspend or bar from any position of employment, management, or control any licensee or unlicensed person if the Commissioner finds that

- The suspension or bar is in the public interest and the person has knowingly (or should have known) that he or she committed or caused a violation of the Real Estate Law or a regulation or order of the Commissioner or the person has cause material damage to the public; and
- The person has been convicted of or pleaded nolo contendere to (1) any crime (or held liable in any final civil or administrative judgment) if the crime or civil or administrative judgment involved any offense involving dishonesty, fraud, or deceit; or (2) any other offense reasonably related to the qualifications, functions, or duties of a real estate licensee.

The debarment may be for any period up to 36 months and requires appropriate notice and an opportunity for a hearing before any final action is taken. Bus & P C §10087.

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B. Actions Initiated by Licensee

§9.24 1. Petition for Reinstatement

When a former licensee seeks to regain a revoked license, the DRE requires the former licensee to file a petition for reinstatement of the license or, if the license has a restriction against it, reduction of the penalty. Govt C §11522. The petition application is available on the DRE website listed in the Directory.

The procedure does not provide the petitioner with a right to a hearing on the matter nor is there a statutory time period in which the DRE must process the petition. The Real Estate Commissioner considers the information provided in the petition along with other supplementary evidence of rehabilitation offered by the petitioner. Under Govt C §11522, the DRE notifies the Attorney General of the petition. In practice, the Attorney General's office does not participate in the petition process. The process is conducted internally at the DRE. As a condition of reinstatement of a revoked or suspended license, the Commissioner may require the applicant to take and pass a qualifying examination. Bus & P C §10182.

The issues in the reinstatement process differ from those at a typical accusation or statement of issues hearing. The purpose of the petition process is to consider whether the restricted licensee or former licensee has shown rehabilitation. See §9.15; 10 Cal Code Regs §§2911-2912 (Criteria of Rehabilitation). In addition, there is usually a waiting period after the revocation before the former licensee is permitted to file a petition for reinstatement.

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§9.25 2. Petition for Reconsideration

In some situations, the respondent may file a petition requesting that the DRE reconsider its disciplinary decision. Govt C §11521. The time limits in which an agency may reconsider a decision are very short, *i.e.,* 30 days after delivery or mailing of the decision to the respondent or before the date set by the DRE as the effective date of the decision, whichever is sooner, or after termination of a 30-day stay granted by the DRE for the purpose of filing a motion to reconsider. Govt C §11521(a).

A licensee may also appeal a DRE decision in a petition for a writ of mandate to the superior court without first seeking reconsideration. Govt C §11523.

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IV. OVERVIEW OF LICENSE DISCIPLINE PROCESS

§9.26 A. Initial Investigation and Evaluation by Agency

When the DRE receives information, either from a consumer complaint or another source, that a licensee may have violated provisions of the applicable licensing act, the DRE first conducts an investigation. The DRE may use both its audit staff and enforcement deputies to conduct investigations of licensee activity. See discussion in §9.3.

Often a DRE investigation begins with a consumer complaint, but that consumer is not the "complainant." The complainant is always the DRE staff member who makes the accusation in his or her official capacity. The consumer who filed the original complaint may be a witness in the case, but is not a party to a typical license discipline case.

If, after the investigation, the DRE enforcement section believes that a violation of the licensing laws has occurred, it forwards the case to the DRE's legal section. The Real Estate Commissioner is the ultimate decision-maker in the case. Government Code §11425.30(a)(1) prevents the decision-maker from serving in the capacity of an investigator, prosecutor, or advocate in the case.

PRACTICE TIP: A DRE staff member will often attempt to contact a licensee by telephone or letter to discuss the complaint. Counsel representing licensees might consider advising the licensee to retain experienced defense counsel to respond to the DRE's initial inquiry rather than have the licensee make direct contact with the staff member.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.27 B. Jurisdiction Over a Lapsed or Suspended License

§9.27 B. Jurisdiction Over a Lapsed or Suspended License

The DRE maintains jurisdiction over a lapsed or suspended license. Bus & P C §10103.

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§9.28 C. Voluntary Surrender of a License

A licensee against whom an investigation is pending or an accusation has been filed may petition the Real Estate Commissioner to voluntarily surrender his or her license. Bus & P C §10100.2. The surrender is only effective on acceptance by the Commissioner. A surrendered licensee may be relicensed only by petitioning for the reinstatement of the license pursuant to Govt C §11522.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.29 D. Contents of Accusation

§9.29 D. Contents of Accusation

A typical accusation is set out in the following order:

- A jurisdictional paragraph with the name of the DRE staff member making the accusation in his or her official capacity;
- A recitation of the history of the licensee's DRE licensure;
- Charging paragraphs (the heart of the accusation), containing a recitation of the facts relevant to the charges and a list of the separate grounds for discipline;
- A list of relevant code sections, and not merely "charges phrased in the language of such statutes and rules" (see Govt C §11503); and
- A prayer containing the request for discipline, including restitution for injured consumers and investigation and prosecution costs when permitted by statute.

Under Bus & P C §10148, the DRE requires the respondent to pay the Real Estate Commissioner's reasonable cost for any audit, if the Commissioner has found, in a final cease and desist order or following a disciplinary hearing, that the respondent violated Bus & P C §10145 or the regulations regarding the deposit of funds belonging to others. On administrative pleadings and a form for an accusation, see California Administrative Hearing Practice, chap 3 (2d ed Cal CEB 1997).

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§9.30 1. The Investigation Report

During the discovery process, the respondent's attorney may request a copy of the DRE's investigative reports (Govt C §11507.6(f)), which might list code sections that the investigator believes were violated and state whether the investigator believes the charges are sustainable. These investigator-listed charges are *not* at issue in the disciplinary case. Only the charges set out in the accusation are at issue. Similarly, in a license denial case, the charges alleged in the statement of issues are the only matters at issue in the case, regardless of whether the DRE's letter to the licensee, explaining why the application was denied, contains different charges.

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§9.31 2. Amending the Accusation

The DRE may amend the accusation to add new charges so long as the licensee is given sufficient time to defend against them. Govt C §§11507, 11516. In addition, a variance between the pleading and the proof at hearing is not material unless it has prejudicially misled the licensee. *Cooper v Board of Med. Exam'rs* (1975) 49 CA3d 931, 942, 123 CR 563.

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§9.32 3. Filing and Service of Accusation

The DRE's legal section will draft and file the charging documents. Although not specifically stated in the Administrative Procedure Act (APA) (Govt C §§11400-11529), in practice the accusation is considered "filed" when it is signed and dated by the complainant. The accusation does not need to be filed with the Office of Administrative Hearings. See California Administrative Hearing Practice §3.26 (2d ed Cal CEB 1997).

Certain documents must by law be sent with the accusation. See Govt C §11505. The accusation must be accompanied by a form of notice of defense, a statement substantially in the form set forth in Govt C §11505(b) (describing how to request a hearing and other procedural matters), and a copy of the discovery provisions of the APA. See §§9.29-9.33.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/9 Disciplinary Procedures/§9.33 E. Response to Accusation

§9.33 E. Response to Accusation

The licensee who is charged with wrongdoing in the accusation is called the "respondent." The respondent has 15 days after service of the accusation to file a notice of defense. In the notice of defense, the respondent may do one or more of the following (Govt C §11506(a)):

- Request a hearing;
- Object to the accusation on the ground that it fails to state acts or omissions on which the DRE may proceed;
- Object to the form of the accusation as indefinite or uncertain;
- Admit the accusation in whole or in part;
- Present new matter by way of defense; or
- Object to the accusation on the ground that compliance with a regulation would materially violate another regulation enacted by another agency that affects substantive rights.

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§9.34 F. Default Decision

If a notice of defense is not filed or if the respondent files a notice of defense but fails to appear for the hearing, the DRE may proceed with the case by default and revoke the license or deny an application for licensing. Govt C §11506(c). The DRE may take the default internally or, if the matter has been scheduled for hearing, evidence may be presented by the DRE at the hearing and the Administrative Law Judge (ALJ) may issue a default decision.

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§9.35 G. Hearing

After receiving the notice of defense, the DRE files a request to set a hearing with the Office of Administrative Hearing (OAH). The respondent is notified of the request by the DRE and has a limited opportunity to inform the OAH of his or her availability to appear for the hearing. This is the first time that the OAH opens a file for the case and assigns a case number. After the OAH sets a hearing date for the case, the DRE counsel sends out a notice of hearing and the case proceeds to hearing. See Govt C §§11508-11509. In some cases, particularly if the case is estimated to take 3 or more days of hearing time, a prehearing conference may be held before the hearing. Govt C §11511.5.

The hearing is conducted in the same manner as a civil bench trial, except that the rules of evidence are more relaxed. Hearsay evidence, often referred to as "administrative hearsay," may be used in administrative proceedings to explain or supplement other evidence. See Govt C §11513.

In an accusation case seeking to revoke or suspend a professional license, the DRE's burden of proof is by clear and convincing evidence to reasonable certainty. See, *e.g.*, *Ettinger v Board of Med. Quality Assur.* (1982) 135 CA3d 853, 857, 185 CR 601. On the burden of proof in licensing cases, see California Administrative Hearing Practice §§7.50-7.62 (2d ed Cal CEB 1997).

PRACTICE TIP: The presentation of evidence at the administrative hearing is critical to preserving the record for judicial review; the hearing record creates the basis for the trial and appellate court review on a petition for writ of mandate. Thus it is imperative that defense counsel put on the very best case before the administrative law judge at the initial hearing. Generally speaking, no new evidence will be allowed to be brought forth in the writ petition. Counsel for the respondent licensee should carefully consider presentation of the evidence at the administrative hearing and call all potential witnesses, including lay witnesses, the respondent, and experts.

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§9.36 H. Decision and Review

At the conclusion of the hearing, the Administrative Law Judge (ALJ) may allow written briefs from the parties. After the ALJ takes the case under submission, he or she has 30 days to issue a proposed decision. Govt C §11517(c)(1). The DRE Regulations contain model language for use in a proposed decision. See 10 Cal Code Regs §2930. In general, the proposed decision will contain findings of fact and law, followed by the ALJ's recommended discipline. The Real Estate Commissioner then has 100 days to adopt, modify, or reject the decision. If the Commissioner fails to act within that time, the ALJ's proposed decision becomes the final decision in the case. Govt C §11517(c)(2).

Judicial review of a final decision by the Commissioner is available by filing a petition for writ of mandate. In general, the petition must be filed within 30 days after the last day on which reconsideration can be ordered by the Commissioner. See Govt C §11523.

On the procedures and rules relating to the Commissioner's decision to reject a proposed decision and relating to seeking reconsideration of an adopted decision or decision after rejection, see California Administrative Hearing Practice §§8.36-8.51 (2d ed Cal CEB 1997).

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§9.37 I. Recovery Account

The Real Estate Recovery Program (Bus & P C §§10470-10481) includes a "Recovery Account" administered by the DRE as a fund of last resort for members of the public who have obtained a final civil judgment or criminal restitution order against a real estate licensee based on fraud or certain other grounds and who have been unable to satisfy the judgment through normal post-judgment proceedings.

Applications to the Recovery Account are time sensitive. The applicant must file the application with the DRE within 1 year of the final judgment or criminal restitution order and must show that the applicant has employed reasonable due diligence to collect from the judgment debtor and any others who may be liable in the transaction. Bus & P C §10471. The forms used to file a claim with the Recovery Account are available online at the DRE website listed in the Directory. Business and Professional Code §10474 sets forth the monetary limits for claims made to the Recovery Account. For applications received after January 1, 2009, the limits have increased from $20,000 to $50,000 for any one transaction and from $100,000 to $250,000 for any one licensee.

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10

Broker Errors and Omissions Liability Insurance

Timothy R. Sullivan

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I. INTRODUCTION

§10.1 A. Scope of Chapter

Most owners or purchasers of real estate realize that they should make sure the contractor they hire to build or remodel their property is insured. However, few people buying or selling real estate, whether commercial or residential, question whether their salesperson or broker has insurance. Although not required by law in California, real estate salespersons and brokers can and should carry errors and omissions (E&O) insurance similar to that carried by doctors, lawyers, and financial professionals.

NOTE: Salespersons employed by brokers are often independent contractors; some E&O policies issued to brokers limit coverage to "employees" of the broker and do not extend coverage to independent contractors. See §§1.3, 8.32-8.42, 10.42. Brokers who employ independent contractor salespersons should keep this distinction in mind. The percentage of real estate salespersons who carry their own E&O insurance is unknown, but it is likely rather low. Nevertheless, E&O policies are available to salespersons, who should carefully consider the cost of premiums versus the risk of "going bare."

Typical E&O liability policies provide for both defense of the insured (payment of legal fees and court costs) and indemnity (payment of a judgment or settlement). See *Morris v Employers Reinsurance Corp.* (2000) 84 CA4th 1026, 101 CR2d 350.

PRACTICE TIP: Unlike commercial general liability (CGL) or property insurance policies, there are no standardized policies for broker E&O policies. See §10.2. The carriers who offer these policies vary from year to year, as some carriers enter the market while others leave. Even those carriers who remain in the market may change their policy language from year to year. As a result, policies should be carefully reviewed, even upon renewal with the same carrier. What sounds like a good deal could turn out to be poor coverage.

This chapter provides an overview of common provisions contained in the insuring language, conditions, and exclusions in many E&O policies for real estate brokers and salespersons, and of issues that frequently arise regarding those provisions. It is beyond the scope of this chapter to discuss all the available policies or all the issues that may arise. For a detailed discussion of liability insurance, including the claims process, duty to defend, and related litigation, see California Liability Insurance Practice: Claims & Litigation (Cal CEB 1991). For more on brokers and title insurance policies, see §3.64; California Title Insurance Practice (2d ed Cal CEB 1997).

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§10.2 B. Lack of Standardized Language

Although many commercial general liability (CGL) insurers use standard forms of liability policies developed by the Insurance Services Office (ISO), there are no standardized forms for real estate broker E&O insurance. ISO is a nonprofit trade association that publishes standard forms of liability policies that are used by many insurers. Since ISO does not provide a standard language form policy for real estate broker liability insurance, each insurer drafts its own insuring language, conditions, and exclusions. As a result, there are many different types of policies available, and even similar types of policies may contain vastly different language. The policy may involve one or more of the following:

- "Claims made" or "claims made and reported" insuring language (see §§10.3-10.7, 10.32);
- Retroactive coverage (see §10.19);
- Extended reporting periods (see §10.18);
- Tail coverage (see §10.31);
- Additional insureds (employees or independent contractors; see §10.42);
- Burning limits (see §10.120);
- Exclusions regarding:
- Disputes over fees, commissions, or charges (see §10.52);
- Property syndication, real estate investment trusts, limited partnerships, or similar investments (see §10.60);
- Activities as a mortgage broker, escrow agent, contractor, developer, property manager, or insurance broker (see §10.63);
- Dealings in real property owned by an insured (see §10.64);
- Guaranties of future value (see §10.66);
- Undue personal profit (see §10.67); and
- Discrimination (see §10.68); and
- Consent to settle, or hammer clause (see §10.121).

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§10.3 II. TYPES OF POLICIES

One of the essential terms of any insurance contract is the policy period or policy term, the "period of time during which the insurance is to continue." Ins C §381(e); *Long v Keller* (1980) 104 CA3d 312, 321, 163 CR 532. For E&O policies, like other liability policies, the policy period is usually 1 year. The date on which coverage is first effective is typically called the "inception date" or "effective date," and the last date of coverage is typically called the "expiration date." See, *e.g., Tosco Corp. v General Ins. Co.* (2000) 85 CA4th 1016, 1019 n3, 102 CR2d 657.

Most commercial general liability (CGL) policies are written on an "occurrence" basis. However, like other E&O policies, coverage for real estate salespersons and brokers is almost always written on a "claims made" or "claims made and reported" basis. The key difference among occurrence, claims made, and claims made and reported policies is what must occur during the policy period to trigger coverage. On what constitutes a claim, see §§10.9-10.12.

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§10.4 A. Distinguishing "Claims Made" From "Occurrence" Policies

A "claims made" insurance policy covers claims asserted against an insured during the policy period regardless of when the underlying damage occurred. Coverage does not depend on when the alleged negligent act, error, or omission occurred, or when the damage or injury was suffered, but on when a claim is made against the insured. *Homestead Ins. Co. v American Empire Surplus Lines Ins. Co.* (1996) 44 CA4th 1297, 1303, 52 CR2d 268; *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1356, 270 CR 779; *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089, 1094 n1.

In contrast, an "occurrence" policy covers losses for which the insured is liable as long as the damage occurs during the policy period; it does not restrict the period during which the claim must be made. *Century Indem. Co. v Hearrean* (2002) 98 CA4th 734, 739, 120 CR2d 66; *A.C. Label Co. v Transamerica Ins. Co.* (1996) 48 CA4th 1188, 1192, 56 CR2d 207; *Homestead Ins. Co. v American Empire Surplus Lines Ins. Co., supra*; *Pacific Employers Ins. Co. v Superior Court, supra*; *World Health & Educ. Found. v Carolina Cas. Ins. Co., supra*.

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§10.5 B. Occurrence Policies

A typical "occurrence" policy, such as the standard form commercial general liability (CGL) policy, provides liability coverage for *damage or injury occurring during the policy period* that results from an accident, or from continuous or repeated exposure to injurious conditions. There is no requirement that the act or conditions giving rise to the damage or injury themselves occur during the policy period in order for potential liability coverage to arise. *Montrose Chem. Corp. v Admiral Ins. Co.* (1995) 10 C4th 645, 675, 686, 42 CR2d 324. The occurrence of bodily injury or property damage during the policy period is the operative event that triggers coverage. 10 C4th at 668. Thus, the standard occurrence-based CGL policy provides coverage for injury or damage that may not be discovered or manifested until after expiration of the policy period (10 C4th at 689), and the claim may not be made until long after the policy has expired. *Homestead Ins. Co. v American Empire Surplus Lines Ins. Co.* (1996) 44 CA4th 1297, 1303, 52 CR2d 268; *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1356, 270 CR 779.

All professional liability policies were at one time occurrence policies. *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1358, 270 CR 779. Because the injury and negligence giving rise to a malpractice claim are often not discoverable until years after the negligent act or omission, professional liability insurance carriers shifted to the claims made policy in an effort to reduce their exposure to an unpredictable and lengthy "tail" of lawsuits. 221 CA3d at 1358; *KPFF, Inc. v California Union Ins. Co.* (1997) 56 CA4th 963, 972, 66 CR2d 36; *Montrose Chem. Corp. v Admiral Ins. Co. (Montrose II)* (1995) 10 C4th 645, 688 n24, 42 CR2d 324. Therefore, practically all E&O policies are now "claims made" policies.

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§10.6 C. Claims Made Policies

In a "claims made" policy, "the carrier agrees to assume liability for any errors, including those made prior to the inception of the policy as long as a claim is made during the policy period." *Homestead Ins. Co. v American Empire Surplus Lines Ins. Co.* (1996) 44 CA4th 1297, 1303, 52 CR2d 268; *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1356, 270 CR 779.

Under a claims made policy, coverage depends not on when the actual or alleged negligent act, error, or omission occurred, but on when the claim is made. The "insurer generally is responsible for loss resulting from claims made during the policy period no matter when the liability-generating event took place." *Homestead Ins. Co.,* 44 CA4th at 1304.

The advantages of claims made policies have been described as follows (*KPFF, Inc. v California Union Ins. Co.* (1997) 56 CA4th 963, 972, 66 CR2d 36; *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1359, 270 CR 779):

> The social utility of "claims made" policies has been well documented. Underwriters, secure in the fact that claims will not arise under the subject policy after its expiration or termination can underwrite a risk and compute premiums with greater certainty. An insurance company can establish its reserves without having to consider the possibilities of inflation beyond the policy period, upward-spiraling jury awards, or later changes in the definition and application of negligence.... There are benefits to the insured as well. Among other things, "claims made" policies aid in making insurance more available and less expensive than "occurrence" policies.

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§10.7 D. "Claims Made and Reported" Policies

In addition to "occurrence" and "claims made" policies, there is a third variation, the "claims made and reported" policy, which requires that the claim be both made *and* reported to the insurer during the policy period. A "claims made" policy does not impose such a reporting requirement. *Pension Trust Fund for Operating Eng'rs v Federal Ins. Co.* (9th Cir 2002) 307 F3d 944, 955. Under a claims made and reported policy, timely reporting of the claim is "the event triggering coverage; this condition is enforceable according to its terms." *KPFF, Inc. v California Union Ins. Co.* (1997) 56 CA4th 963, 972, 66 CR2d 36. In *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 270 CR 779, the court noted that such policies "are essentially *reporting* policies" (221 CA3d at 1358) and rejected an argument that they violated public policy (221 CA3d at 1359). See also *Industrial Indem. v Superior Court* (1990) 224 CA3d 828, 275 CR 218.

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III. CLAIMS AND CLAIMS REPORTING

§10.8 A. The "Whipsaw Nightmare"

Imagine that Attorney is insured under a claims made and reported E&O policy. Attorney receives a phone call from someone who says she is a reporter for a legal journal. The reporter says she wants Attorney's reaction to a malpractice suit filed by Former Client. Attorney thinks the call is a prank because he has never been sued in more than 20 years of practice; he settled Former Client's case for $2.75 million, and Former Client never argued that it was worth a penny more. Attorney receives the call in the middle of a busy Thursday while preparing to leave for a weekend vacation. Unfortunately for Attorney, the call is also received one day before his malpractice insurance with Company A expires and is replaced by a policy with Company B. Attorney does not report the call to Company A before he leaves for the weekend. The following Monday, when he returns to his office, Attorney sees a report of the malpractice case in a legal journal. Attorney has not yet been served with the summons and complaint, but he reports the claim to Company A that same day. Company A denies coverage on the ground that the claim was not reported during the policy period, and its policy has no extended reporting period provision. Attorney also reports the claim to Company B. Company B denies coverage on the ground that Attorney had a basis to believe that a claim would be made against him before Company B's policy took effect.

These "imaginary" facts are real, taken from *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 30 CR3d 631. The *Root* court described this situation as a "nightmare" for an insured, noting how the insured could be "whipsawed" by insurers denying coverage "on both sides of a policy period expiration divide." 130 CA4th at 933. This single case presents issues regarding:

- What is a "claim"? (see §§10.9-10.12);
- Reporting requirement (see §§10.16-10.19);
- Extended reporting period (see §10.18);
- Potential claims, the "Awareness Provision" or "Discovery Clause" (see §10.12);
- Prior notice exclusions (see §10.15);
- Notice-prejudice rule (see §§10.20-10.29);
- Equitable excuse doctrine (see §10.30); and
- Tail coverage (see §10.31).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/10 Broker Errors and Omissions Liability Insurance/§10.9 B. What Is a 'Claim?'

§10.9 B. What Is a "Claim?"

While a "claim" is required to trigger coverage under either a claims made or a claims made and reported policy, there are surprisingly few reported appellate decisions defining what is and what is not a "claim." To add to the confusion, different policies define "claims" in different ways.

A "claim," both in its ordinary meaning and in the interpretation given it by the courts, is a demand for something as a right, or as due. *Safeco Surplus Lines Co. v Employers' Reinsurance Corp.* (1992) 11 CA4th 1403, 1407, 15 CR2d 58; *Phoenix Ins. Co. v Sukut Constr. Co.* (1982) 136 CA3d 673, 677, 186 CR 513. Courts have defined a "claim" as a money demand for a debt due the claimant (*Williamson & Vollmer Eng'g, Inc. v Sequoia Ins. Co.* (1976) 64 CA3d 261, 269, 134 CR 427) or the assertion of a liability of the party, demanding that the party perform some service or pay money (*Abifadel v Cigna Ins. Co*. (1992) 8 CA4th 145, 160, 9 CR2d 910; *Hill v Physicians & Surgeons Exch.* (1990) 225 CA3d 1, 6, 274 CR 702).

It is generally accepted that a formal lawsuit is not required to constitute a "claim." *Abifadel,* 8 CA4th at 160; *Hill,* 225 CA3d at 5; *Phoenix Ins. Co. v Sukut Constr. Co.* (1982) 136 CA3d 673, 677, 186 CR 513; *Williamson & Vollmer Eng'g, Inc. v Sequoia Ins. Co.* (1976) 64 CA3d 261, 270, 134 CR 427.

A request for an explanation is not a claim. *Abifadel v Cigna Ins. Co., supra*; *Hill v Physicians & Surgeons Exch., supra*; *Mt. Hawley Ins. Co. v Federal Sav. & Loan Ins. Co.* (CD Cal 1987) 695 F Supp 469, 479, disapproved on other grounds in *California Union Ins. Co. v American Diversified Sav. Bank* (9th Cir 1990) 914 F2d 1271, 1277. Further, an expression of dissatisfaction or disappointment, "mere complaining," or the lodging of a grievance *without a demand for compensation* is not a claim. *Abifadel v Cigna Ins. Co., supra*; *Hill v Physicians & Surgeons Exch., supra*. At least one reported case holds that threatened action, or a statement of intent to hold the insured responsible, is not a "claim." *Abifadel,* 8 CA4th at 161.

NOTE: This seemingly simple definition of a claim has proved difficult to apply. Exactly when a threat of legal action, or a statement of intent to hold the insured responsible, crosses the line to become a demand for compensation is not clear. A court's decision as to whether a communication constitutes a claim will depend on the relationship of the parties and all the circumstances of the case, including the policy's definition of "claim."

Typical policy definitions of "claim" include:

- "Claim" means receipt of a demand for money or services, naming you and alleging a wrongful act;
- "Claim" means a demand for money or services, including a suit, arising from your wrongful act;
- "Claim" means a notice received by the Insured of an intention to hold the Insured responsible for an Occurrence involving this policy and includes the service of suit or institution of arbitration proceedings against the Insured; and
- "Claim" means any notice received by you of a demand for damages or for nonmonetary relief based on any actual or alleged wrongful act.

In *Evanston Ins. Co. v OEA, Inc.* (9th Cir 2009) 566 F3d 915, the appellate court quoted the district court's decision noting that the insurer and insured appeared to agree that the definition of "claim" incorporated a reasonable person standard, and further stated (566 F3d at 919):

> A foolish or overly sophisticated failure or refusal to realize that one is the intended object of suit would be of no assistance to an insured. Similarly, a confusingly vague or indefinite notice would not amount to a claim if a reasonable insured would not deem it such.

The insured was not served with a lawsuit, but was aware that a lawsuit naming it as a defendant was served on its wholly owned subsidiary prior to the inception of the policy. The district court granted summary judgment in favor of the insurer on the ground that the claim was made prior to the inception of the policy. On appeal, the insured argued that there was a disputed issue of fact regarding whether it was reasonable for the insured to read the complaint as not evincing an intent to hold it liable. The Ninth Circuit held that such a subjective belief was unreasonable as a matter of

law when the complaint specifically alleged that the insured was liable. 566 F3d at 920.

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§10.10 1. Communications Held to Be a Claim

Communications were held to be a claim in the following circumstances:

- Directors and officers of a bank were insured under a directors' and officers' liability policy. Bank regulators sent letters directing the directors to comply with various operating restrictions resulting from the bank's violations of regulations. These letters warned that failure to comply with the regulators' directives could result in "formal enforcement proceedings." The letters were a demand that the directors perform duties owed to the bank and therefore constituted a claim. *Mt. Hawley Ins. Co. v Federal Sav. & Loan Ins. Corp.* (CD Cal 1987) 695 F Supp 469, 479, disapproved in *California Union Ins. Co. v American Diversified Sav. Bank* (9th Cir 1990) 914 F2d 1271, 1277 (no "claim" when regulatory agency's request that insured comply with regulations did not include demand for money or damages). See also *MGIC Indem. Corp. v Home State Sav. Ass'n* (6th Cir 1986) 797 F2d 285, 288 (assertion that "wrongful act" occurred is not same as "claim for payment on account of a wrongful act"; claim for payment required to invoke coverage).
- An attorney insured under a malpractice policy drafted a mechanics' lien for a client too narrowly. The client requested that the insured work without pay to correct the problem caused by the inadequate work for which the attorney had already been paid. This demand constituted a claim. *Phoenix Ins. Co. v Sukut Constr. Co.* (1982) 136 CA3d 673, 677, 186 CR 513.
- An engineering firm insured under an E&O policy erroneously approved shop drawings that failed to comply with the construction drawings. The architect sent a letter asserting it held the insured responsible for correcting the condition and would back-charge the insured for all corrective work. This constituted a claim. *Williamson & Vollmer Eng'g, Inc. v Sequoia Ins. Co.* (1976) 64 CA3d 261, 269, 134 CR 427.

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§10.11 2. Communications Held Not to Be a Claim

Communications were held not to be a claim in the following circumstances:

- An attorney insured under an E&O policy drafted a decedent's will and had the decedent exercise a general power of appointment, with adverse tax consequences. After the decedent died, the decedent's estate attorney sent a letter asking the insured attorney to explain why he had the decedent exercise a power of appointment. That letter was a request for information and explanation and not a claim. *Hoyt v St. Paul Fire & Marine Ins. Co.* (9th Cir 1979) 607 F2d 864.
- Former officers and directors of a bank, insured under a director and officer liability policy, were sued in a shareholders' suit. A statement by the attorney representing the bank, an examination report from the State Banking Department, and a cease and desist order from the Department were not claims. *Abifadel v Cigna Ins. Co*. (1992) 8 CA4th 145, 165, 9 CR2d 910.
- Neither pleadings that sought minor repair costs from the insured structural engineering firm regarding cable failures nor a letter from a defense counsel retained by the insurer speculating that a more serious claim might be brought later was a claim, although the court characterized the issue as "close." *KPFF, Inc. v California Union Ins. Co.* (1997) 56 CA4th 963, 974, 66 CR2d 36.

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§10.12 3. Potential Claims: Awareness Provision or Discovery Clause

A dispute regarding what is a "claim" may leave an insured under a claims made and reported policy in a virtual no man's land. As described in §10.8, assume an insured has coverage in Year 1 with Company A, but switches to Company B for Year 2. During Year 1, the insured receives a "threat" of a lawsuit. Assuming the "threat" is not a "claim" (*Abifadel v Cigna Ins. Co*. (1992) 8 CA4th 145, 161, 9 CR2d 910), the insured does not report the matter Company A. When a lawsuit is filed in Year 2, the insured reports the lawsuit to Company A and Company B. Company A denies coverage on the ground that the claim was not reported during its policy year. Company B denies coverage on the ground that the "threat" was in fact a "claim," which was made prior to its policy year. *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 30 CR3d 631.

To obviate the interpretation problems regarding when a "threat" rises to the level of a claim, most claims made and reported policies allow the insured to provide notice of a "potential claim." Different carriers use different terminology to refer to this type of provision. Some policies define "potential claims." Others may refer to "circumstances which may subsequently give rise to" a claim. *KPFF, Inc. v California Union Ins. Co.* (1997) 56 CA4th 963, 975, 66 CR2d 36. The provision in which such language may be called an "awareness provision" or a "discovery clause." 56 CA4th at 971, 972 n1.

Following is an example of an "awareness provision" (56 CA4th at 968):

If during the Policy Period, the Insured shall first become aware of any circumstances which may subsequently give rise to a Claim against the Insured by reason of any act, error or omission for which coverage is otherwise provided hereunder, and if the Insured shall during the Policy Period give written notice to the Company of such circumstances, any Claim which may subsequently be made against the Insured arising out of such act, error or omission shall be deemed for the purpose of this insurance to have been first made during the Policy Period.

Similar language was analyzed in *Helfand v National Union Fire Ins. Co.* (1992) 10 CA4th 869, 889 n10, 13 CR2d 295.

An "awareness provision" or "discovery clause" assures a "tail" of coverage for situations that have not yet ripened into claims during the policy period but that the insureds expect will develop into full-blown claims down the road. *Helfand v National Union Fire Ins. Co.* (1992) 10 CA4th 869, 889, 13 CR2d 295. It extends the insurance coverage in a claims made policy. *Gyler v Mission Ins. Co.* (1973) 10 C3d 216, 220, 110 CR 139; *KPFF,* 56 CA4th at 972. As long as the insured provides notice of the "potential claim" or "circumstance" to the insurer during the policy period, any claim subsequently made will be deemed to have first been made during that insurer's policy period. *KPFF,* 56 CA4th at 968; *Helfand,* 10 CA4th at 889 n10.

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C. Importance of Disclosing Potential Claims When Applying for or Renewing Policy

§10.13 1. Applications for Insurance

In applications for claims made or claims made and reported policies, virtually every insurer requires applicants to state (usually under penalty of perjury) that they are not aware of any circumstances that may give rise to a claim. See, *e.g., American Int'l Specialty Lines Ins. Co. v Continental Cas. Ins. Co.* (2006) 142 CA4th 1342, 1353, 49 CR3d 1; *Williamson & Vollmer Eng'g, Inc. v Sequoia Ins. Co.* (1976) 64 CA3d 261, 267, 134 CR 427. If the insured falsely represents that he or she is not aware of any such circumstance, or conceals such knowledge, the insurer may deny coverage for a subsequent claim (*American Int'l Specialty Lines,* 142 CA4th at 1372; *Williamson,* 64 CA3d at 273) or seek to rescind the policy based on false representation or concealment in the application for insurance (Ins C §§359 (misrepresentation), 331, 338 (concealment)). For further discussion, see California Liability Insurance Practice: Claims & Litigation, chap 21 (Cal CEB 1991).

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§10.14 2. Prior Knowledge Conditions

In addition to the disclosure required in the application (see §10.13), many claims made or claims made and reported policies make the insured's lack of knowledge of a claim or the potential for a claim a condition precedent to coverage. One example of such a condition states (*Phoenix Ins. Co. v Sukut Constr. Co.* (1982) 136 CA3d 673, 677 n2, 186 CR 513):

> *V. Policy Period, Territory:* This policy applies only to acts or omissions committed anywhere in the world (a) during the policy period, and/or (b) prior to the policy period if claim is made or suit is brought against the insured during the policy period and such insured at the effective date of the insurance did not know or could not have reasonably foreseen that such acts or omissions might be expected to be the basis of a claim or suit, provided that with respect to (a) and (b) foregoing the original suit for damages is brought within the United States of America.

In *Phoenix*, the insured attorney drafted a mechanics' lien too narrowly. During a foreclosure action on the subject property, the client learned the mechanics' lien might not adequately protect him. Before the attorney's E&O policy expired, the insured had a meeting with the client, during which the client asked the attorney to work without pay to correct the problem. The policy required that "at the effective date of the insurance [the insured] did not know or could not have reasonably foreseen that such acts or omissions might be expected to be the basis of a claim or suit." 136 CA3d at 676. The court rejected the insured's argument that the condition was ambiguous, finding it "perfectly clear." Because the insured knew the client sought to hold him responsible for the lien's inadequacy, the appellate court affirmed the judgment that the policy did not cover the loss. 136 CA3d at 677.

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§10.15 3. Prior Notice Exclusions

Many claims made or claims made and reported policies contain a "prior notice exclusion." This type of exclusion states (*Coregis Ins. Co. v Camico Mut. Ins. Co.* (CD Cal 1997) 959 F Supp 1213, 1221):

> THIS POLICY DOES NOT APPLY… to any CLAIM arising out of any act, error or omission occurring prior to the effective date of this policy if any INSURED at the effective date knew or could have reasonably foreseen that such act, error or omission might be expected to be the basis of a CLAIM or suit.

In *Coregis*, the district court held this exclusion to be unambiguous and enforceable.

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§10.16 D. Reporting Requirement

The court in *Pension Trust Fund for Operating Eng'rs v Federal Ins. Co.* (9th Cir 2002) 307 F3d 944, 956, referred to the policy as a claims made policy with no reporting requirement. This policy description is used by some courts to distinguish between a claims made policy and a claims made and reported policy. However, the description could be regarded as a misnomer because a claims made policy does have a reporting requirement. Claims made policies almost uniformly require that the insured provide notice of the claim to the insurer "as soon as practicable." The actual difference between a claims made policy and a claims made and reported policy is that the latter requires the insured to provide notice as soon as practicable but during the policy period.

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§10.17 1. Who Must Provide Notice of a Claim?

At least one case holds that written notice must be provided by the insured, not by a third party, and not even by defense counsel retained by the insurer to defend the insured in other litigation. "The insurer's chance receipt of information from third parties does not constitute an insuring event under a claims-made policy; the insuring event consists rather of reports and notices provided by the insured." *KPFF, Inc. v California Union Ins. Co.* (1997) 56 CA4th 963, 977, 66 CR2d 36. *KPFF, Inc.* also holds that if the insurer has not received written notice from the insured, the insurer has no duty to inquire on its own of circumstances that might give rise to a claim. 56 CA4th at 977.

PRACTICE TIP: Most real estate broker E&O policies specify in the "Conditions" section where and to whom notice must be sent and what information must be provided. See §§10.71-10.77 on notice requirements.

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§10.18 2. Extended Reporting Period

An "extended reporting period" (ERP) may be available under many claims made policies. An extended reporting period allows additional time, after the end of the policy period, for the insured to report a claim. See, *e.g., Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 933, 30 CR3d 631. The ERP may be automatic; for example, when the policy is cancelled or nonrenewed, this automatic extension is for a short term, often 60 days. 130 CA4th at 933. A longer ERP, of 1 year or several years, may be available on payment of an additional premium. See discussion of tail coverage in §10.31.

In *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089, the policy period for a claims made and reported policy was April 4, 2007 to April 4, 2008. The insured was served with a summons and complaint on September 12, 2007, but did not report the claim to the insurer until April 28, 2008, 14 days after the policy expired. The policy contained an ERP provision that applied if the claim was "first made and reported" during a period of 60 days after the date the policy expired. The insured argued that the ERP was ambiguous, and that a reasonable person would not understand that it only applied to a claim made after the policy expired. The district court disagreed, finding that the meaning of the provision was plain and unambiguous. The insured also argued that because it had renewed its policy with the insurer for the subsequent year without a gap in coverage, the insured reasonably expected that it would be covered during this period. The district court again disagreed, stating that "a claim is not timely reported during a policy period, the insured is not covered simply because it has a subsequent policy." 612 F Supp at 1096. See also *Westrec Marina Mgmt, Inc. v Arrowhead Indem. Co.* (2008) 163 CA4th 1387, 1390, 78 CR3d 264 (former employee's complaint to state agency was claim that insured should have timely reported; later policy did not apply).

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§10.19 3. "Retroactive Date" and "Prior Acts" Coverage

Many claims made policies contain a "retroactive date." The policy provides that the error or omission that gives rise to the claim must take place prior to the inception date of the policy, as long as it was on or after the specified retroactive date. This type of provision affords "retroactive coverage" or "prior acts coverage." See *Coregis Ins. Co. v Camico Mut. Ins. Co.* (CD Cal 1997) 959 F Supp 1213, 1221; *Merrill & Seeley, Inc. v Admiral Ins. Co.* (1990) 225 CA3d 624, 631, 275 CR 280. The application typically requires the insured to state, under oath, that he or she is not aware of any events that could give rise to a claim that occurred on or after the retroactive date.

However, some claims made policies provide no prior acts coverage. In *Merrill*, the retroactive date of the claims made and reported policy was the same as the inception date. The insured argued that the policy was so narrow that it violated public policy. The appellate court noted that such a policy (225 CA3d at 629, citing *Sparks v St. Paul Ins. Co.* (1985) 100 NJ 325, 495 A2d 406, 414)

> combines the worst features of "occurrence" and "claims made" policies and the best of neither. It provides neither the prospective coverage typical of an "occurrence" policy, nor the "retroactive" coverage typical of a "claims made" policy.

The court nevertheless held that the language was plain and clear; the policy was therefore valid; the doctrine of reasonable expectation of coverage comes into play only when there is an ambiguity in the policy; and that "an insurer has a right to limit the policy coverage in plain and understandable language, and is at liberty to limit the character and extent of the risk it undertakes to assume." *Merrill,* 225 CA3d at 630. Although stating that it would be rare to ever have meaningful coverage under such terms (225 CA3d at 629), the court noted that in some instances an insured would choose this type of policy over no insurance at all, for example (225 CA3d at 630):

- When the insured is just beginning business, and there are no prior acts lurking in the insured's past;
- When the insured changes from occurrence to claims made protection; or
- When the insured needs to show proof of insurance, is financially limited to funding a minimal level of coverage, and is confident that there are no residual errors or omissions that will surface in the future.

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§10.20 E. Notice-Prejudice Rule

Under the "notice-prejudice rule," an insurer may not disavow coverage on the basis of lack of timely notice of the claim unless the insurer can show that it suffered substantial prejudice. *Campbell v Allstate Ins. Co.* (1963) 60 C2d 303, 305, 32 CR 827; *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 760, 15 CR2d 815. The insurer must show actual prejudice from the delay, not just the mere possibility of prejudice. *Shell Oil Co.,* 12 CA4th at 761; *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1357, 270 CR 779.

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§10.21 1. No Presumption of Prejudice

Prejudice is not presumed from delayed notice alone. *Campbell v Allstate Ins. Co.* (1963) 60 C2d 303, 307, 32 CR 827; *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 761, 15 CR2d 815. Although the insurer may in some situations have difficulty proving prejudice, the injured person would have at least as much difficulty proving a lack of prejudice, which involves proving a negative. "[W]e are of the view that a judicially created presumption of prejudice, whether conclusive or rebuttable, is unwarranted." *Campbell v Allstate Ins. Co.*, *supra; Belz v Clarendon Am. Ins. Co.* (2007) 158 CA4th 615, 629, 69 CR3d 864.

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§10.22 2. Proving Prejudice

The burden of showing actual prejudice is on the insurer. *Campbell v Allstate Ins. Co.* (1963) 60 C2d 303, 30, 32 CR 827; *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 760, 15 CR2d 815.

To establish actual prejudice for lack of timely notice, the insurer must show a substantial likelihood that, with timely notice, it would have settled the claim for less or taken steps that would have reduced or eliminated the insured's liability. *Northwestern Title Sec. Co. v Flack* (1970) 6 CA3d 134, 142, 85 CR 693; *Shell Oil Co.* 12 CA4th at 715.

Moreover, if the insurer asserts the claim is not covered or is excluded from coverage for some reason other than late notice, the insurer cannot establish actual prejudice. *Shell Oil Co. v Winterthur Swiss Ins. Co., supra* ("earlier notice would only result in earlier denial of coverage").

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§10.23 a. Prejudice Not Proven

The insurer did not prove prejudice due to lack of timely notice in the following cases:

- The loss of an opportunity to contemporaneously investigate, the loss of an opportunity for early settlement, and the loss of the right to be represented by the insurer's own counsel in the early stages of the claim did not establish prejudice because the insurer did not establish that there was a substantial likelihood that the insured would have prevailed in the underlying action had it not been for the late notice. *Northwestern Title Sec. Co. v Flack* (1970) 6 CA3d 134, 143, 85 CR 693.
- The prejudice to the insurer from an inability to assure itself that its insureds had selected competent counsel, to exercise its contractual privilege "to associate with them in the defense and settlement" of the claims at a point early enough in the proceedings to have a meaningful opportunity to participate, and otherwise to ensure that both its and its insureds' interests were protected was only speculative. *Xebec Dev. Partners, Ltd. v National Union Fire Ins. Co.* (1993) 12 CA4th 501, 533, 15 CR2d 726, disapproved on other grounds in *Essex Ins. Co v Five Star Dye House, Inc.* (2006) 38 C4th 1252, 1265 n4, 45 CR3d 362.
- The mere inability to investigate the claim thoroughly or to present a defense in the underlying suit resulting in a default judgment against the insured does not satisfy the prejudice requirement. *Belz v Clarendon Am. Ins. Co.* (2007) 158 CA4th 615, 620, 69 CR3d 864.
- The insurer did not show prejudice by providing a list of witnesses who had died or were otherwise unavailable, without showing what evidence they might have provided; or by showing that clean-up estimates for pollution increased over time, without showing that earlier estimates would have defined the insured's liability if the insured had given earlier notice. *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 761, 15 CR2d 815.

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§10.24 b. Prejudice Proven

The insurer proved prejudice due to lack of timely notice in *Collin v American Empire Ins. Co.* (1994) 21 CA4th 787, 26 CR2d 391. The insured contractor was sued for conversion and defended itself. The trial court struck the contractor's answer and entered a default judgment against it as a discovery sanction. The claimant, who was not insured, tendered defense to the contractor's insurer, which hired counsel, but default had already been entered against the insured. The claimant then sued the insurer to satisfy the judgment. The trial court ruled in favor of the claimant for the amount of the judgment for conversion. In reversing, the court of appeal held that the insurer was actually prejudiced by the delayed notice because the judgment was substantially higher than the claimant's actual damages, and the claimant subsequently conceded they had no proof that the insured actually converted anything.

NOTE: *Collin* is the only reported California decision in which prejudice was proven. See §10.23 for examples of cases in which prejudice was not proven. This underscores how difficult it is to prove the insurer was prejudiced by late notice. As suggested in *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 761, 15 CR2d 815, it would appear that the insurer must prove that a key witness has died or that essential evidence has been lost, and that no other witness or evidence is available through which that fact could be proved.

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§10.25 3. Application of Notice-Prejudice Rule to Claims Made Policies

Some cases indicate that there is a split of authority as to whether the notice-prejudice rule applies to claims made policies. See *Helfand v National Union Fire Ins. Co.* (1992) 10 CA4th 869, 887, 13 CR2d 295 ("California courts are of two minds as to whether the 'notice-prejudice' rule applies to claims made policies"); *Burns v International Ins. Co.* (9th Cir 1991) 929 F2d 1422, 1425 ("Authorities in California are split, however, as to whether the notice-prejudice rule applies to claims-made policies").

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§10.26 a. View: Notice-Prejudice Rule Applies

The following cases support the view that the notice-prejudice rule applies to claims made policies:

- *Northwestern Title Sec. Co. v Flack* (1970) 6 CA3d 134, 143, 85 CR 693 (claims made policy; dicta, as court rejected insurer's argument that 13-month delay in providing notice was prejudicial as matter of law and upheld trial court's finding of no actual prejudice because insurer did not establish it could have defended action or settled it for less);
- *Mt. Hawley Ins. Co. v Federal Sav. & Loan Ins. Corp.* (CD Cal 1987) 695 F Supp 469, 480, disapproved on other grounds in *California Union Ins. Co. v American Diversified Sav. Bank* (9th Cir 1990) 914 F2d 1271, 1277 (claims made and reported policy);
- *Xebec Dev. Partners, Ltd. v National Union Fire Ins. Co.* (1993) 12 CA4th 501, 532, 15 CR2d 726, disapproved on other grounds in *Essex Ins. Co v Five Star Dye House, Inc.* (2006) 38 C4th 1252, 1265 n4, 45 CR3d 362 (claims made policy; dicta, because jury found no substantial prejudice); and
- *Pension Trust Fund for Operating Eng'rs v Federal Ins. Co.* (9th Cir 2002) 307 F3d 944, 956 (claims made policy).

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§10.27 b. View: Notice-Prejudice Rule Does Not Apply

The following cases support the view that the notice-prejudice rule does not apply to claims made policies:

- *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1358, 270 CR 779 (claims made and reported policy);
- *Helfand v National Union Fire Ins. Co.* (1992) 10 CA4th 869, 887, 13 CR2d 295 ("loss provision" clause of policy stated that loss occurs on date insured gives written notice to insurer);
- *Burns v International Ins. Co.* (9th Cir 1991) 929 F2d 1422, 1423 (policy required that notice be given within 60 days following termination of policy period); and
- *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089 (claims made and reported policy).

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§10.28 c. Possible Basis to Reconcile Divergent Views

In *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1357, 270 CR 779, the court disagreed with *Northwestern Title Sec. Co. v Flack* (1970) 6 CA3d 134, 85 CR 693, and stated that the notice-prejudice rule did not apply to a claims made policy. The *Pacific Employers* court noted that the *Flack* court had concluded, "without discussion," that the distinction between a claims made policy and an occurrence policy did not require a departure from the application of the notice-prejudice rule. *Pacific Employers,* 221 CA3d at 1357. Notably, *Pacific Employers* involved a claims made and reported policy. The policy afforded coverage only for claims "first made against the Insured and reported to the company during the policy period," which the court noted was "coverage more restrictive than that provided by the basic types of professional liability insurance policies." 221 CA3d at 1359. In *Slater v Lawyers' Mut. Ins. Co.* (1991) 227 CA3d 1415, 278 CR 479, the court relied on *Pacific Employers* to hold that the notice-prejudice rule did not apply to what the court referred to as a claims made policy, although the policy language would constitute a claims made and reported policy; the distinction was noted in the dissent, 227 CA3d at 1425, and in *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 947, 30 CR3d 631.

In *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089, 1096, the district court stated, "…California courts have repeatedly held that the notice-prejudice rule does not apply to claims made policies," but the court was interpreting a claims made and reported policy, and cited *Pacific Employers* and *Slater*, both of which involved claims made and reported policies.

In *Helfand v National Union Fire Ins. Co.* (1992) 10 CA4th 869, 888, 13 CR2d 295, the *Helfand* court stated it was "line[d] up with the reasoning expressed" in *Pacific Employers* and *Slater*—two cases dealing with claims made and reported policies—to hold the notice-prejudice rule did not apply to a claims made policy. Notably, however, the policy language in *Helfand* was unique: the policy's insuring language did *not* state that the "loss" had to occur during the policy period; moreover, a "Loss Provision" clause in the policy stated, "The time when a loss shall be incurred… shall be the date on which the Company… or the Insureds shall give written notice to the Insurer." 10 CA4th at 886. This policy provision led the *Helfand* court to hold that loss did not occur until notice was given.

Some commentators cite *Industrial Indem. v Superior Court* (1990) 224 CA3d 828, 275 CR 218, for the proposition that the notice-prejudice rule does not apply to claims made policies. However, like *Pacific Employers* and *Slater*, this case involved a claims made and reported policy; the policy required that the claim be made during the policy period and be reported to the insurer during a 1-year extended reporting period. *Industrial Indem.,* 224 CA3d at 831. The insured knew of the claim during the extended reporting period, but elected to attempt to settle the loss before reporting it to the insurer in order to avoid an adverse impact on future insurability, and did not report the loss until 3 months after the extended reporting period expired. The court held that the insured "gambled" and lost, and that the policy language unambiguously barred coverage for the claim. 224 CA3d at 832.

Thus, it seems that most cases that have concluded the notice-prejudice rule should not apply have dealt with claims made and reported policies, even if the opinion does not recognize them as such. This explanation may help reconcile what seem to be contrary decisions.

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§10.29 4. Notice-Prejudice Rule Does Not Apply to Claims Made and Reported Policies

While some courts and commentators may fail to draw the distinction between claims made and claims made and reported policies, it does seem clear that the notice-prejudice rule does *not* apply to claims made and reported policies. As stated in *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 947, 30 CR3d 631:

> To apply the notice-prejudice rule to a claims made and reported policy would have been to convert that policy into a pure claims made policy, and therefore give the insured a better policy than he paid for.... Consider the inflexible breadth of the notice-prejudice rule: It can apply to cases involving delays many months, perhaps even years, after the expiration of the policy period, and it puts the burden on the insurer to show prejudice from even long delays in reporting. Application of the rule thus fundamentally rewrites the claims made and reported contract into a pure claims made contract.

See also *Industrial Indem. v Superior Court* (1990) 224 CA3d 828, 832, 275 CR 218; *Pacific Employers Ins. Co. v Superior Court* (1990) 221 CA3d 1348, 1359, 270 CR 779; *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp2d 1089.

PRACTICE TIP: As demonstrated by *Pacific Employers,* 221 CA3d at 1357, the distinction between claims made and claims made and reported policies must be maintained. The notice-prejudice rule may apply to the former, but it does not apply to the latter.

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§10.30 F. Equitable Excuse

While the notice-prejudice rule does not apply to claims made and reported policies, the doctrine of equitable excuse of a condition precedent may apply. See *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 947, 30 CR3d 631; *Oakland-Alameda County Coliseum, Inc. v National Union Fire Ins. Co.* (ND Cal 2007) 480 F Supp 2d 1182, 1192.

Under the doctrine of equitable excuse, a trial court may equitably excuse the satisfaction of conditions in insurance contracts in order to avoid a forfeiture of coverage. *Root*, 130 CA4th at 947; *Oakland-Alameda County Coliseum,* 480 F Supp 2d at 1192. Excusal is appropriate in certain circumstances when the reporting requirement functions as a condition rather than "an element of the fundamental risk insured." *Root*, 130 CA4th at 943; *Oakland-Alameda County Coliseum,* 480 F Supp 2d at 1193. In both cases, the appellate courts referred to the equitable excuse doctrine as "flexible and nuanced" (*Root*, 130 CA4th at 947; *Oakland-Alameda County Coliseum*, 480 F Supp 2d at 1193), noting also the "factually intense nature of the inquiry" required to determine whether the equitable excuse doctrine should be applied (*Root*, 130 CA4th at 948; *Oakland-Alameda County Coliseum, Inc. v National Union Fire Ins. Co., supra*).

Factors a court should consider include (*Root v American Equity Specialty Ins. Co*, *supra*):

- Whether the insurer gave the insured an opportunity to purchase an extended reporting endorsement, and if so, whether the insured purchased it;
- Whether the insured had sufficient time to conduct an investigation as to whether a claim had been made against it; and
- Whether the insured delayed in reporting the claim beyond the day on which it received confirmation of the claim.

See also *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089, 1098 (finding no basis for equitable excuse when insured waited 213 days to report claim).

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§10.31 G. Tail Coverage

"Tail coverage," or an extended reporting period, extends the time within which a claim may be made after the cancellation or expiration of a particular claims made policy. It provides insurance protection for acts, errors, or omissions that occurred while the initial claims made policy was in effect, as long as a claim is made before the expiration of the tail period. *Home Ins. Co. v Law Offices of Jonathan DeYoung, P.C.* (ED Pa 1998) 32 F Supp 2d 219, 224; *Slater v Lawyers' Mut. Ins. Co.* (1991) 227 CA3d 1415, 1424, 278 CR 479. See also *Universal Health Servs., Inc. v Pennsylvania Prop. & Cas. Ins. Guar. Assn* (Pa Super Ct 2005) 884 A2d 889, 891 n2 ("extended reporting period" or "reporting tail").

Although sometimes used interchangeably, "extended reporting period" typically refers to a fairly short term, often 30 to 60 days; a separate premium may or may not be charged. In contrast, "tail coverage" is usually for a term of a year or several years, and a separate premium—often quite large—is usually required.

See California Liability Insurance Practice: Claims & Litigation §5.61 (Cal CEB 1991); 7 Couch on Insurance §102:26 (3d ed). See also discussion of extended reporting periods in §10.18.

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§10.32 IV. INSURING CLAUSE

As discussed in §§10.1-10.2, there is no standardized form for a real estate broker liability policy. Some policy language may afford broader coverage than differing language. Following is an example of a typical insuring clause in a broker claims made and reported liability policy:

The Company will pay on behalf of the Insured all sums in excess of the deductible which the Insured becomes legally obligated to pay as Damages for Claims first made against the Insured during the Policy Period and first reported to the Company in writing during the Policy Period or within sixty (60) days thereafter, arising out of any act, error, omission or Personal Injury in the rendering of or failure to render Professional Services by an Insured covered under this policy; provided always that such act, error, omission or Personal Injury happens: (A) during the Policy Period or (B) prior to the Policy Period provided that: (1) such act, error, omission or Personal Injury happened on or after the Prior Acts Date as indicated on the Declarations Page of this policy and (2) at the inception of this policy the Insured had no reasonable basis to believe that any Insured had breached a professional duty and no reasonable basis to believe an act, error or omission might be expected to result in a Claim or Suit.

On the definition of professional services, see §10.39.

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§10.33 A. Legally Obligated to Pay

One component of the basic insuring agreement is the requirement that the insured is legally obligated to pay the damages. See typical insuring language in §10.32. On its face, this phrase seems to limit coverage to amounts that the insured is obligated to pay by law, not contract, and at one time that was how courts interpreted this provision. However, in *Vandenberg v Superior Court* (1999) 21 C4th 815, 88 CR2d 366, the California Supreme Court interpreted the meaning of the "legally obligated" requirement of the insuring language when an insurer sought to exclude from coverage a contamination claim that was arbitrated as a breach of lease. The court rejected the insurer's argument that the policy responded only to damages arising out of tort (but not contractual) liability because the nature of the property damage was physical, overruling *International Surplus Lines Ins. Co. v Devonshire Coverage Corp.* (1979) 93 CA3d 601, 155 CR 870. See also *Burlington Ins. Co. v Oceanic Design & Constr., Inc.* (9th Cir 2004) 383 F3d 940 (no coverage for contract claims under Hawaii law). The *Vandenberg* court explained, "Predicating coverage upon an injured party's choice of remedy or the form of action sought is not the law of this state.… Instead, courts must focus on the nature of the risk and the injury, in light of the policy provisions, to make that determination." 21 C4th at 840.

Liability insurance does not cover payments made by the insured to the injured party *before* a judgment has been rendered against the insured. Until a judgment is rendered, the insured is not "legally obligated" to make the payment. *San Diego Housing Comm'n v Industrial Indem. Co.* (1998) 68 CA4th 526, 543, 80 CR2d 393.

The California Department of Real Estate (DRE), through the Real Estate Commissioner, has the authority to discipline brokers and salespersons for violations of the licensing laws. See chap 9. The Commissioner may deny, suspend, or revoke real estate licenses or may order a licensee to pay a monetary penalty. Bus & P C §§10071, 10137, 10175, 10175.2. Although there is no case on point, such monetary penalties would not appear to constitute sums the insured becomes legally obligated to pay. The insurer's duty to indemnify the insured for "all sums that the insured becomes legally obligated to pay as damages is limited to money ordered by a court." *Certain Underwriters at Lloyd's of London v Superior Court (Powerine I)* (2001) 24 C4th 945, 951, 103 CR2d 672. Generally, an insurer need not indemnify the insured for payments ordered by an administrative agency (*e.g.,* environmental clean-up orders by the Federal Environmental Protection Agency or similar state agencies). 24 C4th at 951. In *Powerine I*, expenses assessed by a regional water board pursuant to a state environmental statute in connection with clean-up and abatement of contamination in soil and groundwater did not fall within this insuring language in a commercial general liability (CGL) form. See also *County of San Diego v Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 420, 33 CR3d 583 (similar insuring clause in nonstandard excess liability policy; administrative agency order to remediate environmental contamination and for sums to settle related third party property damage claims did not fall within insuring language). Under some circumstances, however, the term "legally obligated" may encompass similar costs if incurred in complying with injunctive orders issued by a court. *AIU Ins. Co. v Superior Court* (1990) 51 C3d 807, 825, 274 CR 820 ("legally obligated" language in CGL policy covered cost of reimbursing government agencies and complying with injunctions ordering clean-up of contaminated property).

However, if the insuring language is broad, the result may be different. If the insuring language includes "expenses" as defined in an "ultimate net loss" provision that includes sums paid for settlement, adjustment, and investigation of claims, coverage may extend to expenses to comply with an administrative agency's orders. *Powerine Oil Co. v Superior Court (Powerine II)* (2005) 37 C4th 377, 33 CR3d 562 (order to clean up contamination).

See also California Liability Insurance Practice: Claims & Litigation §1.24 (Cal CEB 1991).

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§10.34 B. Damages

The insurer has a duty to indemnify the insured for sums that the insured becomes legally obligated to pay as damages for a covered claim. *Aerojet-General Corp. v Transport Indem. Co.* (1997) 17 C4th 38, 56, 70 CR2d 118; *Buss v Superior Court* (1997) 16 C4th 35, 45, 65 CR2d 366. By definition, this duty entails the payment of money, which is expressly limited in amount, to resolve liability. "It is not narrowly confined to money that the insured must give under law as compensation to third parties, but may also include money that the insured must itself expend in equity in order to provide relief of the same sort." *Aerojet-General Corp. v Transport Indem. Co., supra*. See also *AIU Ins. Co. v Superior Court* (1990) 51 C3d 807, 819, 274 CR 820.

However, an order for restitution or disgorgement of money or property wrongfully obtained is not "damages." *Bank of the West v Superior Court* (1992) 2 C4th 1254, 1266, 10 CR2d 538. Furthermore, penalties that are punitive in nature are not "damages." *Bullock v Maryland Cas. Co.* (2001) 85 CA4th 1435, 1448, 102 CR2d 804. In addition, attorney fee awards are not "damages." However, if an award of attorney fees is authorized by contract, statute, or law as recoverable costs of suit, such fees may fall within the insurer's defense obligations if the policy requires the insurer to pay with respect to any claim or suit that it defends "all costs taxed against the insured." *San Diego Housing Comm'n v Industrial Indem. Co.* (2002) 95 CA4th 669, 689, 116 CR2d 103.

Unlike the duty to defend, which arises when the claim presents any potential for indemnity (*Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 413-414, 79 CR2d 52; *Montrose Chem. Corp. v Superior Court (Monrose I)* (1993) 6 C4th 287, 295, 24 CR2d 467), the duty to indemnify runs to claims that are actually covered, in light of the facts proved, and arises only after liability is established and as a result of the liability (*Aerojet-General Corp. v Transport Indem. Co., supra; Buss,* 16 C4th at 46; *Montrose Chem. Corp. v Admiral Ins. Co. (Montrose II)* (1995) 10 C4th 645, 659 n9, 42 CR2d 324).

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§10.35 C. Wrongful Acts

The insuring language for most real estate broker E&O policies extends coverage to either "acts, errors, or omissions" or "wrongful acts" in the rendering of or failure to render "professional services." The definition of "wrongful act" may vary widely from policy to policy. A typical definition might read "any actual or alleged breach of duty, negligent act, error, or omission, misstatement, or misleading statement in the rendering of or failing to render Professional Services." See §10.39 for the definition of professional services. Other policies may define wrongful acts to include personal injury, such as false arrest, detention or imprisonment, malicious prosecution, wrongful eviction, slander and libel, or invasion of privacy.

The gamut of potential "wrongful acts" or "acts, errors, or omissions" can be seen in reported California cases against real estate brokers, including:

- Failure to disclose known material defects. *Easton v Strassburger* (1984) 152 CA3d 90, 99, 199 CR 383, as modified by CC §§2079-2079.24 (see §10.49); *Cooper v Jevne* (1976) 56 CA3d 860, 866, 128 CR 724.
- Failure to exercise reasonable skill and care in setting an asking price and in recommending the acceptance of an offer. *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 164, 177 CR 882.
- Overstatement of value of buyer's property, which was security for note given to sellers. *Schoenberg v Romike Props.* (1967) 251 CA2d 154, 162, 59 CR 359.
- Failure to secure or recommend a title search. *Wilson v Hisey* (1957) 147 CA2d 433, 438, 305 P2d 686.
- Failure to make component transactions contingent on one another in arranging an exchange. *Stiefel v McKee* (1969) 1 CA3d 263, 265, 81 CR 565.
- Improper structuring of an IRC §1031 exchange, which limited the amount of assets available to the plaintiffs for purchase of the homes; improper structuring of the transaction, allowing loan proceeds rather than monies from the sale of the exchange properties to be used to fund the purchase of the homes; and premature closing of escrow without express authorization from the plaintiffs. *Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 412, 79 CR2d 52.
- Failure of a listing broker either to disclose to the purchasers any known unrecorded lien interests in the property, or to notify promptly the persons holding unrecorded liens of the impending sale of the property, so that recording of the liens could take place before sale. *Norman I. Krug Real Estate Invs. v Praszker* (1990) 220 CA3d 35, 42, 269 CR 228.
- Mortgage insurance provider's alleged kickback scheme, which violated the Real Estate Settlement Procedure Act of 1974 (RESPA) (12 USC §§2601-2617) anti-kickback provisions. *PMI Mortgage Ins. Co. v American Int'l Specialty Lines Ins. Co.* (9th Cir 2005) 394 F3d 761, 764. On RESPA, see §§1.22, 3.37, 8.16.

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§10.36 D. Personal Injury

In addition to coverage for wrongful acts or acts, errors, or omissions, some real estate broker E&O liability policies afford coverage for personal injury. "Personal injury" is typically defined not in terms of the injury or harm that results, but in terms of the conduct that produces it. Personal injury coverage applies to injury that arises out of the commission of certain enumerated acts or offenses. Coverage is triggered by the offense, not the injury or damage that a plaintiff suffers. *Fibreboard Corp. v Hartford Acc. & Indem. Co.* (1993) 16 CA4th 492, 511, 20 CR2d 376.

Personal injury may be defined as follows:

Personal Injury means injury, other than Bodily Injury, arising out of one or more of the following offenses: a. False arrest, detention, or imprisonment; b. Malicious prosecution; c. Wrongful eviction from, wrongful entry into, or other invasion of the right of private occupancy of premises that a person occupies, committed by or on behalf of its owner, landlord, or lessor; d. Oral or written publication of material that slanders, libels, or defames a person or organization or disparages a person's or organization's goods, products, or services; or e. Oral or written publication of material that violates a person's right of privacy.

These personal injury offenses should be construed broadly to encompass all specific torts that could reasonably fall within the general category. *Fibreboard Corp.*, 16 CA4th at 515. However, the scope of personal injury liability coverage cannot be expanded beyond the offenses enumerated above. *American Guar. & Liab. Ins. Co. v Vista Med. Supply* (ND Cal 1988) 699 F Supp 787, 793 (applying California law to interpret personal injury provision in commercial general liability (CGL) policy).

NOTE: Most policies that afford personal injury coverage *exclude* coverage for "bodily injury." Unlike personal injury, which is any injury (other than bodily injury) arising from an enumerated offense, excluded bodily injury is defined in terms of the injury that results, not the offense that caused it. Bodily injury is typically defined as follows: "Bodily Injury means physical injury to or sickness, disease, or death of a person, or if arising out of the foregoing, mental injury, mental anguish, emotional distress, pain, suffering, or shock." On bodily injury exclusions, see §§10.55-10.57.

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§10.37 1. Wrongful Eviction

The coverage afforded for wrongful eviction or invasion of the right of private occupancy is restricted to eviction or occupancy rights of a "person," while the coverage for other offenses refers to both "persons" and "organizations." Courts have interpreted the coverage as not applying to wrongful eviction of a corporate lessee (*Golden Eagle Ins. Corp. v Cen-Fed, Ltd.* (2007) 148 CA4th 976, 990, 56 CR3d 279; *Mirpad, LLC v California Ins. Guar. Ass'n* (2005) 132 CA4th 1058, 1071, 34 CR3d 136) and not applying to nuisance and trespass claims brought by a corporation (*Stonelight Tile, Inc. v California Ins. Guar. Assn* (2007) 150 CA4th 19, 40, 58 CR3d 74).

Further, for "wrongful eviction" coverage to apply, the claimant must have a right to occupy the premises. For example, a landlord's actual or constructive dispossession of a tenant is an "eviction" (*Legarra v Federated Mut. Ins. Co*. (1995) 35 CA4th 1472, 1484, 42 CR2d 101), but ejecting a rowdy patron from the insured's premises is not, because the claimant did not have a right of occupancy (*Zelda, Inc. v Northland Ins. Co.* (1997) 56 CA4th 1252, 1263, 66 CR2d 356). Likewise, damages caused by late delivery of leased premises may be actionable as a breach of the covenant of quiet enjoyment, but it is not an "eviction" until the tenant has been placed into possession and is subsequently dispossessed or vacates the property. *Cunningham v Universal Underwriters* (2002) 98 CA4th 1141, 1149, 120 CR2d 162.

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§10.38 2. Trespass and Other Torts

The form of the cause of action selected by the plaintiff does not govern whether the claim is covered. *Vandenberg v Superior Court* (1999) 21 C4th 815, 838, 88 CR2d 366; *Golden Eagle Ins. Corp. v Cen-Fed, Ltd.* (2007) 148 CA4th 976, 989, 56 CR3d 279. Courts broadly construe these offenses to encompass all specific torts that could reasonably fall within the enumerated offenses. *General Acc. Ins. Co. v West Am. Ins. Co.* (1996) 42 CA4th 95, 103, 49 CR2d 603, overruled on other grounds in *Sterling Builders, Inc. v United Nat'l Ins. Co.* (2000) 79 CA4th 105, 112, 93 CR2d 697; *Fibreboard Corp. v Hartford Acc. & Indem. Co.* (1993) 16 CA4th 492, 515, 20 CR2d 376. "Wrongful entry" may include trespass and nuisance claims, even when no force is involved and the insured had no intent to dispossess the occupant. *Martin Marietta Corp. v Insurance Co. of N. America* (1995) 40 CA4th 1113, 1131, 47 CR2d 670. Trespass may be by personal intrusion or failure to leave; by throwing or placing something on the land; or by causing the entry of some other person or property. Nuisance claims involving physical entry may constitute a "wrongful entry." 40 CA4th at 1132.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/10 Broker Errors and Omissions Liability Insurance/§10.39 E. Professional Services

§10.39 E. Professional Services

The example of insuring language in §10.32 affords coverage for damages arising out of wrongful acts or personal injury "in the rendering of or failure to render Professional Services by an Insured." Absent a definition in the policy, professional services has been defined by the courts as services involving "specialized knowledge, labor, or skill, and the labor or skill involved is predominantly mental or intellectual, rather than physical or manual." *Food Pro Int'l, Inc. v Farmers Ins. Exch.* (2008) 169 CA4th 976, 986, 89 CR3d 1; *Tradewinds Escrow, Inc. v Truck Ins. Exch.* (2002) 97 CA4th 704, 713, 118 CR2d 561. This definition is broader than "profession" and encompasses services performed for remuneration. 97 CA4th at 713; *Stone v Hartford Cas. Co.* (CD Cal 2006) 470 F Supp 2d 1088, 1098.

The following cases illustrate services that have been held to constitute professional services:

- *Tradewinds Escrow, Inc. v Truck Ins. Exch.* (2002) 97 CA4th 704, 713, 118 CR2d 561 (escrow services);
- *PMI Mortgage Ins. Co. v American Int'l Specialty Lines Ins. Co.* (9th Cir 2005) 394 F3d 761 (illegal kickback scheme, consisting of undercharging of lender clients in exchange for customer referrals on mortgage insurance);
- *Stone v Hartford Cas. Co.* (CD Cal 2006) 470 F Supp 2d 1088, 1098 (draftsman's performing work of contractor);
- *Hollingsworth v Commercial Union Ins. Co.* (1989) 208 CA3d 800, 806, 256 CR 357 (ear piercing service at cosmetic store); and
- *Amex Assur. Co. v Allstate Ins. Co.* (2003) 112 CA4th 1246, 1252, 5 CR3d 744 (plumbing; "[T]he ordinary meaning of the word 'professional' is no longer limited to the 'learned professions,' but has a broader scope that includes skilled services").

Because real estate brokers receive specialized education and training and are licensed, it is difficult to imagine that a court could fail to hold that almost everything a broker or salesperson does for a client is a professional service. A parallel may be found in *Food Pro Int'l, Inc. v Farmers Ins. Exch.* (2008) 169 CA4th 976, 89 CR3d 1, in which a court found that an insured was retained to develop detailed designs and specifications and provide high-level supervision of plant relocation, all of which are "professional services." Nevertheless, the court held that with regard to the circumstances involving a construction worker injured during a relocation, the insured's role was limited to coordination of the overall process, and that the injured worker was performing a project that had been ordered by his own employer rather than the insured. Since the insured's professional services did not extend to the creation of the dangerous condition, the safety of the site, or the direction of the crew, the insurer could not apply the professional services exclusion contained in the policy. 169 CA4th at 988. The court instead reasoned that the insured's involvement in the accident was merely as an observer who noticed the danger and notified the responsible party, and that any failure to rectify the situation was ordinary negligence. 169 CA4th at 989.

However, a court's definition of professional services may be inapplicable if the policy defines the term. For example, some real estate broker and salesperson liability policies define the term as those services listed in the declarations or in an accompanying endorsement to the policy.

The following examples illustrate typical policy language regarding the definition of professional services:

Example 1:

… solely in the performance of services as a Residential Real Estate Salesperson or Broker of non-owned property, for others for a fee.

Example 2:

"Professional Services" means solely those services identified below that are performed by you for others for compensation: (1) Residential Real Estate Salesperson or Broker or (2) Property Manager.

Example 3:

"Professional Services" means services performed by an Insured in an Insured's capacity as a Broker, buyer's broker, salesperson, appraiser of real estate, real estate consultant, auctioneer, counselor, or property manager, as long as such service is rendered on or behalf of the customer or client in return for a fee, commission, or other compensation or in the course of solicitation of a client or customer for services which would result in payment of a fee, commission, or other compensation. It includes incidental services rendered by any Insured as a notary public, title agent, or as a member of a formal accreditation committee, standards review committee, or similar board or committee.

PRACTICE TIP: A broader definition of "Professional Services" could be extremely important to a broker or salesperson who provides services in addition to those as a real estate licensee.

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§10.40 V. WHO IS AN INSURED

If the appropriate procedures are followed, real estate brokers may conduct their brokerage services through a corporation (Bus & P C §10211; 10 CCP §2740); partnership (Bus & P C §10137.1; 88 Ops Cal Atty Gen 203 (2005)); or under a fictitious name (Bus & P C §10159.5). If the policy is issued to an entity or a fictitious name, issues may arise as to who is insured under the policy.

Most policies contain a separate section, or at least a definition, of who qualifies as an insured under the policy. This may include "named insureds," "additional named insureds," and "additional insureds" (sometimes called "omnibus insureds").

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§10.41 A. Named Insureds and Additional Named Insureds

The person indemnified under an insurance policy is the "insured." Ins C §23. The party purchasing the insurance is typically listed in the declarations for the policy as the "named insured." The "named insured" is the person(s) or entity(ies) listed on the declarations page of the policy. *Fidelity & Deposit Co. v Charter Oak Fire Ins. Co.* (1998) 66 CA4th 1080, 1086, 78 CR2d 429. Most liability policies extend coverage not only to the person or entity expressly listed on the policy, but also to other classes of additional insureds. On additional insureds, see §§10.42-10.44.

The definition of "named insured" in a real estate broker and salesperson liability policy may state:

"Named Insured" means the individual, entity, partnership or corporation designated as such in Item 1 of the Declarations.

"Additional named insureds" generally are persons who are added as insureds after the policy issues. *Kotlar v Hartford Fire Ins. Co.* (2000) 83 CA4th 1116, 1121 n3, 100 CR2d 246. An additional named insured may be added in the policy declarations or by endorsement.

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§10.42 B. Additional Insureds or Omnibus Insureds

In contrast to a "named insured" or an "additional named insured," an "additional insured" or "omnibus insured" is one who is not listed by name in the declarations or an endorsement, but who falls within the policy's omnibus definition of insureds. Additional insureds typically include the following:

- Past, present, or future officers, directors, or trustees of the named insured;
- Employees of the named insured; or
- Any entity the named insured is required by contract to add as an insured.

The names of such "additional insureds" do not appear in the policy and the insurer typically does not even know who these persons are until a claim is filed. *Kotlar v Hartford Fire Ins. Co.* (2000) 83 CA4th 1116, 1121 n3, 100 CR2d 246.

Following is an example of the definition of the terms "you," "your," and "insured":

"You," "your," or "insured" means: (1) the Named Insured listed on the Declarations page of this Policy; (2) any of your partners, if you are a partnership; (3) any past, present, or future executives, officers, directors, trustees, or subsidiaries if you are a corporation; (4) any of your employees or employees of your subsidiaries, but only while acting within the scope of their duties as such; (5) any entity whom you are required by contract to add as an insured under this policy, but only for your wrongful acts; and (6) any subsidiary of yours, but only with respect to wrongful acts which occur while it is a subsidiary and is otherwise covered by this policy.

The example given above includes "employees" as insureds. Other policies add an independent contractor endorsement. Such a definition or endorsement is important to salespersons because they are often independent contractors to, rather than employees of, their broker. See discussion of broker and salesperson relationship in §§8.32-8.42. An independent contractor endorsement adds to the definition of "you, your, or insured" language such as the following:

any independent contractor, but only for wrongful acts committed, or allegedly committed, in the performance of professional services for, or on behalf of, at the direction of, or at the request of the named insured.

Whether a party is an "additional insured" or an "additional named insured" should not affect the scope of the coverage afforded. It has been said that "the rights of a named insured under a policy of insurance inure to all additional insureds under that policy." See *National Auto. & Cas. Ins. Co. v California Cas. Ins. Co.* (1983) 139 CA3d 336, 341, 188 CR 670. While many statutory provisions, such as those governing cancellation and notice of cancellation of auto or commercial policies, limit that general proposition—*e.g.,* an "additional insured" is not entitled to notice of cancellation under Ins C §677.2, although all named insureds, including all "additional named insureds," are so entitled (*Kotlar v Hartford Fire Ins. Co.* (2000) 83 CA4th 1116, 1121 n3, 100 CR2d 246)—an additional insured is entitled to defense and indemnity like a named insured. *Presley Homes, Inc. v American States Ins. Co.* (2001) 90 CA4th 571, 575, 108 CR2d 686.

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§10.43 1. Partnerships

Brokerage partnerships are rare, and generally each of the partners will have an individual broker license. If a policy is issued to a partnership, the general or managing partner of the named insured is usually an additional insured, "but only while acting within the scope of their duties as such." Although a limited liability partnership (LLP) and limited liability corporation (LLC) may own, purchase, and sell property in California, they cannot be licensed as brokers. Only a natural person or a corporation may receive a broker license. Corp C §§13401, 17375.

Individual partners may be named as defendants in a lawsuit against the partnership. See §11.13. To avoid any dispute regarding whether the individual partners are sued "within the scope of their duties" in the business, partnerships often list each individual partner as an additional named insured.

In *Milazo v Gulf Ins. Co.* (1990) 224 CA3d 1528, 274 CR 632, a commercial general liability (CGL) policy listed the named insured as each partner "dba" the partnership. The court held that the policy insured the partnership and the individual partners only with respect to their liability as partners, and not as individuals. 224 CA3d at 1536.

PRACTICE TIP: In the opening sentence of the *Milazo* opinion, the court described the facts as: "[A] duplicitous partner seeks to obtain indemnification under a partnership liability policy for the damages caused to his innocent copartners by his misappropriation of a partnership opportunity." 224 CA3d at 1531. When partners are sued along with a partnership, the distinction between the partners' liability as individuals and their liability as partners will seldom be an issue. However, the "belt and suspenders" approach is to seek a policy that names the partnership and each individual partner as named insureds, without any qualification as to their capacity or whether they are using a fictitious business name as ("dba" or "doing business as") the partnership.

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§10.44 2. Fictitious Names or "DBA"

A broker may use a fictitious name if the fictitious name is listed on the broker's license as a "dba" ("doing business as"). Bus & P C §10159.5; 10 CCP §2731. Unfortunately, sole proprietors doing business under a fictitious name often obtain policies listing their dba as the named insured. The named insured must be a legal person, such as an individual, partnership, or corporation. Ins C §151; *Providence Washington Ins. Co. v Valley Forge Ins. Co.* (1996) 42 CA4th 1194, 1200, 50 CR2d 192. "The designation 'd/b/a'… is merely descriptive of the person or corporation who does business under some other name. Doing business under another name does not create an entity distinct from the person operating the business." 42 CA4th at 1200. See also Bus & P C §§17900-17930 (regulating fictitious business names).

If the policy lists a "dba" as the named insured because of a mistake by the insured and the insurer, the policy may be interpreted as if the individual sole proprietor were the named insured. *Providence Washington Ins. Co*., 42 CA4th at 1200.

If the named insured has any other business activities, describing the named insured as a "dba" may limit coverage. For example, in *Fidelity & Deposit Co. v Charter Oak Fire Ins. Co.* (1998) 66 CA4th 1080, 78 CR2d 429, the policy listed the named insured as "Western Savings & Loan Assoc DBA Marina Inn." The Marina Inn was located in Arkansas. Western Savings & Loan was sued for construction defects in townhomes located in California. The appellate court held the policy provided coverage only for liability connected with the Inn, not the named insured's other business activities.

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§10.45 VI. EXCLUSIONS

In most circumstances, an insurer is free to select the character of the risk it will assume, and it is liable only for a loss within the terms of the policy. *Fresno Econ. Import Used Cars, Inc. v United States Fid. & Guar. Co.* (1977) 76 CA3d 272, 280, 142 CR 681. An insurer has the right to limit the coverage of a policy issued by it, and when it has done so, the plain language of the limitation must be respected. *Continental Cas. Co. v Phoenix Constr. Co.* (1956) 46 C2d 423, 296 P2d 801; *Fresno Econ.,* 76 CA3d at 280. See also *Julian v Hartford Underwriters Ins. Co.* (2005) 35 C4th 747, 759, 27 CR3d 648. The words of an exclusion must be part of the working vocabulary of the average person, and the exclusion must be phrased logically. *Blasiar, Inc. v Fireman's Fund Ins. Co.* (1999) 76 CA4th 748, 754, 90 CR2d 374. The insurer bears the burden of drafting the exclusion in clear language comprehensible to a layperson. *Cal-Farm Ins. Co. v TAC Exterminators, Inc.* (1985) 172 CA3d 564, 578, 218 CR 407. Exclusionary clauses are subjected to heightened scrutiny by courts, and if the exclusion is not conspicuous, plain, and clear, it will be invalidated. *Thompson v Mercury Cas. Co.* (2000) 84 CA4th 90, 94, 100 CR2d 596.

Under settled rules for insurance policy interpretation, the court must accept a tenable construction of an exclusion most favorable to the insured. *Freedman v Queen Ins. Co.* (1961) 56 C2d 454, 458, 15 CR 69.

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§10.46 A. Exceptions

Some exclusions contain exceptions that restore some of the coverage taken away by the exclusion. Thus, because an exception is somewhat analogous to insuring language, exceptions are construed broadly. *Old Republic Ins. Co. v Superior Court* (1998) 66 CA4th 128, 145, 77 CR2d 642, disapproved on other grounds in *Vandenberg v Superior Court* (1999) 21 C4th 815, 841 n13, 88 CR2d 366. However, an exception to an exclusion cannot create coverage for a loss not otherwise covered under the insuring language. 66 CA4th at 145.

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§10.47 B. Burden of Proof

The insurer has the burden of proof to establish the exclusion that bars coverage for the loss. *Garvey v State Farm Fire & Cas. Co.* (1989) 48 C3d 395, 406, 257 CR 292. Most cases place the burden of proof on the insured to establish that the exception to the exclusion applies. *Travelers Cas. & Sur. Co. v Superior Court* (1998) 63 CA4th 1440, 1454, 75 CR2d 54.

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§10.48 C. Effect of Exclusions on Duty to Defend

To establish that there is no duty to defend, the insurer must prove that there is no potential for coverage. *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 300, 24 CR2d 467. "[T]he insured need only show that the underlying claim *may* fall within policy coverage; the insurer must prove it *cannot*." 6 C4th at 300. An insurer may rely on an exclusion to deny coverage only if it provides conclusive evidence demonstrating that the exclusion applies. *Atlantic Mut. Ins. Co. v J. Lamb, Inc.* (2002) 100 CA4th 1017, 1038, 123 CR2d 256; *Wausau Underwriters Ins. Co. v Unigard Sec. Ins. Co.* (1998) 68 CA4th 1030, 1035, 80 CR2d 688.

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§10.49 D. No Exclusion for Statutory Liability for Inspection and Disclosure

The same statute that authorizes an exclusion in a real estate broker insurance policy for liability arising out of a "dishonest, fraudulent, criminal, or malicious act, error, or omission," prohibits any exclusion for liability arising from breach of the duty of inspection and disclosure set forth in CC §§2079-2079.24. Ins C §11589.5. The Civil Code codifies a real estate broker's duty as expressed in *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383, "to conduct a reasonably competent and diligent visual inspection of the property offered for sale and to disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal." CC §2079; *Loken v Century 21-Award Props.* (1995) 36 CA4th 263, 270 n3, 42 CR2d 683. See discussion of statutory broker duties in chap 3.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/10 Broker Errors and Omissions Liability Insurance/§10.50 E. Specific Exclusions

§10.50 E. Specific Exclusions

Because there is no ISO standard language form policy for real estate liability insurance (see §10.2), counsel may come across a great number of types of exclusions, many with variations in language. A few of the more common exclusions are discussed in §§10.51-10.70.

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§10.51 1. Insurance Code §11589.5 Exclusions

An exclusion for dishonest, fraudulent, criminal, or malicious acts, errors, or omissions is expressly authorized by statute. Under Ins C §11589.5, "an insurer may exclude coverage against liability arising out of a dishonest, fraudulent, criminal, or malicious act, error, or omission committed by, at the direction of, or with the knowledge of the insured."

There are no cases that have interpreted this exclusion in a real estate broker liability policy. For guidance, counsel must turn to similar exclusions in other types of policies.

An exclusion for "criminal" acts, although unusual, applies even if the insured did not intend to cause harm or damage. *20th Century Ins. Co. v Schurtz* (2001) 92 CA4th 1188, 1196, 112 CR2d 547 (homeowners' insurance); *Allstate Ins. Co. v Talbot* (ND Cal 1988) 690 F Supp 886, 889 (homeowners' insurance). However, the insurer must prove that the criminal acts were committed, not merely that criminal charges have been filed. *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1249, 37 CR3d 918 (aircraft insurance).

Likewise, the insurer must prove that a theft in fact occurred and that the insured was liable, in order for an exclusion for liabilities caused by "misappropriation, secretion, [or] conversion" to apply. *Atlas Assur. Co. v McCombs Corp.* (1983) 146 CA3d 135, 145, 194 CR 66 (business liability insurance).

In *State Farm Fire & Cas. Co. v Superior Court* (2008) 164 CA4th 317, 78 CR3d 828, 514 P2d 953, a homeowners' policy contained an exclusion for bodily injury "which is the result of willful and malicious acts of the insured." 164 CA4th at 320. The insured pled no contest to misdemeanor assault and battery. The appellate court held that this exclusion did not apply to the insured's act of throwing another person into a pool, but not throwing him hard enough, so that he landed on the pool's concrete step, because even though the insured intended his acts, he did not intend to cause any injury.

Notably, the exclusion authorized by Ins C §11589.5 is for liability arising out of a dishonest, fraudulent, criminal, or malicious act, error, or omission "committed by, at the direction of, or with the knowledge of *the insured*." (Emphasis added.) When interpreting other exclusions, California courts have held that the term "the insured" refers to the named insured, while "an insured" or "any insured" means any insured or additional insured. *State Farm Mut. Auto. Ins. Co. v Jacober* (1973) 10 C3d 193, 207, 110 CR 1, 514 P2d 953 (exclusion regarding bodily injury to "the insured" held ambiguous). For example, an exclusion for intentional acts of "the insured" excludes coverage only for the intentional acts of the named insured, while an exclusion for intentional acts of "an insured" or "any insured" excludes coverage for the intentional acts of any insured. *Western Mut. Ins. Co. v Yamamoto* (1994) 29 CA4th 1474, 1486, 35 CR2d 698; *Fire Ins. Exch. v Altieri* (1991) 235 CA3d 1352, 1360, 1 CR2d 360.

In *Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 79 CR2d 52, an insurer issued an E&O policy to a real estate partnership. The policy excluded coverage for claims arising from the sale of any property owned by "any entity in which *you* have a financial interest." 67 CA4th at 411 (emphasis in original). The policy defined "you" to include any partner of the named insured. Smith, one of the firm's partners, owned an interest in a piece of property. The purchaser of that property sued the partnership, Smith, and Benedict, an employee of the partnership. The insurer denied coverage and refused to defend. The appellate court noted that Smith, Benedict, and the partnership all potentially qualified as a "you" entitled to coverage. 67 CA4th at 416. The appellate court relied on prior case law that when a policy covers multiple insureds, the fact that the exclusion might bar coverage for one insured does not automatically preclude coverage for the other insureds, and a policy extending coverage to multiple insureds creates several obligations and the exclusion must be applied severally to each insured to determine its effect. 67 CA4th at 416. The court held that the exclusion applied only if the claim against the insured arises from the sale of property owned by the insured against whom the claim is made, rather than from the sale of property owned by another member of the group of insureds. 67 CA4th at 417.

By analogy, under the exclusion authorized by Ins C §11589.5, counsel for a broker or salesperson could argue that, although coverage would be precluded for liability arising out of a dishonest, fraudulent, criminal, or malicious act, error, or omission committed by, or at the direction of, or with the knowledge of, the named insured, an additional insured, such as an employee, might still be entitled to coverage as long as he or she did not commit, direct, or have

knowledge of the act, error, or omission.

PRACTICE TIP: Counsel should carefully review cases from other jurisdictions interpreting this exclusion. See, *e.g., Seaboard Indus., Inc. v Monaco* (Pa Super Ct 1978) 392 A2d 738, 743 (similar exclusion precluded any duty to defend insured sued for conspiracy to defraud; under Pennsylvania law, duty to defend is determined solely by express allegations of the complaint); *Town Crier, Inc. v Hume* (ED Va 1989) 721 F Supp 99, 102 (similar exclusion precluded duty to defend insured sued for fraud and conspiracy to injure plaintiff's business; under Virginia law insurer's duty to defend is determined solely by "claims" (causes of action, not allegations) set forth in pleadings); *Moscarillo v Professional Risk Mgmt. Servs., Inc.* (Md 2007) 921 A2d 245, 256 (under Maryland law; unasserted cause of action, even if potentially supported by factual allegations or extrinsic evidence, cannot form basis of insurer's duty to defend). Because California law requires the insurer to consider possible amendments and extrinsic evidence, cases like *Seaboard, Town Crier*, and *Moscarillo* would appear to have little precedential value in California disputes, but they may provide reasoning and arguments that may be helpful to counsel.

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§10.52 2. Disputes Involving Insured's Fees, Commissions, or Charges

A policy may exclude any claim "arising out of any disputes involving any Insured's fees, commission, or charges." Many claims may involve disputes over fees, commissions, or charges as one element of the claim. However, if the claim involves any claim for damages other than fees, commissions, or charges, this exclusion, by itself, will not preclude a duty to defend or to indemnify for those other damages. See *Hartford Cas. Ins. Co. v Chase Title, Inc.* (D Md 2003) 247 F Supp 2d 779, 781; *Stewart Title Guar. Co. v Kiefer* (ED La 1997) 984 F Supp 988, 993.

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§10.53 3. Insured Versus Insured

An "insured versus insured" exclusion may read as follows: "Any claim made by an Insured against any other Insured, unless such claim arises solely out of Professional Services performed for that party in a broker-client capacity." This exclusion is sometimes referred to as a "cross-suits exclusion." See, *e.g., Westchester Fire Ins. Co. v Wallerich* (8th Cir 2009) 563 F3d 707, 713 (D&O policy; under Minnesota law, insured versus insured exclusion barred coverage for lawsuit by officer and officer's spouse against other officers); *Great W. Drywall, Inc. v Interstate Fire & Cas. Co.* (2008) 161 CA4th 1033, 1037, 74 CR3d 657 (commercial general liability (CGL) policy); *Paragon Homes, Inc. v Insurance Co. of State of Pennsylvania* (Jan. 30, 2006, B171147; not certified for publication) 2006 Cal App Unpub Lexis 842 (CGL policy).

No California cases have interpreted this exclusion in a real estate broker liability policy. This exclusion presents a number of potential issues:

- What does the phrase "broker-client capacity" mean?
- Will the courts give "arises solely out of" a broad or narrow construction?
- Does this exclusion apply to current "insureds," former "insureds," or both?
- What is the insurer's obligation if some, but not all, of the claimants are (or were) "insureds"?

Similar "insured versus insured" exclusions are found in other types of policies. If the exclusions contain similar wording, their reasoning may be persuasive. See, *e.g., Montgomery v Cal Accountants Mut. Ins. Co.* (1998) 61 CA4th 854, 72 CR2d 39 (accountant professional liability policy; "insured versus insured" exclusion expressly applied to "present, former or prospective" partners, officers, and principals; exclusion applied even though insured sued in capacity of "investor" rather than former partner); *American Med. Int'l, Inc. v National Union Fire Ins. Co.* (9th Cir 2001) 244 F3d 715, 723 (director and officer policy; "insured versus insured" exclusion of suits by former director not limited to suits for harm suffered in capacity as director).

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§10.54 4. Failure to Render Professional Services

The policy may contain an exclusion for

claims based on or arising out of the rendering of or failure to render Professional Services by any Insured as employee, owner, partner, stockholder, director, or officer of any sole proprietorship, corporation, partnership, limited liability partnership, or other business enterprise not listed on the Declarations Page.

This exclusion reflects the importance of the declarations page, as well as the insurer's right to limit coverage and charge a premium based on the scope of coverage provided. Courts are unlikely to extend coverage for professional services rendered by entities for which no premium has been paid. See, *e.g., Fidelity & Deposit Co. v Charter Oak Fire Ins. Co.* (1998) 66 CA4th 1080, 1086, 78 CR2d 429 (party not listed on declarations page was not an insured). For a discussion of the term "Professional Services," see §10.39.

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§10.55 5. Bodily Injury, Sickness, Disease, or Death

The policy may contain an exclusion for "claims [a]rising out of… Bodily Injury, sickness, disease or death of any person." Real estate broker E&O policies typically either define "bodily injury" to include emotional distress or include an exclusion that extends to bodily injury and emotional distress. If not, an issue may arise regarding whether bodily injury includes emotional distress. This issue often arises under commercial general liability (CGL) policies.

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§10.56 a. Pure Emotional Distress

When interpreting the undefined term bodily injury, courts have found that the critical word in the term is "bodily." *Aim Ins. Co. v Culcasi* (1991) 229 CA3d 209, 219, 280 CR 766. Dictionary definitions of the word "bodily" draw a distinction between physical or corporeal and mental or spiritual. "Such definitional unanimity indicates that the ordinary and popular meaning of the word 'bodily' does not reasonably encompass, and in fact suggests a contrast with, the purely mental, emotional, and spiritual." 229 CA3d at 219. Claims for emotional distress, without physical injury or manifestation—referred to as "pure emotional distress"—do not constitute claims for "bodily injury." 229 CA3d at 227. See also *Chatton v National Union Fire Ins. Co.* (1992) 10 CA4th 846, 855, 13 CR2d 318; *Mercury Ins. Co. v Ayala* (2004) 116 CA4th 1198, 1204, 11 CR3d 158.

In *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 23, 44 CR2d 370, the supreme court held that commercial general liability (CGL) policies do not provide coverage for economic losses that cause emotional distress:

> These policies were never intended to cover emotional distress damages that flow from an uncovered "occurrence," and the parties could not reasonably have expected that coverage would be expanded merely because a claim of emotional or physical distress is alleged as a result of the economic loss.

See also *American Int'l Bank v Fidelity & Deposit Co.* (1996) 49 CA4th 1558, 1570, 57 CR2d 567 (potential borrowers' emotional distress flowing from economic loss allegedly caused by insured lender was outside coverage of CGL policy); *Miller v Western Gen. Agency, Inc.* (1996) 41 CA4th 1144, 1151, 49 CR2d 55 (emotional distress caused by misrepresentation and concealment of defective plumbing in home sale did not constitute bodily injury).

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§10.57 b. Emotional Distress Accompanied by Physical Injury or Manifestations

If the term bodily injury is not defined in the policy, a more difficult issue involves whether physical manifestations of emotional distress constitute bodily injury. In *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 40, 44 CR2d 370, Justice Kennard noted in her concurring and dissenting opinion that

> [m]ost of the courts that have addressed the issue have held that any physical manifestations accompanying emotional distress are "bodily injuries" as that term is used in insurance policies. [Citations] On its face, the policy's definitional language, "bodily injury, sickness, or disease," broadly covers any somatic condition, and does not exclude those that are caused or accompanied by mental distress.

NOTE: Thus, an exclusion in a real estate broker liability policy for bodily injury would appear to preclude coverage for physical injury or physical manifestations of emotional distress, but not preclude coverage for emotional distress caused by a covered wrongful act.

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§10.58 6. Injury, Disease, or Illness

The policy may contain an exclusion for "claims [r]esulting from… Injury, disease, or illness (including death at any time resulting therefrom)." There are no California cases interpreting this exclusion in a real estate broker liability policy. Further, the terms "injury," "disease," or "illness" are not defined in most broker liability policies.

NOTE: As noted in §10.56, in commercial general liability (CGL) policies, the term "bodily injury" has been interpreted to not include "pure emotional distress," *i.e.,* emotional distress unaccompanied by physical manifestations. See *Mercury Ins. Co. v Ayala* (2004) 116 CA4th 1198, 1204, 11 CR3d 158; *Chatton v National Union Fire Ins. Co.* (1992) 10 CA4th 846, 855, 13 CR2d 318; *Aim Ins. Co. v Culcasi* (1991) 229 CA3d 209, 227, 280 CR 766. In contrast, this exclusion uses the term "injury," not "bodily injury." This raises the issue of whether "pure emotional distress" would fall within this exclusion.

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§10.59 7. Physical Injury, Damage to, Destruction of, or Loss of Use of Tangible Property

The policy may contain an exclusion for "claims arising out of property damage." There are no California cases interpreting this exclusion in a broker liability policy. The term "property damage" will likely be defined as that term has been defined by the courts in commercial general liability (CGL) policies: "physical injury, damage to or destruction of, or loss of use of tangible property. As used in other types of policies, the term "tangible property" refers to things that can be touched, seen, and smelled. "Tangible property" does not include intangible property losses, such as loss of an investment, loss of goodwill, or loss of intangible property use. See *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 17, 44 CR2d 370; *Kazi v State Farm Fire & Cas. Co.* (2001) 24 C4th 871, 879, 103 CR2d 1.

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§10.60 8. Activities Involving Property Syndication, Real Estate Investment Trusts, Limited Partnerships, or Similar Investments

The policy may contain an exclusion for "claims based on or arising out of activities involving property syndication, real estate investment trusts, limited partnerships, or similar investments." There are no California cases interpreting this exclusion in a real estate broker liability policy. In *Nowacki v Federated Realty Group, Inc*. (ED Wis 1999) 36 F Supp 2d 1099, a brokerage firm's E&O liability policy contained an exclusion for "any claim arising out of the formation, syndication, operation or administration of any corporation, general or limited partnership, joint venture or real estate investment trust." The district court held that this exclusion barred coverage for the formation and operation of a corporation that was a title company allegedly controlled by the insured broker and to whom the insured referred the insured's customers, but did not preclude coverage for claims based on the insured's conduct toward third parties regarding its relationship with that corporation. 36 F Supp 2d at 1106.

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§10.61 9. Sale or Purchase of Insurance, or Failure to Effect or Maintain Adequate Levels or Types of Insurance

The policy may contain an exclusion for "claims based on or arising out of the sale or purchase of insurance, or the failure to effect or maintain adequate levels or types of insurance." There are no California cases interpreting this exclusion in a real estate broker liability policy. In *Fireman's Fund Ins. Co. v University of Georgia Athletic Ass'n, Inc*. (Ga Ct App 2007) 654 SE2d 207, a university athletic association purchased a liability policy. The policy excluded coverage for any claim arising out of or in any way related to "the Insured's failure to effect or maintain insurance." 654 SE2d at 359. The appellate court held the exclusion was ambiguous, because it could be construed as limited to the insured's failure to obtain and maintain other kinds of insurance typically carried by a similar insured, such as property hazard and premises liability coverage. 654 SE2d at 361.

In contrast, in *Management Specialists, Inc. v Northfield Ins. Co.* (Colo Ct App 2004) 117 P3d 32, 35, a real estate property management company was sometimes required to obtain liability insurance, including director and officer (D&O) insurance for homeowners associations that were its clients. The management company carried its own E&O liability insurance that contained an exclusion for "any damages arising out of the failure or inability to maintain adequate levels or types of insurance." The Colorado court of appeals held that the exclusion referred to the management company's failure to maintain insurance of any kind, regardless of the type of insurance or whether the insurance should have been maintained for itself or for others. As a result, the court held that the management company's E&O carrier was not required to provide a defense in the action filed by the management company's clients who alleged that the company had failed to purchase D&O coverage for them or had allowed coverage to lapse by failing to make premium payments on time.

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§10.62 10. Liability Assumed by Insured Under Any Oral or Written Contract

The policy may contain an exclusion for claims based on, or arising out of, liability assumed by an insured under any oral or written contract, agreement, or warranty, except liability the insured would have in the absence of such contract, agreement, or warranty.

There are no California cases interpreting this type of exclusion in a real estate broker liability policy. However, many other types of professional liability policies contain an exclusion for any claim "arising out of a breach of contract," or arising "out of liability assumed under any contract or agreement." *August Entertainment, Inc. v Philadelphia Indem. Ins. Co.* (2007) 146 CA4th 565, 579, 52 CR3d 908.

In other types of policies, this type of endorsement has been held to preclude coverage when the insured would not be liable to a third party except for the fact that the insured contracted to assume such liability. In other words, if the insured would be liable without the contract, the exclusion does not apply. *Golden Eagle Ins. Co. v Insurance Co. of the West* (2002) 99 CA4th 837, 846, 121 CR2d 682; *Roger H. Proulx & Co. v Crest-Liners, Inc.* (2002) 98 CA4th 182, 201, 119 CR2d 442.

NOTE: Even absent such an express exclusion, many claims for breach of contract will not be covered under a broker liability policy because there will be no "wrongful act" and no "loss" because the insured is simply being required to pay an amount it agreed to pay by contract. See *August Entertainment,* 146 CA4th at 579.

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§10.63 11. Activities of Insured as Mortgage Broker, Escrow Agent, Contractor, Developer, Insurance Broker, or Property Manager

The policy may contain an exclusion for "claims arising out of activities of an Insured as a mortgage banker, mortgage counselor, mortgage broker, business broker, independent third party escrow agent, contractor, construction advisor, property developer, insurance agent, or insurance broker." Other policies may exclude claims arising out of the insured's activities as a property manager. There are no California cases interpreting this exclusion in a real estate broker liability policy. However, this exclusion may be extremely important to those brokers who provide these real estate related, but nonbrokerage, services. The insurer may be willing to delete the exclusion, but undoubtedly at a higher premium to cover the risks associated with those services.

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§10.64 12. Real Property Owned by Insured

Because real estate broker professional liability insurance is designed to cover risks in selling property for others, policies often exclude claims that arise when the insured deals with his or her own inventory—property owned by the insured or an entity in which the insured has a financial interest. *Morris v Employers Reinsurance Corp*. (2000) 84 CA4th 1026, 1029, 101 CR2d 350. In *Morris*, an exclusion stated that the policy did not apply to

> any claim made against the Insured arising out of or in connection with any property, entity or enterprise controlled, managed, operated, or in which there is an ownership interest by: 1. An Insured; 2. A member of an Insured's immediate family. 84 CA4th at 1028.

The insured broker attempted to acquire an equitable interest in property from a property owner, thereby acting in conflict of interest with her client who made an offer on the property in question. The exclusion did not apply because "her very act of attempting to purchase the property from [the owner] reveals that she was not dealing with her own property and places her conduct outside of the purview of [the] Exclusion." 84 CA4th at 1030.

When interpreting other exclusions, California courts have held that an exclusion for intentional acts of "an insured" or "any insured" excludes coverage for the intentional acts of any insured. *Western Mut. Ins. Co. v Yamamoto* (1994) 29 CA4th 1474, 1486, 35 CR2d 698; *Fire Ins. Exch. v Altieri* (1991) 235 CA3d 1352, 1360, 1 CR2d 360. The term "the insured" refers to the named insured (see §10.41), while "an insured" or "any insured" means any insured or additional insured (see §10.42). *State Farm Mut. Auto. Ins. Co. v Jacober* (1973) 10 C3d 193, 207, 110 CR 1, 514 P2d 953. Under this interpretation, an exclusion for loss involving property owned by "any insured" should bar coverage even if the insured seeking defense or indemnity had no ownership interest in the property, as long as at least one "insured" had such an ownership interest.

In contrast to the exclusion quoted above, some exclusions are narrower, and preclude coverage for property owned by "the insured" or owned by "you." See *Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 79 CR2d 52, discussed in §10.51.

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§10.65 13. Damage to or Reduction in Financial Value of Any Property

The policy may contain an exclusion for "claims relating to damage to or reduction in financial value of any property." Such an exclusion might apply if buyers allege that they relied on the broker's assurance that property values were sure to go up by at least a certain percent, while values stayed flat or fell.

There are no California cases interpreting this exclusion in a real estate broker liability policy. In an unreported decision, a federal court applied an exclusion for "reduction in financial value of intangible property" found in an excess liability policy to preclude coverage for damages arising from breach of patent licensing agreements. *Houbigant, Inc. v Federal Ins. Co.* (D NJ, Dec. 30, 2002, No. 015993 (MLC)) 2002 WL 34413201.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/10 Broker Errors and Omissions Liability Insurance/§10.66 14. Guarantee or Promise of Future Status, Performance, or Valuation

§10.66 14. Guarantee or Promise of Future Status, Performance, or Valuation

The policy may contain an exclusion for "claims arising out of any guarantee or promise of future status, performance, or valuation in the course of performing Professional Services by the Insured."

There are no California cases interpreting this exclusion in a real estate broker liability policy.

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§10.67 15. Personal Profit or Advantage to Which Any Insured Is Not Legally Entitled

The policy may contain an exclusion for "claims based on or arising out of the Insured gaining any personal profit or advantage to which any Insured is not legally entitled, including misappropriation, conversion, embezzlement, commingling, or defalcation of funds or other property."

There are no California cases interpreting this exclusion in a real broker liability policy. However, this type of exclusion has been used in other types of liability policies, and requires that the insurer prove that the acts were committed, not merely that criminal charges have been filed. See *Atlas Assur. Co. v McCombs Corp.* (1983) 146 CA3d 135, 145, 194 CR 66 (business liability insurance). See also *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1249, 37 CR3d 918 (aircraft insurance).

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§10.68 16. Discrimination

The policy may contain an exclusion for "claims arising out of, based on, alleging, or arising out of discrimination of any kind by an Insured, including but not limited to discrimination due to or on the basis of age, sex, race, color, religion, disability, marital status, pregnancy, national origin, HIV or AIDS status, sexual origin, sexual orientation, or sexual preference."

There are no California cases interpreting this exclusion in a real estate broker liability policy. For analogous authorities, counsel may look to cases interpreting "employment-related practices" exclusions that preclude coverage for discrimination in employment. See, *e.g., Golden Eagle Ins. Corp. v Rocky Cola Café, Inc.* (2001) 94 CA4th 120, 114 CR2d 16; *Frank & Freedus v Allstate Ins. Co.* (1996) 45 CA4th 461, 52 CR2d 678; *HS Servs., Inc. v Nationwide Mut. Ins. Co.* (9th Cir 1997) 109 F3d 642.

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§10.69 17. Pollution

The policy may contain an exclusion for "claims for or arising out of the discharge, dispersal, release, or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials, or other irritants, contaminants, or pollutants into or upon land, the atmosphere, or any watercourse or body of water."

In *Homestead Ins. Co. v Ryness Co.* (ND Cal 1992) 851 F Supp 1441, the plaintiff alleged that a real estate broker failed to disclose that waste had been dumped on the land purchased by the plaintiff. The court held that such nondisclosure fell within the pollution exclusion, because it was "dependent upon and inextricably linked to the excluded dumping of waste." 851 F Supp at 1444.

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§10.70 18. Prior Notice Exclusion

Many claims made or claims made and reported policies contain a "prior notice exclusion." See discussion in §10.15.

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§10.70A 19. Willful Acts

Insurance Code §533 provides that an insurer is not liable for a "wilful act of the insured." The statute is "an implied exclusionary clause which by statute is read into all insurance policies." *J.C. Penney Cas. Ins. Co. v M.K.* (1991) 52 C3d 1009, 1019, 278 CR 64. An act is willful within the meaning of Ins C §533 if the insured intended to commit the act and either intended to cause the harm or the act was inherently harmful. 52 C3d at 1025 (insured's behavior was inherently harmful); but see *Horace Mann Ins. Co. v Barbara B.* (1993) 4 C4th 1076, 17 CR2d 210 (insured's behavior was inherently harmful, but triable issue of fact existed as to whether alleged negligent conduct was "inseparably intertwined" with willful conduct). See also *Downey Venture v LMI Ins. Co.* (1998) 66 CA4th 478, 500, 78 CR2d 142 (§533 precludes indemnification for, but not defense against, malicious prosecution); *State Farm Gen. Ins. Co. v Mintarsih* (2009) 175 CA4th 274, 288, 95 CR3d 845 (failure to obtain medical care was inseparably intertwined with insured's willful conduct of false imprisonment).

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VII. CLAIMS PROCESS

§10.71 A. Mandatory Written Notice of Claim

Virtually all real estate broker liability policies contain a provision requiring prompt notice, in writing, of any claim, whether submitted on a claims made or claims made and reported form. This type of provision is usually found under a heading labeled "Conditions" or "Other Provisions Affecting Coverage." Such a provision in a claims made and reported policy may state:

Your Duties in the Event of a Claim. Before coverage will apply, you must notify us in writing of any claim against you as soon as practicable during the policy period or Extended Reporting Period (if applicable). You must also: (1) immediately record the specifics of the claim and date you received it; and (2) specify the names and addresses of the persons making the claim against you, and any witnesses; (3) provide us with information regarding the time, place, and nature of the claim; and (4) send copies of all demands, suit papers, or other legal documents you receive, as soon as possible to us at [address] or [our address indicated in the Declarations].

While a notice condition almost always requires written notice, courts may find a waiver of (or estoppel to assert) the requirement of written notice if the insurer does not object to oral notice. *Hall v San Jose Abstract & Title Ins. Co.* (1959) 172 CA2d 421, 342 P2d 362 (interpreting notice provision in title insurance policy).

This type of notice condition is consistent with the Fair Claims Settlement Practices Regulations (10 Cal Code Regs §§2695.1-2695.14). Although 10 Cal Code Regs §2695.2(n) states that "notice of claim" may be verbal or written, an insurer may require that the notice be given in writing as long as the policy or an endorsement to it provides for written notice. 10 Cal Code Regs §2695.5(f).

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§10.72 B. Contents of Notice

Many real estate broker liability policies do not specify what information must be included in the notice of claim. According to the Fair Claims Settlement Practices Regulations, the notice of claim need only apprise the insurer that the claimant wishes to make a claim against a policy issued by the insurer and that a condition giving rise to the insurer's obligations under that policy may have arisen. 10 Cal Code Regs §2695.2(n). Under these regulations, the "notice of claim" triggers the time limits for the insurer to acknowledge receipt of the notice (10 Cal Code Regs §2695.5(e)(1)), begin its investigation (10 Cal Code Regs §2695.5(e)(3)), and if it includes "proof of claim," *i.e.,* documentation of the magnitude or amount of the loss, to affirm or deny coverage and liability (10 Cal Code Regs §2695.7(b)(1)). Under 10 Cal Code Regs §2695.2(n), however, the notice of claim may "not include any written or oral communication provided by an insured or principal solely for informational or incident reporting purposes."

PRACTICE TIP: To avoid any dispute over the form of the notice, the insured's attorney is advised to comply with the policy requirement that notice be in writing and be sent to the address specified in the policy. Further, if the claim involves litigation against the insured, counsel should be careful to state explicitly that the insured is requesting the insurer to provide a defense. In addition, to avoid any claim that the insurer did not receive notice of the claim, counsel should send written notice by certified mail or any method that provides proof of delivery. And, although few (if any) current policies allow the insured to choose counsel, the insurer may consent to counsel of the insured's choice. Counsel for the insured should not hesitate to express the insured's reasons for preference, and pertinent qualifications of counsel (*e.g.,* long relationship with the insured; knowledge of the insured's procedures, recordkeeping practices, and personnel; experience handling E&O claims; experience working with other insurers).

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§10.73 C. To Whom Notice Should Be Sent

Most forms of policies will specify to whom the notice should be sent. However, by the time a claim is made, many insureds cannot find their insurance policy. Many insureds send the notice of claim to their insurance agent or broker, rather than to the insurer. Notably, the Fair Claims Settlement Practices Regulations state that notice may be given to the insurer "or its agent." 10 Cal Code Regs §2695.2(n). Further, the regulations provide that the failure of an insurance agent or a claims agent to transmit promptly a notice of claim to the insurer is "imputed to the insurer." 10 Cal Code Regs §2695.5(e)(1). Presumably, this means that the insurer would be estopped from asserting late notice as a coverage defense if an insurance agent or a claims agent received notice. See *Zurich Ins. Co. v Killer Music, Inc.* (9th Cir 1993) 998 F2d 674, 679 (notice to agent sufficient when agent's address was only address on policy); *General Acc. Assur. Co. v Caldwell* (9th Cir 1932) 59 F2d 473, 475 (evidence admitted to show that broker acted as agent of insurer regarding notices of loss).

PRACTICE TIP: Obviously, it is best to strictly comply with any notice provision, including sending the notice to the correct person or entity designated in the policy. However, if the insured cannot locate the policy, he or she should not wait until the policy is located to send a notice. Written notice should be sent to the insurance agent or broker who sold the policy, as well as to a general claims office for the insurer. The insured should include a request that the agent immediately forward the notice to the insurer and provide the insured with the proper address for notice of the claim.

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§10.74 D. Notice of Potential Claims

Many real estate broker and salesperson liability policies contain a condition allowing the insured to provide notice of a "potential claim." The following is an example of such a condition:

Notice of Potential Claims. If, during the Policy Period or Extended Policy Period (if any), you first become aware of any facts or circumstances to which this insurance applies and which might reasonably give rise to a Claim against you for a Wrongful Act, you may give written notice to us of a potential Claim. Such notice must include: (1) the identity of the potential claimants; (2) the identity of the person(s) who allegedly committed the Wrongful Act; (3) the date of the alleged Wrongful Act; (4) specific details of the alleged Wrongful Act; and (5) any written notice from the potential claimant describing the Wrongful Act.

If this notice is submitted to us during the Policy Period or Extended Reporting Period (if any), then any Claim that is subsequently made against you arising from the Wrongful Act about which notice was given to us will be deemed for the purpose of this Policy to have been first made during the Policy Period.

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§10.75 E. Denial of Claim Based on Lack of Timely Notice

An insurer may not disavow coverage on the basis of lack of timely notice of the claim unless the insurer can show that it suffered substantial prejudice. *Campbell v Allstate Ins. Co.* (1963) 60 C2d 303, 305, 32 CR 827; *Safeco Ins. Co. v Parks* (2009) 170 CA4th 992, 1003, 88 CR2d 730; *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 760, 15 CR2d 815. This is known as the "notice-prejudice rule." For complete discussion of the notice prejudice rule, see §§10.20-10.29. The notice-prejudice rule does not apply to claims made and reported policies, but the doctrine of equitable excuse of a condition precedent may apply. *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 947, 30 CR3d 631; *World Health & Educ. Found. v Carolina Cas. Ins. Co.* (ND Cal 2009) 612 F Supp 2d 1089; *Oakland-Alameda County Coliseum, Inc. v National Union Fire Ins. Co.* (ND Cal 2007) 480 F Supp 2d 1182, 1192. For discussion, see §10.30.

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F. Waiver of Defects in Notice

§10.76 1. Insurer's Denial of Coverage

If the insurer denies coverage under the policy, that denial constitutes a waiver of the notice condition. *Clemmer v Hartford Ins. Co.* (1978) 22 C3d 865, 883, 151 CR 285; *Shell Oil Co. v Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 762, 15 CR2d 815; *Lagomarsino v San Jose Abstract & Title Ins. Co.* (1960) 178 CA2d 455, 460, 3 CR 80. The rationale for this waiver rule is that an insurer that denies coverage presumably had enough information to make a fully informed decision and therefore presumably was not prejudiced by the defective notice.

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§10.77 2. Insurer's Failure to Object

An insurer that fails to object specifically and promptly to defects as to the content or form of a notice or proof of loss waives the defects. Ins C §553. An insurer waives the late presentation of a notice or proof of loss if the delay is caused by an act of the insurer or if the insurer fails to object specifically and promptly on that ground. Ins C §554. See *Lagomarsino v San Jose Abstract & Title Ins. Co.* (1960) 178 CA2d 455, 459, 3 CR 80 (5-year delay in objecting to oral notice of claim waived title insurer's right to demand written notice of claim or statement of loss).

For a more comprehensive discussion of waiver and estoppel to avoid the harsh results of a defective notice of claim or proof of loss, see California Liability Insurance Practice: Claims & Litigation §8.32 (Cal CEB 1991).

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VIII. TENDERING THE DEFENSE

§10.78 A. Definition of "Tender"

There is no authoritative definition of a "tender of defense." Generally speaking, a tender of defense is a notice to the insurer that legal action has been brought against the insured, coupled with a request that the insurer defend the insured. It has been defined as "an offer by the policyholder to the insurer to allow the insurer to defend the policyholder in a lawsuit." *Faust v The Travelers* (9th Cir 1995) 55 F3d 471, 472. Real estate broker liability policies typically do not use the term "tender." No specific words are mandated to constitute a tender or request for a defense.

PRACTICE TIP: Some insureds are reluctant to tender the defense to an insurer because "it will make my premiums go up." Insureds may want to determine if the "value" of the claim will exceed their deductible. Or they may not want to tender the defense "if the insurer is just going to deny coverage anyway." Unless there is a valid economic or business reason, it is seldom advisable to delay in sending notice to the insurer and tendering the defense. The insurer is generally not responsible for pre-tender defense costs. At a minimum, the insurer will attempt to avoid paying any pre-tender defense fees and costs "voluntarily" incurred by the insured. See §10.80. No particular words are required to constitute a tender of defense, but counsel should be sure that a request for defense is clearly communicated so that the insurer cannot claim that the insured was simply requesting information or reporting an incident. See 10 Cal Code Regs §2695.2(n). If further information, explanation, or citations to legal authorities are required by the insurer before it will agree to defend, they should be provided as soon as possible.

For additional discussion on the content and manner of tendering the defense of third party actions, see California Liability Insurance Practice: Claims & Litigation §8.23 (Cal CEB 1991).

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§10.79 B. Consequences of Late Tender

Prompt tender of defense of the claim is important. If the insurer is able to demonstrate prejudice from any delay by the insured in tendering the claim, the insured may forfeit not only the right to defense but also the right to indemnity under the policy. *Select Ins. Co. v Superior Court* (1990) 226 CA3d 631, 276 CR 598. The insurer bears the burden of proving substantial prejudice from the delay. 226 CA4th at 636.

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§10.80 C. Recovery of Pre-Tender Fees

Many types of liability policies contain a "no-voluntary-payments" provision prohibiting the insured from voluntarily assuming an obligation, incurring an expense, or making a payment without the insurer's consent, except at the insured's own expense. See *Belz v Clarendon Am. Ins. Co*. (2007) 158 CA4th 615, 625, 69 CR3d 864. Such payments are often referred to as "pre-tender fees" because they generally are incurred before the insured tenders the defense to the insurer. California courts have consistently honored no-voluntary-payments provisions. *Northern Ins. Co. v Allied Mut. Ins. Co.* (9th Cir 1992) 955 F2d 1353, 1360. For further discussion of pre-tender fees, including the issue of whether they were voluntarily incurred, see §10.93.

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IX. INSURER'S TIME LIMITS TO RESPOND TO NOTICE OF CLAIM OR TENDER OF DEFENSE

§10.81 A. Time Limit to Respond to Notice

Notice of the claim triggers certain deadlines for the insurer under the Fair Claims Settlement Practices Regulations (10 Cal Code Regs §§2695.1-2695.14).

Receipt of notice of the claim obligates the insurer to respond by acknowledging receipt of the claim, providing certain information to the insured, beginning investigation, accepting or denying the claim, and affirming or denying liability. On receiving notice of the claim (unless it is a notice of legal action), the insurer must "immediately," but no more than 15 calendar days later, do the following:

- Acknowledge receipt of the notice, unless payment is made within that time (10 Cal Code Regs §2695.5(e)(1));
- Provide the claimant with necessary forms, instructions, and "reasonable assistance," including specifying the information the claimant must provide for proof of claim (10 Cal Code Regs §2695.5(e)(2));
- Begin any necessary investigation of the claim (10 Cal Code Regs §2695.5(e)(3)); and
- If the notice of claim includes a "proof of claim" (evidence or documentation of the amount of loss), to accept or deny the claim.

"Proof of claim" is defined in 10 Cal Code Regs §2695.2(s). See §10.83.

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§10.82 B. Time Limit to Respond to Communications From Insured

The insurer's responsibility to respond to the insured does not end with response to the notice of claim. Until the claim is finally resolved, if the insured sends any communication that reasonably suggests a response is expected, the insurer must respond "immediately, but in no event more than fifteen (15) calendar days" and furnish the claimant with a complete response based on the facts currently known to the insurer. 10 Cal Code Regs §2695.5(b).

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§10.83 C. Time Limit to Accept or Deny Claim

On receiving proof of claim, an insurer must "immediately," but no more than 40 calendar days later, accept or deny the claim, in whole or in part. 10 Cal Code Regs §2695.7(b). "Proof of claim" is defined in 10 Cal Code Regs §2695.2(s) to mean

> any evidence or documentation in the possession of the insurer, whether as a result of its having been submitted by the claimant or obtained by the insurer in the course of its investigation, that provides any evidence of the claim and that reasonably supports the magnitude or the amount of the claimed loss.

Under 10 Cal Code Regs §2695.7(c)(1), if the insurer requires more time to determine whether a claim should be accepted or denied, the insurer must provide the claimant with written notice of the need for additional time. The notice must specify why more time is needed and describe any additional information required to make the determination. If further additional time is needed, the insurer must provide written notice every 30 calendar days until the determination is made or notice of legal action is served. If the determination cannot be made until some event occurs, the insurer must advise the claimant of that situation and estimate when the determination can be made.

While an insurer is making its determination about whether a timely filed claim is covered, the statute of limitations is equitably tolled. *Prudential-LMI Commercial Ins. v Superior Court* (1990) 51 C3d 674, 693, 274 CR 387; *Forman v Chicago Title Ins. Co.* (1995) 32 CA4th 998, 1001, 38 CR2d 790.

PRACTICE TIP: In processing an insurance claim, insurers often need an extended period of time to investigate coverage. Not only are insurers required to respond to communications from the insured (see §10.82), but maintaining communication with the claimant during this process will result in more cooperation from the claimant during settlement discussions down the road. Similarly, the insured is not only required by the policy to "cooperate" with the insurer (see §10.85), but cooperation and communication will also allow the insurer to process the claim more rapidly and more accurately.

Under 10 Cal Code Regs §2695.7(f), no insurer may continue negotiations directly with the claimant for settlement up to the time that the claimant's rights may be affected by a statute of limitations or by an insurance policy or contractual time limit, unless the insurer has given the claimant written notice that the time limit may be expiring and may affect the claimant's rights. Such notice must be given at least 60 days before the date on which the time limit will expire. Section 2695.7(f) does not apply, however, to claimants represented by counsel.

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X. RIGHTS AND DUTIES PENDING RESOLUTION OF CLAIM

§10.84 A. Insured's Duty of Good Faith and Fair Dealing

Like the insurer, the insured is contractually bound by a duty of good faith and fair dealing. *Commercial Union Assur. Cos. v Safeway Stores, Inc*. (1980) 26 C3d 912, 918, 164 CR 709; *Crisci v Security Ins. Co.* (1967) 66 C2d 425, 429, 58 CR 13. The scope of the insured's duty of good faith, like that of the insurer's, is "dependent upon the nature of the bargain struck between the insurer and the insured and the legitimate expectations of the parties which arise from the contract." *Commercial Union,* 26 C3d at 918. However, the insured's breach is a breach of contract and not a tort; thus, absent misrepresentation or fraud by the insured, the insured's breach may not be asserted as an affirmative defense to the insured's bad faith action. *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 402, 408, 97 CR2d 151.

Although the *Kransco* court stated that the insured's bad faith may not be asserted as a defense to the bad faith action, the court held that evidence of the insured's misconduct may factually disprove the insurer's liability for bad faith by showing the insurer acted reasonably under the circumstances. The supreme court noted that the insured's breach of the covenant of good faith and fair dealing is also separately actionable as a contract claim. Further, some forms of misconduct by an insured, such as material misrepresentation in the application for insurance, will void coverage altogether, and "without coverage there can be no liability for bad faith on the part of the insurer." 23 C4th at 408.

NOTE: While the *Kransco* court held that the insured's bad faith may not be asserted as a defense to the insured's bad faith claim against the insurer, the supreme court did *not* hold that the insured's bad faith cannot be asserted as a defense to the insured's breach of contract claim. Until that issue is definitively decided, insurers will likely continue to assert "comparative bad faith" as a defense to the breach of contract claim.

The insured's duty of good faith continues at least until the insurer denies coverage for the claim. During the claims process, the insured's duty of good faith is inextricably bound up with the insured's duty of cooperation (see §10.85).

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§10.85 B. Insured's Duty of Cooperation

Generally, under any liability insurance policy, an insured must cooperate with the insurer at the inception of a claim by providing timely notice of the claim, promptly tendering defense of any litigation, and complying with any reasonable demand for proof of loss. During the insurer's initial investigation, the insured must comply with reasonable requests such as submitting to a required examination under oath, providing documents related to the claim, and cooperating with the insurer's investigation. When the insurer accepts the defense of a third party action, the insured must cooperate with the insurer's efforts to defend the action.

Real estate broker liability policies typically contain a cooperation condition such as the following:

Your Assistance and Cooperation. You agree to cooperate with and help us: (1) in making settlements; (2) in enforcing any legal rights you or we may have against anyone who may be liable to you; (3) by attending depositions, hearings, and trials; and (4) by securing and giving evidence, and obtaining the attendance of witnesses. In addition, you must take such actions which, in your judgment, are deemed necessary and practicable to prevent or limit loss arising from your wrongful acts.

Other policy forms may include a requirement that the insured submit to an examination under oath by a representative of the insurer. See §10.86.

For further discussion of an insured's duty of cooperation under general liability insurance policies, see California Liability Insurance Practice: Claims & Litigation, chap 11 (Cal CEB 1991).

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§10.86 C. Insurer's Right to Examination Under Oath

Many liability policies contain a condition requiring the insured to submit to an examination under oath (EUO). This condition is found in some real estate broker liability policies. The term "examination under oath" is not defined in most policy forms. In *Globe Indem. Co. v Superior Court* (1992) 6 CA4th 725, 730, 8 CR2d 251, the court described the meaning of this term:

> "Examination" is defined as "(examination of the witness by counsel) [i]nvestigation, questioning, probing, probe, scrutiny, inquiry," in Statsky, West's Legal Thesaurus/Dictionary (West, 1986) at page 291. The word is commonly understood to mean interrogation with questions and answers.

The insurer's right to conduct an EUO and to require the insured to produce documents is so significant that, if required in the insurance contract, the insured's compliance is a prerequisite to the right to receive policy benefits. *Brizuela v Calfarm Ins. Co.* (2004) 116 CA4th 578, 587, 10 CR3d 661. In *Brizuela,* the court held that the insured's failure to attend the EUO as scheduled by the insurer and failure for 6 months to propose any alternative dates for the EUO legally constituted a refusal to submit to an EUO. The court also held that the insurer had no obligation to provide the insured with a copy of the insured's previously recorded statements before the EUO. 116 CA4th at 589. The insurer was not required to show prejudice before denying policy benefits to an insured who violated a policy provision requiring submission to an EUO. 116 CA4th at 590. Finally, the insurer's failure to take the insured's deposition in the bad faith litigation did not excuse the insured's breach of the policy regarding an EUO. 116 CA4th at 592.

Although the insurer's right to conduct an EUO and require production of records is contractual, the insured's duties to cooperate, submit to an EUO, and produce records are all subject to limits of reasonableness. "It is obvious… that only the possible is required." *Beasley v Pacific Indem. Co.* (1962) 200 CA2d 207, 210, 19 CR 299.

PRACTICE TIP: Although an EUO may not be required in every case, the complex, technical nature of real estate claims makes the insurer's right to one vitally important. The insurer is entitled to all information supporting the basis of the claim and the amount of the loss. If the insured voluntarily supplies this information early in the claims process, an EUO may not be necessary even though the insurer retains the right to one under the terms of the policy.

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§10.87 1. Insured's Rights Under Ins C §2071.1

In 2001, the California Legislature enacted Ins C §2071.1, which codifies certain rights of an insured asked to submit to an examination under oath (EUO) in regard to a claim under a fire or homeowners' policy. The insured's rights include the following:

- The insurer must notify the insured of its determination to conduct an EUO and provide the insured with a copy of §2071.1. Ins C §2071.1(a)(1).
- The insurer may ask only for information that is relevant and reasonably necessary to process or investigate the claim. Ins C §2071.1(a)(2).
- The EUO may be conducted only on reasonable notice, at a reasonably convenient place, and for a reasonable length of time. Ins C §2071.1(a)(3).
- The insured may be represented by counsel and may record the proceedings. Ins C §2071.1(a)(4).
- The insurer must notify the insured that, on request and free of charge, it will provide the insured with a copy of the transcript and a tape, if one exists. Ins C §2071.1(a)(5).
- The insured may assert any objection that can be made in a deposition under state or federal law. If, by asserting an objection, an insured fails to provide an answer to a material question, and that failure prevents the insurer from being able to determine the extent of loss and validity of the claim, the rights of the insured under the contract may be affected. Ins C §2071.1(a)(6).
- An insured who submits a fraudulent claim may be subject to criminal and civil penalties. Ins C §2071.1(a)(7).

PRACTICE TIP: Section 2071.1 does not, by its express terms, apply to an EUO conducted by an insurer under a broker liability policy. However, cautious insurers may wish to follow the guidelines of §2071.1 to help avoid any argument that their EUOs were conducted in bad faith.

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§10.88 2. Insurer's Duty of Good Faith and Fair Dealing

Even if the contract contains a condition requiring the insured to submit to an EUO, the right of an insurer to conduct an examination under oath (EUO) of an insured is governed by principles of good faith and fair dealing.

For example, in *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 108 CR 480, an insured was charged with arson and insurance fraud. While the criminal charges were pending, the insurer insisted that the insured submit to an EUO and produce certain documents. The insured's attorney informed the insurer that he had advised the insured to avoid making any statements while the criminal charges were pending and asked the insurer to waive the requirements of an EUO until the criminal charges were resolved. The insurer refused and ultimately denied liability under the policy because of the insured's failure to submit to the EUO and to produce documents. In addition, the insurer's representative testified during the criminal proceedings that the insured had excessive fire coverage for his business. The criminal charges were ultimately dismissed and the insured volunteered to submit to an EUO. The insurer again denied coverage based on the insured's prior refusal to appear for the EUO. The insured then sued for bad faith, alleging that the insurer demands were designed "to secure further evidence to support the false implication that [the insured] was guilty of arson." 9 C3d at 572. The supreme court held that the complaint "does allege in substance a breach on the part of defendant insurance companies of their duty of good faith and fair dealing." 9 C3d at 575. The court also concluded that the insurer's duty of good faith is unconditional and independent of the performance of the insured's contractual obligations. 9 C3d at 578.

Similarly, in *Tomaselli v Transamerica Ins. Co.* (1994) 25 CA4th 1269, 1281, 31 CR2d 433, the court concluded that the manner in which the insurer conducted an EUO supported an inference of bad faith. In that case, the insureds sued their homeowners' insurer for bad faith after the insurer denied coverage for losses arising from the cracking of the insureds' foundation. The insureds contended and the court agreed that the EUO was merely one means for the insurer to avoid paying the claim, because an EUO is frequently used to investigate fraudulent first party claims. 25 CA4th at 1281.

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§10.89 D. Insured's Duty to Cooperate With Defense

In addition to a duty to cooperate with the insurer's investigation of the claim, virtually all liability policies contain a condition which requires the insured to cooperate with the defense of the claim (assuming the insurer agrees to defend).

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§10.90 1. Cooperation Clause

A cooperation clause serves an important purpose. A policy condition that requires that the insured cooperate and assist in opposing a claim by an injured person is "material to the risk and of the utmost importance in a practical sense. Without such cooperation and assistance the insurer is severely handicapped and may in some instances be absolutely precluded from advancing any defense." *Valladao v Fireman's Fund Indem. Co.* (1939) 13 C2d 322, 328, 89 P2d 643; *Truck Ins. Exch. v Unigard Ins. Co.* (2000) 79 CA4th 966, 975, 94 CR2d 516. Cooperation clauses enable the insurer "to possess itself of all knowledge, and all information as to other sources and means of knowledge, in regard to facts, material to [its] rights, to enable [it] to decide upon [its] obligations, and to protect [itself] against false claims." When an insured violates a cooperation clause, the insurer's performance is excused if its ability to provide a defense has been substantially prejudiced. *Truck Ins Exch.,* 79 CA4th at 976.

See §10.85 for a sample cooperation condition in a real estate broker liability policy.

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§10.91 2. Insured's Breach of Duty

An insurer may assert the insured's breach of the duty of cooperation as a defense to coverage under the policy (*Campbell v Allstate Ins. Co.* (1963) 60 C2d 303, 305, 32 CR 827; *Hynding v Home Acc. Ins. Co.* (1932) 214 C 743, 746, 7 P2d 999; *Brizuela v Calfarm Ins. Co.* (2004) 116 CA4th 578, 590, 10 CR3d 661), providing the insurer exercised reasonable diligence to procure the cooperation of the insured (*Hall v Travelers Ins. Cos.* (1971) 15 CA3d 304, 308, 93 CR 159. See also *Billington v Interinsurance Exch.* (1969) 71 C2d 728, 744, 79 CR 326; *Jensen v Eureka Cas. Co*. (1935) 10 CA2d 706, 708, 52 P2d 540), and providing the insurer is substantially prejudiced by the failure of the insured to cooperate *(Campbell v Allstate Ins. Co., supra*; *Hynding*, 214 C at 752).

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§10.92 3. Substantial Prejudice to Insurer

Possible prejudice from lack of cooperation is not limited to failure to appear at the trial; prejudice may occur before the trial by reason of the failure of the insured to cooperate. Cooperation conditions may require the insured to attend hearings, attend depositions, attend trials, assist in securing evidence, assist in giving evidence, and assist in obtaining the attendance of witnesses. These duties require affirmative action by the insured when it is requested. The violation of any of these duties may result in prejudice to the insurer. Prejudice may result from action or inaction on the part of the insured before the actual trial of the action. *Brizuela v Calfarm Ins. Co.* (2004) 116 CA4th 578, 591, 10 CR3d 661); *Hall v Travelers Ins. Cos.* (1971) 15 CA3d 304, 308, 93 CR 159. See also *Billington v Interinsurance Exch.* (1969) 71 C2d 728, 79 CR 326; *State Farm Fire & Cas. Co. v Miller* (1970) 5 CA3d 837, 85 CR 288.

The burden of proving the insurer was substantially prejudiced by the failure of the insured to cooperate is on the insurer. *Billington*, 71 C2d at 737; *Campbell v Allstate Ins. Co.* (1963) 60 C2d 303, 306, 32 CR 827; *Brizuela,* 116 CA4th at 590. To prove substantial prejudice by the failure of the insured to cooperate in the defense of the action against him or her, the insurer "must establish at the very least that if the cooperation clause had not been breached there was a substantial likelihood the trier of fact would have found in the insured's favor." *Billington v Interinsurance Exch., supra*.

To determine whether there was a substantial likelihood the trier of fact would have found in favor of an insured not present at the trial of the action, the fact that the insured was absent must be considered in light of the evidence in support of the case in the insured's favor, including the testimony the insured might give, and the evidence in support of the case against the insured. A mere showing of absence is not sufficient. *State Farm,* 5 CA3d at 843.

The difficulty in proving substantial prejudice can be demonstrated by two cases involving similar facts: *State Farm Fire & Cas. Co. v Miller*, *supra,* and *Hall v Travelers Ins. Cos., supra*. Both cases involved a cooperation condition in an auto insurance policy. In each case, the insured was sued for personal injuries caused in an auto accident and the insured failed to communicate with defense counsel retained by the insurer. In both cases, the appellate court agreed with the trial court's finding that the insured had breached the duty of cooperation. However, in *State Farm*, the appellate court held that the insurer failed to prove the breach caused substantial prejudice because the insured's initial report of the accident indicated that he was at fault. In *Hall*, the appellate court held that the insurer proved substantial prejudice because there was evidence that the insured was not at fault and, considering the contributory fault doctrine in effect at that time, a substantial likelihood that the trier of fact would have found in the insured's favor.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/10 Broker Errors and Omissions Liability Insurance/§10.93 E. Insured's Duty to Refrain From Making Voluntary Payments

§10.93 E. Insured's Duty to Refrain From Making Voluntary Payments

Virtually all liability policies contain a condition that prohibits the insured from making "voluntary payments." Such a provision states that the insured "will not, except at his or her own expense, voluntarily make a payment, assume any obligation, or incur any expense, without the insurer's consent." *Belz v Clarendon Am. Ins. Co*. (2007) 158 CA4th 615, 625, 69 CR3d 864.

A typical real estate broker liability policy may state:

You may not admit any liability, assume any financial obligation, settle any claim, or make any payment without our prior written consent. If you do, it will be at your own expense.

California courts have consistently honored such provisions. *Northern Ins. Co. v Allied Mut. Ins. Co.* (9th Cir 1992) 955 F2d 1353, 1360. See, *e.g., Gribaldo, Jacobs, Jones & Assocs. v Agrippina Versicherunges, A.G.* (1970) 3 C3d 434, 450, 91 CR 6.

Typically, an alleged breach of a no-voluntary-payment clause occurs before the insured has tendered the defense to the insurer. *Belz,* 158 CA4th at 626. Case law establishes that the duty to defend does not arise until the insurer has been provided with tender of the defense. *Belz v Clarendon Am. Ins. Co., supra*; *Truck Ins. Exch. v Unigard Ins. Co.* (2000) 79 CA4th 966, 976, 94 CR2d 516. Based on this rule, insurers typically argue that fees "voluntarily" incurred by the insured before tendering the defense to the insurer are not covered.

In *Jamestown Builders, Inc. v General Star Indem. Co.* (1999) 77 CA4th 341, 91 CR2d 514, a developer spent more than $1.4 million to repair defects in a residential development, all without notifying its insurer of the homeowners' damage claims. The insurer declined to reimburse the developer for the repair expenses. In a subsequent bad faith action by the developer, the insurer invoked the provision prohibiting voluntary payments. The trial court dismissed the action on demurrer. The court of appeal affirmed, stating (77 CA4th at 346):

> California law enforces such no-voluntary-payments provisions in the absence of economic necessity, insurer breach, or other extraordinary circumstances.... They are designed to ensure that responsible insurers that promptly accept a defense tendered by their insureds thereby gain control over the defense and settlement of the claim.

The court explained that a no-voluntary-payment provision, unlike a notice provision or a cooperation clause, can be enforced without a showing of prejudice (77 CA4th at 350):

> [T]he existence or absence of prejudice to [the insurer] is simply irrelevant to [its] duty to indemnify costs incurred *before* notice. The policy plainly provides that notice is a *condition precedent* to the insured's right to be indemnified; a fortiori the right to be indemnified cannot relate back to payments made or obligations incurred before notice.

See also *Truck Ins. Exch. v Unigard Ins., supra*; *Insua v Scottsdale Ins. Co.* (2002) 104 CA4th 737, 746, 129 CR2d 138 (insurer must show prejudice when insured breaches notice provision or cooperation clause but not when insured makes voluntary payment); *Faust v The Travelers* (9th Cir 1995) 55 F3d 471, 472 (California courts consistently enforce no-voluntary-payment provision in absence of prejudice, but prejudice is necessary to enforce notice provision or cooperation clause).

Most cases applying a no-voluntary-payment provision have involved pre-tender payments made by the insured. *Truck Ins. Exch. v Unigard Ins. Co.* (2000) 79 CA4th 966, 976, 94 CR2d 516. In *Low v Golden Eagle Ins. Co.* (2003) 110 CA4th 1532, 1546, 2 CR3d 761, however, the court enforced a no-voluntary-payment provision with respect to *post-tender* payments, "reasoning that the prohibition on voluntary payments is based on an insurer's *lack of consent,* which can also occur *after* acceptance of tender and while the insurer is providing a defense." *Belz,* 158 CA4th at 628.

Even if a court concluded that "voluntary" pre-tender fees need not be borne by the insurer, the issue of whether such fees were voluntarily incurred may be a question of fact. For example, in *Fiorito v Superior Court* (1990) 226 CA3d 433, 277 CR 27, the court refused to rule that pre-tender defense fees cannot be recovered from the insurer as a matter of law. The claimants in the case contended that they were "compelled" to incur defense fees and costs to

respond to legal process and protect their interests while they searched for applicable insurance policies. The court concluded that these contentions raised a question of fact regarding whether the fees had been voluntarily incurred. See also *Shell Oil Co. v National Union Fire Ins. Co.* (1996) 44 CA4th 1633, 1649, 52 CR2d 580 (pre-tender defense costs not voluntary during period insured was unaware of either its insurer's identity or contents of policy). When the facts are undisputed, however, voluntariness may be decided as a question of law. *Tradewinds Escrow, Inc. v Truck Ins. Exch.* (2002) 97 CA4th 704, 710, 118 CR2d 561 (payments were voluntary as a matter of law when delay in tender of defense was because insured believed policy did not cover loss).

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XI. INSURER'S DUTY TO INVESTIGATE

§10.94 A. Source of Insurer's Duty to Investigate

When an insurer receives a notice of claim or a request by an insured to defend an action brought against the insured, the insurer has a duty to investigate the facts underlying the claim or action. This duty is imposed by statute, regulation, and the common law.

The statutory standards for the investigation of claims are primarily found in the Unfair Insurance Practices Act (Ins C §§790-790.15), which requires the insurer to act fairly, promptly, and reasonably in processing claims (Ins C §790.03(h)). These obligations are owed to both the first party insured and the third party claimant. *Travelers Ins. Co. v Lesher* (1986) 187 CA3d 169, 189, 231 CR 791, disapproved on other grounds in *Buss v Superior Court* (1997) 16 C4th 35, 50 n12, 52 n14, 65 CR2d 366. No private right of action exists, however, for either first or third party claimants under Ins C §790.03(h). *Moradi-Shalal v Fireman's Fund Ins. Cos.* (1988) 46 C3d 287, 250 CR 116 (third party claimants); *Zephyr Park, Ltd. v Superior Court* (1989) 213 CA3d 833, 837, 262 CR 106 (holding *Moradi-Shalal* also abolished statutory cause of action brought by first party claimants).

The Fair Claims Settlement Practices Regulations (10 Cal Code Regs §§2695.1-2695.14) were adopted under Ins C §790.03(h) to establish minimum standards for investigation and settlement of claims. See 10 Cal Code Regs §2695.1. The most pertinent provisions provide for establishment and maintenance of claim files (10 Cal Code Regs §2695.3), timely acknowledgment of communications (10 Cal Code Regs §2695.5(a)-(e)(1)), and prompt investigation of claims (10 Cal Code Regs §2695.5(e)(2)-(3)).

The insurer's duty to investigate is also imposed by the common law standards for good faith and reasonable handling of insurance claims that are incorporated into every policy by operation of law. *Frommoethelydo v Fire Ins. Exch.* (1986) 42 C3d 208, 214, 228 CR 160.

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§10.95 B. Scope of Insurer's Duty to Investigate

The insurer's investigation should at least ascertain whether the claim is potentially a first party covered loss (see *McCormick v Sentinel Life Ins. Co.* (1984) 153 CA3d 1030, 1046, 200 CR 732) or a third party covered loss, so as to determine whether a duty to defend exists (see *Safeco Ins. Co. v Parks* (2009) 170 CA4th 992, 1006, 88 CR3d 730; *Stalberg v Western Title Ins. Co.* (1991) 230 CA3d 1223, 1233, 282 CR 43; *California Shoppers, Inc. v Royal Globe Ins. Co.* (1985) 175 CA3d 1, 37, 221 CR 171).

The parameters of the initial coverage investigation are discussed in a number of appellate court decisions. For example, the supreme court has held that an insurer is obligated to investigate thoroughly the grounds for denying a claim before refusing to pay it. See *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 819, 169 CR 691; *Bosetti v United States Life Ins. Co.* (2009) 175 CA4th 1208, 1236, 96 CR3d 744; *Safeco Ins. Co. v Parks, supra*; *Safeco Title Ins. Co. v Moskopoulos* (1981) 116 CA3d 658, 665, 172 CR 248 (dicta). The implied covenant of good faith and fair dealing requires an insurer to search diligently for evidence supporting the claim and not to ignore available information supporting a basis for coverage. *Wilson v 21st Century Ins. Co.* (2007) 42 C4th 713, 721, 68 CR3d 746; *Mariscal v Old Republic Life Ins. Co.* (1996) 42 CA4th 1617, 1620, 50 CR2d 224. The covenant of good faith and fair dealing also "places the burden on the insurer to seek information relevant to the claim." *Hughes v Blue Cross* (1989) 215 CA3d 832, 846, 263 CR 850.

However, without referring to the level or nature of investigation and after concluding that the terms of a comprehensive general liability policy did not provide coverage for the claims, a court of appeal found that plaintiffs had suffered no harm, even if the insurer had been delinquent in investigating or processing the claims. See *McLaughlin v National Union Fire Ins. Co.* (1994) 23 CA4th 1132, 1160, 29 CR2d 559. In *Ticor Title Ins. Co. v Employers Ins.* (1995) 40 CA4th 1699, 1714, 48 CR2d 368, the court concluded that there is no duty on the part of a second-level excess general liability insurer to investigate a third party claim when the duty to defend is obviated by the lack of potential for coverage under the policy terms.

Further, it has been held that the duty to investigate is not a continuing duty. The insurer is entitled to determine whether there is potential for coverage, and thus whether it will provide a defense, based on facts known to it at the time of tender. It is the insured's responsibility to call to the insurer's attention new facts that indicate a potential for coverage. *Gunderson v Fire Ins. Exch.* (1995) 37 CA4th 1106, 1114, 44 CR2d 272. "In the absence of any new tender of defense from appellants, [the insurer has] no way to know of these new extrinsic facts, and no obligation to find them out by itself." 37 CA4th at 1117. Although an insurer's duties to investigate its insured's claims are "akin to" and may resemble fiduciary duties, an insurer is not required to act as a fiduciary in every instance. *Love v Fire Ins. Exch.* (1990) 221 CA3d 1136, 1148, 271 CR 246.

In *White v Western Title Ins. Co.* (1985) 40 C3d 870, 886, 221 CR 509, the supreme court held that an insurer's duty of good faith continues even after litigation between the insured and insurer is filed. The court noted that a contrary rule would encourage insurers to induce early filing of suits and to delay serious investigation until they would be unencumbered by a duty to deal in good faith. The court also discussed a policy of encouraging prompt investigation.

For further discussion of the authorities governing an insurer's duty to investigate claims, see California Liability Insurance Practice: Claims & Litigation, chap 9 (Cal CEB 1991).

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§10.96 C. Breach of Duty to Investigate

A breach of the insurer's common law duty to investigate claims is actionable in both contract and tort. *Stalberg v Western Title Ins. Co.* (1991) 230 CA3d 1223, 1233, 282 CR 43. There is no private right of action, however, for either first or third party claimants for violations of Ins C §790.03(h) and regulations promulgated under the statute. See §10.94.

Constructive notice of a third party claim may trigger the contractual duty to investigate (*California Shoppers, Inc. v Royal Globe Ins. Co.* (1985) 175 CA3d 1, 37, 221 CR 171), but the insurer's failure to do so is not actionable as a breach of the covenant of good faith and fair dealing unless the insurer has actual notice of the claim. 175 CA3d at 57. Constructive notice, however, will support a breach of contract action for failure to investigate a third party claim sufficiently to determine the existence of a duty to defend. 175 CA3d at 38.

An insurer's refusal to conduct a proper investigation of a claim may have other problematic and costly consequences. In *Eigner v Worthington* (1997) 57 CA4th 188, 66 CR2d 808, an insurer that refused to defend a claim without reasonably investigating it was not permitted to set aside a judgment on the claim against the insured on the grounds of surprise or excusable neglect.

Dicta in cases has indicated that, under certain circumstances, an insurer might be liable to its insured for bad faith conduct in its investigation of a claim even if the policy does not provide coverage for the disputed claim. *McMillin Scripps N. Partnership v Royal Ins. Co.* (1993) 19 CA4th 1215, 1222, 23 CR2d 243 (dicta, citing Arizona case in which insurer refused to disclose to insured results of investigation showing that loss was caused by another of insurer's policyholders, who had liability coverage); *Murray v State Farm Fire & Cas. Co.* (1990) 219 CA3d 58, 65 n5, 268 CR 33 (dicta, positing that insurer unreasonably delays investigation of claim before determining that there is no coverage and insured suffers consequential damages from delay). However, in *Benavides v State Farm Gen. Ins. Co.* (2006) 136 CA4th 1241, 1250, 39 CR3d 650, the appellate court rejected the "extreme circumstances" hypothesized in *Murray* as dicta, and held that there was no tort liability for negligent investigation of a first party insurance claim absent coverage under the policy.

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XII. INSURER'S OPTIONS IN RESPONDING TO NOTICE OF CLAIM OR TENDER OF DEFENSE

§10.97 A. Defending the Insured

The insurer's duty to defend runs to claims that are merely potentially covered, in light of facts alleged or otherwise disclosed. *Buss v Superior Court* (1997) 16 C4th 35, 46, 65 CR2d 366; *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 295, 24 CR2d 467; *Gray v Zurich Ins. Co.* (1966) 65 C2d 263, 276, 54 CR 104; *Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 413, 79 CR2d 52.

The insurer has no duty to defend, however, if the lawsuit against the insured does not involve the nature and kinds of risks covered by the policy (*Stellar v State Farm Gen. Ins. Co.* (2007) 157 CA4th 1498, 1504, 69 CR3d 350), or, stated differently, if neither the complaint nor the known extrinsic facts indicate any basis for potential coverage. *Essex Ins. Co. v City of Bakersfield* (2007) 154 CA4th 696, 704, 65 CR3d 1.

Real estate broker and salesperson liability policies typically state that the insurer has the right to control the defense, including the right to select defense counsel. A typical policy provision may state:

Defense and Settlement. (A) We have the right and the duty to defend any covered Claim, including but not limited to the appointment of legal counsel, subject to the limits of liability, the deductible and all applicable terms and conditions of the Policy, even if such Claim is groundless, false or fraudulent. (B) Notwithstanding Clause A above, the Insured may request in writing the right to appoint defense counsel to defend any covered Claim, but only with the prior written consent of Insurer, who will have the sole discretion to consent to such an appointment. The appointment by the Insured of defense counsel pursuant to this provision will not waive or alter Insurer's rights with respect to review and determination as to the reasonableness of any Claim Expenses presented for payment.

PRACTICE TIP: As mentioned in §10.72, few (if any) current policies allow the insured to choose counsel. However, as this provision indicates, the insurer may consent to appoint counsel of the insured's choice. It may be helpful to provide a letter from the insured explaining the reasons for the insured's preference, such as: long-standing relationship with the attorney; the attorney's reputation in the community for doing quality work; or rapport between the attorney and the insured's management personnel. The attorney should also not hesitate to inform the insurer about his or her pertinent qualifications, such as: long relationship with the insured; knowledge of the insured's procedures, recordkeeping practices, and personnel; experience handling E&O claims; experience working with other insurers; or familiarity and willingness to comply with billing and reporting guidelines. In some cases, the insurer's decision may turn on the attorney's willingness to accept panel defense counsel rates. If the attorney is willing to accept the insurer's rates, or if the insured is willing to pay the difference between the attorney's hourly rates and rates typically paid by the insurer, this willingness should also be included in the insured's letter to the insurer.

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§10.98 1. Defending With a Reservation of Rights

If the insurer decides to defend the insured, the defense may be provided under a reservation of rights. *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 656, 31 CR3d 147; *Gray v Zurich Ins. Co.* (1966) 65 C2d 263, 279, 54 CR 104. The insurer must notify the insured that it is conducting the investigation or defense of the claim under a reservation of the right to assert policy defenses at a later time. The insured's acceptance of a defense under those conditions is considered to be acquiescence to the reservation of rights. *Blue Ridge Ins. Co. v Jacobsen* (2001) 25 C4th 489, 498, 106 CR2d 535, 22 P3d 313; *Val's Painting & Drywall, Inc. v Allstate Ins. Co.* (1975) 53 CA3d 576, 586, 126 CR 267.

PRACTICE TIP: Typically, in addition to mentioning specific policy defenses, the reservation of rights will also reserve the insurer's rights to later withdraw its defense of the third party action, to seek a declaratory adjudication of its defense or indemnity obligations, or both, and to seek reimbursement of defense fees and costs.

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§10.99 a. Mixed Causes of Action

When an insurer defends a lawsuit against the insured containing "mixed" causes of action, generally the insurer must defend the entire action and seek reimbursement for noncovered claims later. The right to reimbursement of defense fees for those claims potentially covered by the policy cannot be created unilaterally by simply making a reservation of rights. Such a right is not implied in law, but can be created only by express policy language or an agreement with the insured supported by new consideration. *Buss v Superior Court* (1997) 16 C4th 35, 49, 65 CR2d 366; *State Farm Gen. Ins. Co. v Mintarsih* (2009) 175 CA4th 274, 283, 95 CR3d 845. An insurer does have an implied-in-law right to reimbursement of defense fees that can be allocated solely to claims that are "not even potentially covered," because the insurer has no contractual duty to defend noncovered claims, even when they are combined in an action with potentially covered claims. 16 C4th at 50. See also *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 658, 31 CR3d 147. To obtain reimbursement of any defense fees for noncovered claims, the insurer has the burden of proving by a preponderance of the evidence that the fees were fairly and reasonably allocable solely to the noncovered claims. *Buss,* 16 C4th at 53. See 19 CEB Civ Litigation Rep 206 (Aug. 1997).

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§10.100 b. Failure to Reserve Right to Reimbursement of Defense Fees and Costs

Unlike the cases in which the failure to mention policy provisions will not limit or defeat coverage, there is ample authority indicating that if the insurer neglects to reserve the right to seek reimbursement of the defense fees and costs, the right of reimbursement is waived. See *Golden Eagle Ins. Co. v Foremost Ins. Co.* (1993) 20 CA4th 1372, 1391, 25 CR2d 242; *American Motorists Ins. Co. v Allied-Sysco Food Servs., Inc.* (1993) 19 CA4th 1342, 1355, 24 CR2d 106, disapproved on other grounds in *Buss v Superior Court* (1997) 16 C4th 35, 50 n12, 65 CR2d 366; *Val's Painting & Drywall, Inc. v Allstate Ins. Co.* (1975) 53 CA3d 576, 587, 126 CR 267.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/10 Broker Errors and Omissions Liability Insurance/§10.101 2. Conflict of Interest and Independent, or Cumis, Counsel

§10.101 2. Conflict of Interest and Independent, or *Cumis,* Counsel

An insurer should carefully consider whether a reservation of rights is necessary, particularly if that reservation may create a conflict of interest that entitles the insured to independent, or *Cumis*, counsel. See *Israelsky v Title Ins. Co.* (1989) 212 CA3d 611, 619 n6, 261 CR 72; *San Diego Navy Fed. Credit Union v Cumis Ins. Soc'y, Inc.* (1984) 162 CA3d 358, 375, 208 CR 494. The insurer's obligation to provide independent counsel has now been codified in CC §2860. See *Derivi Constr. & Architecture, Inc. v Wong* (2004) 118 CA4th 1268, 1276 n1, 14 CR3d 329 (noting that *San Diego Fed. Credit Union* was superseded by CC §2860). The provisions of CC §2860 include the following:

- The insurer must provide independent counsel when the policy includes a duty to defend and a conflict of interest arises that by statute creates the right to independent counsel (CC §2860(a)).
- The insured may waive its right to independent counsel if the appropriate language is used (CC §2860(e)).
- The policy may specify a process for selecting independent counsel consistent with the statute (CC §2860(a)).
- Statutory grounds for an insured's right to independent counsel (CC §2860(b)):
- May arise when an insurer reserves its rights on an issue, the outcome of which is in the control of defense counsel first retained by the insurer.
- Do *not* arise with respect to allegations or facts for which the insurer has denied coverage, with respect to allegations of punitive damages, or solely because an insured is sued for an amount exceeding the policy limits.
- The insurer has the right to require that counsel selected by the insured is qualified and has malpractice insurance (CC §2860(c)).
- The insurer is obligated to pay the fees of the independent counsel, subject to certain limitations, and unresolved fee disputes must be resolved by binding arbitration (CC §2860(c)).
- Both the insured and independent counsel are required to disclose to the insurer all information about the action except privileged information relevant to coverage disputes (CC §2860(d)).
- The insured and both insurer-retained defense counsel and independent counsel have a duty to cooperate (CC §2860(f)).

As indicated in CC §2860(b), not every reservation of rights by the insurer creates a conflict of interest requiring appointment of independent counsel for the insured. If coverage is determined by an issue that is independent of the issues involved in the underlying case, no conflict of interest exists that would require the appointment of independent counsel. *Blanchard v State Farm Fire & Cas. Co.* (1991) 2 CA4th 345, 350, 2 CR2d 884.

In *James 3 Corp. v Truck Ins. Exch.* (2001) 91 CA4th 1093, 1101, 111 CR2d 181, the court laid out some of the situations that may create a conflict of interest requiring appointment of independent counsel. Independent counsel may be required if:

- The insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by the insurer's retained counsel;
- The insurer insures both the plaintiff and the defendant;
- The insurer has filed suit against the insured, whether or not the suit is related to the lawsuit the insurer is obligated to defend;
- The insurer pursues settlement in excess of policy limits without the insured's consent, leaving the insured exposed to claims by third parties; and
- Any other situation in which an attorney who represents the interests of both the insurer and the insured finds that the representation of one is rendered less effective because of the representation of the other.

In addition, the *James 3* court held that the following does *not* give rise to a conflict of interest (91 CA4th at 1102):

- The insurer's refusal to prosecute affirmative defenses when the insurer has agreed to defend the insured as to the plaintiff's claims without a reservation of rights;

- The insurer's refusal to prosecute cross-claims for affirmative relief;
- The insurer's reservation of rights to seek reimbursement of defense costs allocable to noncovered claims (a *Buss* reservation; see *Buss v Superior Court* (1997) 16 C4th 35, 51, 65 CR2d 366).

See California Liability Insurance Practice: Claims & Litigation, chap 13 (Cal CEB 1991) for further discussion of the defense of an action with the participation of independent counsel when there is a conflict of interest between an insurer and an insured.

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§10.102 B. Denying Coverage and Refusing to Defend

The regulations governing the denial of a first party claim require the insurer to refer to specific policy provisions, conditions, or exclusions or the factual basis of these items. 10 Cal Code Regs §2695.7(b)(1). There is no comparable regulation governing the content of a denial of tender of defense in a third party claim. Further, when the insurer denies coverage on one ground, the insurer does not automatically waive other policy defenses not specifically stated in the denial, absent clear and convincing evidence of the insurer's intent to waive such defenses. *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 31, 44 CR2d 370.

PRACTICE TIP: The insured's attorney should politely insist that the insurer specify which policy provisions, conditions, or exclusions apply to the facts of the claim. Clear communication between counsel for the insured and the insurer may convince the insured that the insurer is correct or may reveal omissions or mistaken assumptions by the insurer that would provide the insured with an appropriate basis to request that the insurer reconsider its denial. It may also be appropriate for the insured to engage the assistance of experts to strengthen its request for reconsideration or determine whether the insured has a chance to succeed in an action for declaratory relief on the coverage issues.

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§10.103 C. Filing Declaratory Relief Action

If the insurer believes that the claim is not covered by the policy, it may file a declaratory relief action to determine coverage. If the insurer files a declaratory relief action before the insured files an action for breach of contract or bad faith, the insured's subsequent action for breach of contract or bad faith should be abated until the declaratory relief action is resolved. *Food Pro Int'l, Inc. v Farmers Ins. Exch.* (2008) 169 CA4th 976, 989, 89 CR3d 1; *Lawyers Title Ins. Corp. v Superior Court* (1984) 151 CA3d 455, 199 CR 1.

Although the filing of a declaratory relief action will not eliminate the insurer's potential liability for bad faith, it may help to mitigate any bad faith exposure. In fact, the insurer may agree to a declaratory relief action to determine coverage, particularly if an agreement can be reached that the declaratory relief action may be determined on stipulated facts or a limited record, thus providing an efficient and economical presentation of the declaratory relief action.

If the claim involves litigation against the insured, the insurer may agree to defend the insured under a reservation of rights (including the right to withdraw the defense or to seek reimbursement of defense costs) and file a declaratory relief action to determine coverage and the extent of the duty to defend. See *Safeco Title Ins. Co. v Moskopoulos* (1981) 116 CA3d 658, 663, 172 CR 248. To prevail in the action, the insurer must establish the absence of any potential coverage, while the insured need only show that the claim may fall within the policy coverage. *Truck Ins. Exch. v Bennett* (1997) 53 CA4th 75, 81, 61 CR2d 497.

The insured may, however, obtain a stay of the declaratory relief action when the coverage question turns on facts to be litigated in the underlying action. In *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 301, 24 CR2d 467, the supreme court summarized the general principles to be applied when a declaratory relief action is brought to determine coverage issues while the underlying claim on which the coverage dispute centers is still pending:

> To eliminate the risk of inconsistent factual determinations that could prejudice the insured, a stay of the declaratory relief action pending resolution of the third party suit is appropriate when the coverage question turns on facts to be litigated in the underlying action. [Citations.] For example, when the third party seeks damages on account of the insured's negligence, and the insurer seeks to avoid providing a defense by arguing that its insured harmed the third party by intentional conduct, the potential that the insurer's proof will prejudice its insured in the underlying litigation is obvious. This is the classic situation in which the declaratory relief action should be stayed. By contrast, when the coverage question is logically unrelated to the issues of consequence in the underlying case, the declaratory relief action may properly proceed to judgment.

See also *Kleis v Superior Court* (1995) 37 CA4th 1035, 1051, 44 CR2d 181 (stay of declaratory relief action); *Haskel, Inc. v Superior Court* (1995) 33 CA4th 963, 978, 39 CR2d 520 (stay of discovery in declaratory relief action). For further discussion of the use of actions for declaratory relief to resolve coverage questions, see California Liability Insurance Practice: Claims & Litigation, chap 20 (Cal CEB 1991).

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XIII. INSURER'S DUTY TO DEFEND

§10.104 A. Duty to Defend Is Broader Than Duty to Indemnify

The insurer's duty to indemnify runs to claims that are actually covered, in light of the facts proved. *Montrose Chem. Corp. v Admiral Ins. Co. (Montrose II)* (1995) 10 C4th 645, 659 n9, 42 CR2d 324; *Buss v Superior Court* (1997) 16 C4th 35, 46, 65 CR2d 366. By definition, it entails the payment of money to resolve liability. *Buss*, 16 C4th at 46. It arises only after liability is established. *Montrose II*, 10 C4th at 659 n2.

By contrast, the insurer's duty to defend runs to claims that are merely potentially covered, in light of facts alleged or otherwise disclosed. *Buss v Superior Court, supra*; *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 295, 24 CR2d 467; *Gray v Zurich Ins. Co.* (1966) 65 C2d 263, 276, 54 CR 104; *Fire Ins. Exch. v Superior Court* (2010) 181 CA4th 388, 391, 104 CR3d 534; *State Farm Gen. Ins. Co. v Mintarsih* (2009) 175 CA4th 274, 283, 95 CR3d 845; *Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 413, 79 CR2d 52. See §10.104. The insurer's duty to defend entails the rendering of a service, *i.e.,* the mounting and funding of a defense to avoid or at least minimize liability. *Buss v Superior Court*, *supra*. See also *Gray,* 65 C2d at 279. The duty arises as soon as tender is made. It is discharged when the action is concluded. It may be extinguished earlier, if it is shown that no claim can in fact be covered. *Buss*, 16 C4th at 46; *Montrose I*, 6 C4th at 295. If the duty is extinguished, however, it is extinguished only prospectively and not retroactively: before, the insurer had a duty to defend; after, it does not have a duty to defend further. *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 655, 31 CR3d 147; *Buss v Superior Court*, *supra*.

Therefore, it is frequently said that the insurer's duty to defend is broader than its duty to indemnify. *Delgado v Interinsurance Exch.* (2009) 47 C4th 302, 308 n1, 97 CR3d 298; *Scottsdale*, 36 C4th at 654; *Buss v Superior Court*, *supra; Montrose I, supra*. But the insurer's duty to defend is not unlimited. *Buss v Superior Court*, *supra; Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 19, 44 CR2d 370. The insurer's duty to defend extends beyond claims that are actually covered to those that are merely potentially so, but no further. *Buss v Superior Court*, *supra*.

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§10.105 1. Duty to Defend When Potential for Indemnity Exists

A carrier owes a broad duty to defend its insured against a lawsuit that seeks damages potentially within the policy coverage. *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 654, 31 CR3d 147; *Blue Ridge Ins. Co. v Jacobsen* (2001) 25 C4th 489, 497, 106 CR2d 535, 22 P3d 313; *American Int'l Specialty Lines Ins. Co. v Continental Cas. Ins. Co*. (2006) 142 CA4th 1342, 1369, 49 CR3d 1; *Standard Fire Ins. Co. v Spectrum Community Ass'n* (2006) 141 CA4th 1117, 46 CR3d 804. A "potential for coverage" refers to the possibility that facts alleged in the complaint or otherwise known to the insurer establish a basis for indemnity under the policy. *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 654, 31 CR3d 147; *State Farm Gen. Ins. Co. v Mintarsih* (2009) 175 CA4th 274, 284 n6, 95 CR3d 845. "Implicit in this rule is the principle that the duty to defend is broader than the duty to indemnify; an insurer may owe a duty to defend its insured in an action in which no damages ultimately are awarded." *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 295, 24 CR2d 467.

In *Foster-Gardner, Inc. v National Union Fire Ins. Co.* (1998) 18 C4th 857, 878, 77 CR2d 107, the court held that a liability policy that stated the insurer would defend the insured "in any suit against the insured seeking damages" for harm alleged within the policy was limited to defense of a civil action prosecuted in a court, and did not extend to "claims" or proceedings brought by a governmental agency. The court reasoned that such a proceeding might be a "claim," but it was not a "suit."

The insured "must prove the existence of a *potential for coverage*, while the insurer must establish *the absence of any such potential*. In other words, the insured need only show that the underlying claim *may* fall within policy coverage; the insurer must prove it *cannot*." *Delgado v Interinsurance Exch.* (2009) 47 C4th 302, 308, 97 CR3d 298 (emphasis in original) citing *Montrose I*, 6 C4th at 300; *Fire Ins. Exch. v Superior Court* (2010) 181 CA4th 388, 391, 104 CR3d 534; *Food Pro Int'l, Inc. v Farmers Ins. Exch.* (2008) 169 CA4th 976, 992, 89 CR3d 1. Any doubt about the existence of the defense duty must be resolved in the insured's favor. *Montrose I,* 6 C4th at 299.

Montrose I reiterated the principle that the duty to defend (1) rests not on the ultimate adjudication of coverage under the policy but on those facts known by the insurer at the commencement of a third party lawsuit and (2) may exist even if coverage is doubtful and ultimately does not develop. 6 C4th at 295. See also *Century Sur. Co. v Polisso* (2006) 139 CA4th 922, 951, 43 CR3d 468. Furthermore, the defense duty is continuing, "arising on tender of defense and lasting until the underlying lawsuit is concluded" or until it is demonstrated that there is no potential for coverage. *Montrose I,* 6 C4th at 295. See also *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 655, 31 CR3d 147.

The defendant in *Montrose I* contended that the correct test for determining whether the insurer owes a duty to defend its insured in the underlying action is whether there is a reasonable potential for coverage. The supreme court rejected this argument, noting that it "betrays a fundamental misunderstanding of *Gray* [*v Zurich Ins. Co.* (1966) 65 C2d 263, 54 CR 104]… and of what is at issue in an adjudication of the defense duty." 6 C4th at 299. The court explained (6 C4th at 300):

> Thus, Travelers' advocacy of a "reasonable potential for coverage" standard finds no support in *Gray*. Indeed, in that case we said that "the insurer need not defend if the third party complaint *can by no conceivable theory raise a single issue which could bring it within the policy coverage*." [Citation.] The quoted language cannot reasonably be understood to refer to anything beyond a bare "potential" or "possibility" of coverage as the trigger of a defense duty. Contrary to Travelers's interpretation, California courts have used the terms "possibility" and "potential" interchangeably, and we see no difference between them.

An unreasonable refusal to defend is actionable as a breach of contract or breach of the covenant of good faith and fair dealing. *Campbell v Superior Court* (1996) 44 CA4th 1308, 1319, 52 CR2d 385; *Stalberg v Western Title Ins. Co.* (1991) 230 CA3d 1223, 1233, 282 CR 43. See also *Eigner v Worthington* (1997) 57 CA4th 188, 66 CR2d 808 (insurer that refused to defend claim without investigation was not permitted to set aside judgment against insured on grounds of surprise or excusable neglect).

PRACTICE TIP: An insurer may choose to defend an insured under a reservation of rights, so that if it is later

determined that the policy did not afford coverage of the underlying claim, the insurer may recover its defense costs from the insured. *Scottsdale Ins. Co.,* 36 C4th at 656. See §10.97.

For further discussion on determining whether insurer must defend, see California Liability Insurance Practice: Claims & Litigation, chap 4 (Cal CEB 1991).

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§10.106 2. Comparing Complaint Allegations to Policy Terms

In *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 24 CR2d 467, the court affirmed the long-established rule that the existence of an insurer's duty to defend is usually determined "by comparing the allegations of the complaint with the terms of the policy." 6 C4th at 295. See also *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 654, 31 CR3d 147; *Kazi v State Farm Fire & Cas. Co*. (2001) 24 C4th 871, 879, 103 CR2d 1.

Although facts pleaded in a complaint against an insured may indicate the potential for coverage when compared to the insuring language of the policy, such facts do not necessarily negate coverage when an exception to coverage is suggested by facts that are in dispute. In other words, the courts decline to "designate the third party as the arbiter of the policy's coverage." *Gray v Zurich Ins. Co*. (1966) 65 C2d 263, 276, 54 CR 104. Compare with *Scottsdale Ins. Co. v MV Transp., supra*, in which the insurer complied with its defense duty under a reservation of rights, but later properly sought reimbursement of its costs from the insured.

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§10.107 3. Extrinsic Evidence May Give Rise to Duty to Defend

Determination of the duty to defend depends, in the first instance, on a comparison between the allegations of the complaint and the terms of the policy. See §10.106. But the duty also exists when extrinsic facts known to the insurer suggest that the claim may be covered. *Delgado v Interinsurance Exch.* (2009) 47 C4th 302, 308, 97 CR3d 298; *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 654, 31 CR3d 147; *Foster-Gardner, Inc. v National Union Fire Ins. Co*. (1998) 18 C4th 857, 880, 77 CR2d 107; *Montrose Chem. Corp. v Superior Court (Montrose I)* (1993) 6 C4th 287, 295, 24 CR2d 467; *Gray v Zurich Ins. Co*. (1966) 65 C2d 263, 276, 54 CR 104; *Smith Kandal Real Estate v Continental Cas. Co.* (1998) 67 CA4th 406, 414, 79 CR2d 52. Such extrinsic facts may come from the insured, legal proceedings, and other available sources. *Montrose I,* 6 C4th at 296; *Gray,* 65 C2d at 276.

If, however, the potential for coverage is clearly eliminated by reliable and uncontradicted extrinsic facts, an insurer may properly decline to accept the defense of a third party action whether or not the allegations of the complaint indicate potential liability. *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 19, 44 CR2d 370. See also *Stearns v Title Ins. & Trust Co.* (1971) 18 CA3d 162, 167, 95 CR 682.

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§10.108 4. Considering Effect of Potential Amendment to Complaint

The fact "that the precise causes of action pled by the third party complaint may fall outside policy coverage does not excuse the duty to defend." An insured is entitled to a defense if the third party complaint alleges the insured's liability for damages potentially covered under the policy, or the complaint might be amended to assert liability that would be covered. *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 654, 31 CR3d 147; *Montrose Chem. Corp. v Superior Court* (*Montrose I*) (1993) 6 C4th 287, 299, 24 CR2d 467; *Griffin Dewatering Corp. v Northern Ins. Co.* (2009) 176 CA4th 172, 198, 97 CR3d 568. In other words, when the facts alleged in the complaint (read alone or with extrinsic facts learned by the insurer from an investigation) reveal that the complaint could be amended to add another theory that would fall within the policy's coverage provisions, the "potential of liability" test has been satisfied and the duty to defend is established. *Scottsdale Ins., Co. v MV Transp., supra*; *Gray v Zurich Ins. Co*. (1966) 65 C2d 263, 276, 54 CR 104.

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§10.109 B. Duty Limited to Nature and Kinds of Risks Covered by Policy

The duty to defend is not unlimited but is measured "by the nature and kinds of risks covered by the policy." *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 19, 44 CR2d 370; *Gray v Zurich Ins. Co.* (1966) 65 C2d 263, 275, 54 CR 104. See also *Buss v Superior Court* (1997) 16 C4th 35, 46, 65 CR2d 366. If the policy provides no potential for coverage, "the insurer acts properly in denying a defense even if that duty is later evaluated under case law that did not exist at the time of the defense tender." *Waller,* 11 C4th at 26.

In the following liability insurance cases, the courts affirmed an insurer's rejection of defense of claims outside policy-covered risks:

- *Kazi v State Farm Fire & Cas. Co.* (2001) 24 C4th 871, 879, 103 CR2d 1 (alleged interference with easement did not allege damage to tangible property within policy's coverage for "property damage");
- *Ticor Title Ins. Co. v Employers Ins.* (1995) 40 CA4th 1699, 1707, 48 CR2d 368 (even if third party claim is potentially covered and primary carrier refuses to defend, insured must first exhaust policy limits with primary carrier before excess liability insurer is required to participate in defense);
- *Coit Drapery Cleaners, Inc. v Sequoia Ins. Co.* (1993) 14 CA4th 1595, 1608, 18 CR2d 692 (sexual harassment not covered under general liability policy because of "willful act" exclusion);
- *Devin v United Servs. Auto. Ass'n* (1992) 6 CA4th 1149, 1159, 8 CR2d 263 (injury occurring after homeowner's policy expired not covered); and
- *Giddings v Industrial Indem. Co.* (1980) 112 CA3d 213, 219, 169 CR 278 (economic losses such as lost profits, loss of good will, and loss of investment not covered as injury to tangible property under general liability policy).

For a more comprehensive discussion of an insurer's duty to defend arising from general liability policies, see California Liability Insurance Practice: Claims & Litigation, chap 4 (Cal CEB 1991).

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§10.110 C. Duty to Defend Extends to Entire Action

While certain decisions state or imply that the duty to defend is "independent" of the duty to indemnify (see, *e.g., Gray v Zurich Ins. Co.* (1966) 65 C2d 263, 274, 54 CR 104), such language "means nothing more than that the former is broader than the latter." *Buss v Superior Court* (1997) 16 C4th 35, 47 n10, 65 CR2d 366. The duty to indemnify and the duty to defend are in fact both dependent on coverage. The duty to indemnify is dependent on actual coverage, the duty to defend depends on at least potential coverage. 16 C4th at 47 n10.

Thus, in an action in which all the claims are at least potentially covered, the insurer has a duty to defend. "This obligation is express in the policy's language. It rests on the fact that the insurer has been paid premiums by the insured for a defense. The rule is grounded in basic principles of contract law." 16 C4th at 47.

Conversely, in an action in which none of the claims is even potentially covered, the insurer has no duty to defend. *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 655, 31 CR3d 147; *Buss v Superior Court, supra; Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 29, 44 CR2d 370; *Gray,* 65 C2d at 275 n15. "This freedom is implied in the policy's language. It rests on the fact that the insurer has not been paid premiums by the insured for a defense. This 'rule' too 'is grounded in basic principles of contract law.'" *Buss*, 16 C4th at 47.

In a "mixed" action, which includes some claims that are at least potentially covered and others that are not, the insurer has a duty to defend the entire action. *Buss*, 16 C4th at 48; *Horace Mann Ins. Co. v Barbara B*. (1993) 4 C4th 1076, 1081, 17 CR2d 210; *Fire Ins. Exch. v Superior Court* (2010) 181 CA4th 388, 392, 104 CR3d 534.The duty as to the claims that are at least potentially covered is contractual, the insurer having been paid premiums by the insured therefor. The duty to defend as to those claims that are not even potentially covered is imposed by law in support of the policy, for "prophylactic" reasons. *Buss*, 16 C4th at 48. The supreme court justified this duty as follows (16 C4th at 49):

> To defend meaningfully, the insurer must defend immediately. [Citation]. To defend immediately, it must defend entirely. It cannot parse the claims, dividing those that are at least potentially covered from those that are not. To do so would be time consuming. It might also be futile: The "plasticity of modern pleading" [citation] allows the transformation of the claims that are at least potentially covered into claims that are not, and vice versa. The fact remains: As to the claims that are at least potentially covered, the insurer gives, and the insured gets, just what they bargained for, namely, the mounting and funding of a defense. But as to the claims that are not, the insurer may give, and the insured may get, more than they agreed, depending on whether defense of these claims necessitates any additional costs.

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§10.111 D. Duty to Defend Arises Immediately

Once triggered, an insurer's duty to defend is "immediate" because the insured has the right to the full protection of a defense on its behalf. *Montrose Chem. Corp. v Superior Court* (Montrose I) (1993) 6 C4th 287, 295, 24 CR2d 467. See *Lambert v Commonwealth Land Title Ins. Co.* (1991) 53 C3d 1072, 1077, 282 CR 445 (duty to defend commences on tender of defense); *CNA Cas. v Seaboard Sur. Co.* (1986) 176 CA3d 598, 605, 222 CR 276 (if insurer is obliged to defend, it must do so as soon as possible). An insurer's duty to defend may arise even when the insurer has constructive notice of the claim from a party other than the insured. See *California Shoppers, Inc. v Royal Globe Ins. Co.* (1985) 175 CA3d 1, 37, 221 CR 171.

The duty to defend is measured not at the conclusion of the litigation after all factual disputes have been resolved, but rather by the facts known by the insurer at the inception of the lawsuit. *Montrose I, supra; CNA Cas. v Seaboard Sur. Co.* (1986) 176 CA3d 598, 610, 222 CR 276. Thus, the time for an insurer to investigate and evaluate whether to defend is when the insurer first receives notice of the claim; an insurer may not rely on hindsight to justify its refusal to defend. *B&E Convalescent Ctr. v State Compensation Ins. Fund* (1992) 8 CA4th 78, 92, 9 CR2d 894; *CNA Cas.*, 176 CA3d at 605.

In *Mullen v Glens Falls Ins. Co.* (1977) 73 CA3d 163, 173, 140 CR 605, a comprehensive personal liability insurer conducted no investigation before refusing to defend its insured. The trial court found no duty to defend. The issue before the appellate court was whether an insurance company, without investigating the claim, has the right to deny a defense to its insured when the insurer has reason to believe that there is potential liability under the insurance policy but relies on the outcome of the third party action against the insured and subsequent events to justify its denial of defense. The appellate court held (73 CA3d at 173):

> [P]ublic policy alone mandates a negative answer to the question; otherwise an insurance carrier could refuse to defend its insured on the slightest provocation and then resort to hindsight for the justification. Furthermore, a contrary holding would force the insured to finance his own investigation and the defense of the lawsuit, and then to seek reimbursement in a second lawsuit against the insurance company. This, in turn, could not only impose an undue financial burden on persons who have purchased insurance protection, but it could deprive them of the expertise and resources available to insurance carriers in making prompt and competent investigations as to the merits of lawsuits filed against their insureds.

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§10.112 E. Reimbursement of Defense Costs

As to the claims that are at least potentially covered, the insurer may not seek reimbursement for defense costs. *Buss v Superior Court* (1997) 16 C4th 35, 49, 65 CR2d 366. As to the claims that are not even potentially covered, however, the insurer may indeed seek reimbursement for defense costs. 16 C4th at 50; *Scottsdale Ins. Co. v MV Transp.* (2005) 36 C4th 643, 650, 31 CR3d 147.

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§10.113 XIV. INSURER'S DUTY TO SETTLE

There is an implied covenant of good faith and fair dealing in every liability insurance policy that obligates the insurer to accept a reasonable demand to settle a lawsuit against the insured within policy limits. *Hamilton v Maryland Cas. Co.* (2002) 27 C4th 718, 724, 117 CR2d 318; *PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 312, 84 CR2d 455; *Comunale v Traders & Gen. Ins. Co.* (1958) 50 C2d 654, 658, 328 P2d 198; *Safeco Ins. Co. v Parks* (2009) 170 CA4th 992, 1006, 88 CR3d 730. In *Comunale,* the supreme court first considered whether an insurer who declined to defend its insured and refused to accept a reasonable settlement offer was liable for a judgment against the policy holder in an amount exceeding the policy limits. The supreme court held (50 C2d at 661):

> [A]n insurer, who wrongfully declines to defend and who refuses to accept a reasonable settlement within the policy limits in violation of its duty to consider in good faith the interest of the insured in the settlement, is liable for the entire judgment against the insured even if it exceeds the policy limits.

See also *Hamilton,* 27 C4th at 725.

The *Comunale* holding was subsequently extended to a case in which the insurer *did* provide a defense, but refused to accept a reasonable settlement offer within policy limits. The implied covenant settlement obligation exists in order to avoid exposing the insured to personal liability in excess of the insurance policy limits. See *Johansen v California State Auto. Ass'n Inter-Ins. Bureau* (1975) 15 C3d 9, 14, 123 CR 288. If an insurer unreasonably refuses to settle a third party action against the insured, the policyholder may sue the insurance company in tort. *PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 312, 84 CR2d 455; *Wolkowitz v Redland Ins. Co.* (2003) 112 CA4th 154, 162, 5 CR3d 95.

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§10.114 A. Factors Governing Duty to Settle

The insurer is obligated to accept a settlement demand that is reasonable. *Hamilton v Maryland Cas. Co.* (2002) 27 C4th 718, 724, 117 CR2d 318; *Isaacson v California Ins. Guarantee Ass'n* (1988) 44 C3d 775, 793, 244 CR 655. In deciding whether to settle, the insurer must give at least as much consideration to the insured's interest as it does to its own. "In determining whether an insurer has given consideration to the interests of the insured, the test is whether a prudent insurer without policy limits would have accepted the settlement offer." *Crisci v Security Ins. Co.* (1967) 66 C2d 425, 429, 58 CR 13. See also *Kinder v Western Pioneer Ins. Co.* (1965) 231 CA2d 894, 900, 42 CR 394; *Martin v Harford Acc. & Indem. Co.* (1964) 228 CA2d 178, 183, 39 CR 342; *Hodges v Standard Acc. Ins. Co.* (1961) 198 CA2d 564, 579, 18 CR 17; *Davy v Public Nat'l Ins. Co.* (1960) 181 CA2d 387, 399, 5 CR 488. Moreover, the insurer must fairly appraise the potential exposure and the strengths and weaknesses of the case based on facts known or available at the time of the settlement demand. *Isaacson,* 44 C3d at 792; *Camelot by the Bay Condominium Owners' Ass'n v Scottsdale Ins. Co.* (1994) 27 CA4th 33, 48, 32 CR2d 354.

The insurer must make an honest and intelligent decision whether to settle the claim. The decision "must be based on knowledge of the facts and circumstances on which liability is predicated, and on knowledge of the nature and extent of the injuries as far as they reasonably can be ascertained." *Brown v Guarantee Ins. Co.* (1957) 155 CA2d 679, 685, 319 P2d 69.

According to the California Supreme Court, "the only permissible consideration in evaluating the reasonableness of the settlement offer becomes whether, in light of the victim's injuries and the probable liability of the insured, the ultimate judgment is likely to exceed the amount of the settlement offer." *Johansen v California State Auto. Ass'n Inter-Ins. Bureau* (1975) 15 C3d 9, 16, 123 CR 288. See also *Blue Ridge Ins. Co. v Jacobsen* (2001) 25 C4th 489, 498, 106 CR2d 535, 22 P3d 313; *Isaacson,* 44 C3d at 792 n12; *Samson v Transamerica Ins. Co.* (1981) 30 C3d 220, 243, 178 CR 343. The likelihood that the third party will recover against the insured in excess of the policy limits must be substantial. *Murphy v Allstate Ins. Co.* (1976) 17 C3d 937, 941, 132 CR 424; *Northwestern Mut. Ins. Co. v Farmers' Ins. Group* (1978) 76 CA3d 1031, 1041, 143 CR 415. See also *Comunale v Traders & Gen. Ins. Co.* (1958) 50 C2d 654, 659, 328 P2d 198. The insurer's conduct must be measured against "the totality of the circumstances" in which its decision was made. *Wilson v 21st Century Ins. Co.* (2007) 42 C4th 713, 723, 68 CR3d 746. See also *Nager v Allstate Ins. Co.* (2000) 83 CA4th 284, 288, 99 CR2d 348.

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§10.115 B. Insured Must Establish Breach

The insured has the burden of proving that the insurer rejected a reasonable settlement demand. *Isaacson v California Ins. Guarantee Ass'n* (1988) 44 C3d 775, 793, 244 CR 655; *Hamilton v Maryland Cas. Co.* (2002) 27 C4th 718, 730, 117 CR2d 318.

"The size of the judgment recovered in the personal injury action when it exceeds the policy limits, although not conclusive, furnishes an inference that the *value of the claim* is the equivalent of the amount of the judgment and that acceptance of an offer within those limits was the most reasonable method of dealing with the claim." (Emphasis added.) *Crisci v Security Ins. Co.* (1967) 66 C2d 425, 431, 58 CR 13, quoted with approval in *Johansen v California State Auto. Ass'n Inter-Ins. Bureau* (1975) 15 C3d 9, 17, 123 CR 288; *Archdale v American Int'l Specialty Lines Ins. Co.* (2007) 154 CA4th 449, 471 n23, 64 CR3d 632; *Walbrook Ins. Co. v Liberty Mut. Ins. Co.* (1992) 5 CA4th 1445, 1461, 7 CR2d 513; *Northwestern Mut. Ins. Co. v Farmers' Ins. Group* (1978) 76 CA3d 1031, 1054, 143 CR 415.

The Judicial Council of California jury instruction on third party bad faith refusal to accept a reasonable settlement demand within policy limits (CACI 2334) states:

> A settlement demand is reasonable if [name of defendant] knew or should have known at the time the settlement demand was rejected that the potential judgment was likely to exceed the amount of the settlement demand based on [name of plaintiff in underlying case]'s injuries or loss and [name of plaintiff]'s probable liability.

Cases in which a refusal to settle was held to constitute bad faith include:

- *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 410, 97 CR2d 151 (insurer rejected settlement demand, knowing insured had given false answers during discovery);
- *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc*. (2000) 78 CA4th 847, 883, 93 CR2d 364 (failure of insurer to obtain statements from responsible parties or consult with expert to assess cause of loss, coupled with refusal to reconsider denial when presented with evidence of factual errors);
- *Mariscal v Old Republic Life Ins. Co.* (1996) 42 CA4th 1617, 1624, 50 CR2d 224 (insurer denied payment on accidental death policy, contending insured died of illness; insurer failed to consider other medical records and testimony of treating physician which strongly indicated insured's death was due to auto accident);
- *Betts v Allstate Ins. Co.* (1984) 154 CA3d 688, 707, 201 CR 528 (insurer refused to settle, basing liability evaluation on insured's version of facts; insurer ignored other credible evidence, including accident reconstructionist's report showing insured was liable);
- *Garner v American Mut. Liability Ins. Co.* (1973) 31 CA3d 843, 850, 107 CR 604 (medical malpractice insurer improperly delegated responsibility for determining whether insured committed malpractice to county medical society review committee, and refused to settle despite insured's requests);
- *Davy v Public Nat'l Ins. Co.* (1960) 181 CA2d 387, 396, 5 CR 488 (insurer rejected settlement demand without requesting opinion from attorney assigned to case, knowing jury could go either way on liability and verdict would almost certainly exceed policy limit).

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§10.116 C. Extent of Duty to Settle in Mixed Action

The extent of the duty to settle in a mixed action (see §§10.99, 10.110) is unclear. In *Camelot by the Bay Condominium Owners' Ass'n v Scottsdale Ins. Co.* (1994) 27 CA4th 33, 52, 32 CR2d 354, the trial court had held the insurer to a duty to protect its insured against a financial risk for even those construction defects that would ultimately be determined to be *uncovered* items. The court of appeal reversed, declining to read the broad restatement of the *Comunale* rule in *Johansen v California State Auto. Ass'n Inter-Ins. Bureau* (1975) 15 C3d 9, 14, 123 CR 288 (see §10.113) to so burden a liability insurer in a case in which the third party claims embraced clearly uncovered risks as well as those that fell within coverage. The *Camelot* court emphasized the language from *Comunale v Traders & Gen. Ins. Co.* (1958) 50 C2d 654, 658, 328 P2d 198, that an insurer denies coverage "at its own risk, and… *if the denial is found to be wrongful*… it is liable for the full amount which will compensate the insured." *Camelot,* 27 CA4th at 52. The court thus read the *Comunale* rule to presuppose (27 CA4th at 53).

> that an insurer denies coverage at its own risk *if, and only if,* coverage is ultimately found. Essentially, there are two separate coverage questions: coverage within the monetary limits of a policy ("vertical coverage") and substantive coverage of an insurance policy ("horizontal coverage"). These two coverage questions are not readily comparable and should not be confused. We do not believe Scottsdale can reasonably be said to have run the risk of bad faith liability by refusing to settle the case for the amount demanded, where no danger of excess liability of the insured existed and where it was essentially undisputed that some of the defects at the property fell outside the scope of its policy. Where coverage up to the settlement demand is ultimately found, and an excess judgment is ultimately entered, the situation is far different from the case before us in which some of the defects were found not to be covered and there was never any threat of an excess judgment.

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§10.117 D. Damages for Breach of Duty to Settle

In *Crisci v Security Ins. Co.* (1967) 66 C2d 425, 431, 58 CR 13, the California Supreme Court stated that "an insurer should not be permitted to further its own interests by rejecting opportunities to settle within the policy limits unless it is also willing to absorb losses which may result from its failure to settle." Thus, an insurer that breaches its duty of reasonable settlement is liable for all the insured's damages proximately caused by the breach, regardless of policy limits. *Hamilton v Maryland Cas. Co.* (2002) 27 C4th 718, 725, 117 CR2d 318; *PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 315, 84 CR2d 455; *Comunale v Traders & Gen. Ins. Co.* (1958) 50 C2d 654, 661, 328 P2d 198. When the underlying action has proceeded to trial and a judgment in excess of the policy limits has been entered against the insured, the insurer is ordinarily liable to its insured for the entire amount of that judgment (*Hamilton v Maryland Cas. Co., supra; Blue Ridge Ins. Co. v Jacobsen* (2001) 25 C4th 489, 502, 106 CR2d 535, 22 P3d 313; *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 401, 97 CR2d 151), excluding any punitive damages awarded (*PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 313, 84 CR2d 455). The insured's action for breach of the contractual duty to settle may be assigned to the claimant, regardless of whether assignments are permitted by the policy. *Hamilton v Maryland Cas. Co., supra; Comunale v Traders & Gen. Ins. Co., supra*. Such an assignment may be made before trial, but the assignment does not become operative, and the claimant's action against the insurer does not mature, until a judgment in excess of the policy limits has been entered against the insured. *Hamilton,* 27 C4th at 725; *Safeco Ins. Co. v Superior Court* (1999) 71 CA4th 782, 788, 84 CR2d 43; *Critz v Farmers Ins. Group* (1964) 230 CA2d 788, 799, 41 CR 401, disapproved on other grounds in *Crisci v Security Ins. Co.* (1967) 66 C2d 425, 430, 58 CR 13.

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XV. POLICY LIMITS

§10.118 A. Per Claim and Aggregate Policy Limits

Most liability policies have both an "each claim" or "each wrongful occurrence" limit and an "aggregate limit." The per-claim limit is the maximum amount the insurer will pay for any one claim during the policy period. The aggregate limit is the maximum amount the insurer will pay for all injury or damage during the policy period. *National Union Fire Ins. Co. v Lynette C.* (1994) 27 CA4th 1434, 1458 n12, 33 CR2d 496.

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§10.119 B. Self-Insured Retention Versus Deductible

Most liability policies contain a deductible or self-insured retention (SIR) that requires the insured to pay a portion of a loss otherwise covered by the policy. *Forecast Homes, Inc. v Steadfast Ins. Co.* (2010) 181 CA4th 1466, 1473, 105 CR3d 200; *General Star Nat'l Ins. Corp. v World Oil Co.* (CD Cal 1997) 973 F Supp 943, 948.

A deductible is a portion of an insured loss for which the insured is responsible. It is generally a specific amount that the insured must pay before the insurer owes a duty to indemnify the insured for a loss. A deductible usually relates only to the damages sustained by the insured, not to defense costs. The insurer is fully responsible for defense costs as long as the loss is potentially covered under the policy. *Forecast Homes, Inc.*, 181 CA4th at 1474; *Padilla Constr. Co. v Transportation Ins. Co.* (2007) 150 CA4th 984, 993 n10, 58 CR3d 807; *General Star,* 973 F Supp at 948.

An SIR is generally a specific amount of loss that is not covered by the policy but instead must be borne by the insured. *Padilla Constr. Co. v Transportation Ins. Co., supra; General Star Nat. Ins. Corp. v World Oil Co., supra*. An SIR endorsement may provide that the insurer shall have the right, but not the duty, to assume charge of the defense and settlement of any claim, including those below the level of the SIR. *General Star,* 973 F Supp at 949.

In *Forecast Homes, Inc. v Steadfast Ins. Co.* (2010) 181 CA4th 1466, 105 CR3d 200 the SIR stated that a condition precedent to coverage was that the named insured make "actual payment of all damages and defense costs." The court held that this provision unambiguously prohibited payments by any additional insured from satisfying the SIR, and thus the insurer's duty to defend was not triggered.

For further discussion of SIRs and deductibles, see Financing and Protecting California Businesses §11.48 (Cal CEB 2006); California Liability Insurance Practice: Claims & Litigation §15.19 (Cal CEB 1991).

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§10.120 C. Burning Limits

A "burning limit" or "self-consuming" policy is one in which the policy limit for indemnification is reduced dollar-for-dollar by defense costs until the policy limit is exhausted. *Aerojet-General Corp. v Transport Indem. Co.* (1997) 17 C4th 38, 76 n29, 70 CR2d 118; *Lipton v Superior Court* (1996) 48 CA4th 1599, 1606, 56 CR2d 341. When the insurer has paid out the full limits in defense, the insurer's duty to defend terminates, even if no settlement or judgment has been reached. *Aerojet-General Corp. v Transport Indem. Co., supra*.

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§10.121 D. Consent to Settle, or Hammer Clause

Errors and omissions insurance policies for many types of professionals contain a provision prohibiting the insurer from settling without the insured's consent. However, some E&O policies, including some issued to real estate brokers and salespersons, contain what is in essence a penalty provision that may go into effect if an insured refuses to consent to a settlement. Often referred to as a "hammer clause," such a provision may state:

> The company shall not settle any claim without the written consent of the insured. If, however, the insured shall refuse to consent to any settlement recommended by the company and shall elect to contest the claim or continue any legal proceedings in connection with such claim, then the company's liability for the claim shall not exceed the amount for which the claim would have been settled, plus the cost and expenses incurred, with its consent, up to the date of such refusal.

See *Transit Cas. Co. v Spink Corp*. (1979) 94 CA3d 124, 129 n1, 156 CR 360, disapproved on other grounds in *Commercial Union Assur. Cos. v Safeway Stores, Inc.* (1980) 26 C3d 912, 164 CR 709.

Under a hammer clause, if the insured refuses to consent to a settlement recommended by the insurer, the insured is responsible for any amount by which a subsequent settlement or judgment exceeds the amount of the recommended settlement. And, because most broker liability policies include defense costs in the policy limit, under a hammer clause, the insured would also be responsible for all defense fees and costs incurred after the insured withholds consent to the settlement.

PRACTICE TIP: A hammer clause may lead to a game of chicken between the insurer and the insured. Note that the consent-to-settle provision is limited to a settlement "recommended" by the insurer. Assume that, through the course of settlement negotiations, the insurer knows the insured will refuse to consent to a proposed settlement. If so, the insurer faces no risk in recommending the settlement demand, even if it is more than the insurer would otherwise be willing to pay. If the insured refuses to consent, the insurer may then invoke the hammer clause to attempt to "cap" the indemnity and defense costs. Thus, the insured and their counsel may wish to keep their settlement considerations to themselves until the insurer expressly "recommends" a settlement.

There are no reported California cases on the enforceability of hammer clauses. However, at least one court has indicated, in dicta, that it would enforce such a provision. *Transit Cas. Co.,* 94 CA3d at 129.

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XVI. CLAIMS AGAINST INSURER

§10.122 A. Common Law Bad Faith

The duty of good faith and fair dealing requires that neither party to the contract do anything to deprive the other of benefits due under the contract. *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 818, 169 CR 691. The covenant of good faith is a supplement to the express contractual agreements and does not exist separately from its contractual underpinnings. *McMillin Scripps N. Partnership v Royal Ins. Co.* (1993) 19 CA4th 1215, 1222, 23 CR2d 243; *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 36, 44 CR2d 370. Thus, if no breach of contract can be shown, there is no basis for finding a breach of the covenant of good faith. *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 408, 97 CR2d 151; *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 35, 44 CR2d 370; *Brehm v 21st Century Ins. Co.* (2008) 166 CA4th 1225, 1235, 83 CR3d 410; *San Diego Housing Comm'n v Industrial Indem. Co.* (1998) 68 CA4th 526, 544, 80 CR2d 393.

The gravamen of a claim for first party bad faith is the insurer's refusal, without proper cause, to compensate the insured for a loss covered by the policy (*Wilson v 21st Century Ins. Co.* (2007) 42 C4th 713, 723, 68 CR3d 746; *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 574, 108 CR 480; *Bosetti v United States Life Ins. Co.* (2009) 175 CA4th 1208, 1236, 96 CR3d 744; *McCoy v Progressive W. Ins. Co.* (2009) 171 CA4th 785, 793, 90 CR3d 74; *Major v Western Home Ins. Co.* (2009) 169 CA4th 1197, 1210, 87 CR3d 556), or the insurer's unreasonable delay in paying benefits due under the policy (*Waters*, 41 CA4th at 1070; *Austero v National Cas. Co.* (1978) 84 CA3d 1, 25, 148 CR 653, disapproved on other grounds in *Egan v Mutual of Omaha Ins. Co*. (1979) 24 C3d 809, 824 n7, 169 CR 691). Mere denial of benefits is not by itself bad faith. *Dalrymple v United Servs. Auto. Ass'n* (1995) 40 CA4th 497, 523, 46 CR2d 845; *Opsal v United Servs. Auto. Ass'n* (1991) 2 CA4th 1197, 1205, 10 CR2d 352; *Safeco Ins. Co. v Guyton* (9th Cir 1982) 692 F2d 551, 557. A denial of coverage based on a reasonable, but incorrect, interpretation of the insurance policy will ordinarily not support a bad faith action. *Dalrymple*, 40 CA4th at 523; *Opsal*, 2 CA4th at 1205; *Hanson v Prudential Ins. Co.* (9th Cir 1985) 783 F2d 762, 766.

Generally, bad faith cannot exist in the absence of coverage. See *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 408, 97 CR2d 151. In certain circumstances, however, California courts have held that even a claim that does not come within a policy's coverage may trigger a bad faith claim if unreasonable failure to investigate the claim, or unreasonable delay in providing a coverage decision, harms an insured. Further, if the carrier provides a defense, it can incur bad faith liability by mishandling that defense, even if a court later finds that it owed no duty to defend. See *Travelers Ins. Co. v Lesher* (1986) 187 CA3d 169, 186, 231 CR 791, disapproved on other grounds in *Buss v Superior Court* (1997) 16 C4th 35, 50 n12, 65 CR2d 366. But see *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 886, 93 CR2d 364 (court affirmed insurer's bad faith failure "to conduct a meaningful investigation before denying coverage," but reversed large punitive damages award because insurer's conduct was not proved "despicable" by clear and convincing evidence as required by CC §3294).

In sum, the reasonableness of the carrier's conduct in adjusting and paying, or in denying, a claim rests on three considerations:

- Was the carrier's decision to deny the claim based on an adequate and thorough investigation? See *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 819, 169 CR 691; but see *Benavides v State Farm Gen. Ins. Co.* (2006) 136 CA4th 1241, 1250, 39 CR3d 650 (if insurer's investigation, adequate or not, results in correct conclusion of no coverage, no tort liability arises for breach of covenant of good faith).
- Did the carrier delay unreasonably in deciding either to pay or to deny the claim? See *McCormick v Sentinel Life Ins. Co.* (1984) 153 CA3d 1030, 1049, 200 CR 732.
- Was the carrier's decision to withhold coverage a reasonable interpretation of the policy in light of the facts the carrier knew or should have known? See *Hanson v Prudential Ins. Co.* (9th Cir 1985) 783 F2d 762.

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§10.123 B. Damages

Breach of the insurance contract, without bad faith, will support an award of contract benefits. Prejudgment interest may be recoverable if the amount due was certain or capable of being made certain by calculation. CC §3287(a); *Fireman's Fund Ins. Co. v Allstate Ins. Co.* (1991) 234 CA3d 1154, 1173, 286 CR 146.

An insured who establishes bad faith may recover a full array of tort remedies, including those described in §§10.124-10.129.

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§10.124 1. Emotional Distress

If the insured establishes economic loss or injury apart from the emotional distress itself, all resulting emotional distress is compensable as damages. *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 580, 108 CR 480 (insurer's failure to pay caused loss of earnings, loss of business, creditor suits, and medical problems); *Major v Western Home Ins. Co.* (2009) 169 CA4th 1197, 1214, 87 CR3d 556 (insurer's failure to pay for personal property loss); *Clayton v United Servs. Auto. Ass'n* (1997) 54 CA4th 1158, 1162 n3, 63 CR2d 419 (insurer's unreasonable refusal to settle); *Delos v Farmers Group, Inc.* (1979) 93 CA3d 642, 659, 155 CR 843 (attorney fees and costs incurred to enforce claim for benefits may establish requisite economic loss). Compare *Waters v United Servs. Auto. Ass'n* (1996) 41 CA4th 1063, 1079, 48 CR2d 910 (no economic loss established when insured failed to prove payment of medical bills; delay in payment of benefits insufficient to establish loss); *Continental Ins. Co. v Superior Court* (1995) 37 CA4th 69, 85 n11, 43 CR2d 374 (delay in payment by itself insufficient to establish financial loss).

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§10.125 2. Attorney Fees and Costs

The insured may obtain attorney fees and costs incurred for recovery of wrongfully withheld policy benefits (known as *Brandt* fees), but not fees or costs incurred in proving tort claims. See *Brandt v Superior Court* (1985) 37 C3d 813, 817, 210 CR 211; *Slottow v American Cas. Co*. (9th Cir 1993) 10 F3d 1355, 1362 (applying California law, holding it is insured's burden to allocate fees and costs incurred to recover policy benefits). See also *Essex Ins. Co. v Five Star Dye House, Inc.* (2006) 38 C4th 1252, 45 CR3d 362 (assignee of bad faith claim for insurer's wrongful withholding of policy benefits may recover *Brandt* fees); CACI 2350 (plaintiff "may recover attorney fees… incurred to obtain policy benefits but not attorney fees… incurred for other purposes"). Courts have reached conflicting results on whether attorney fees incurred in defending against an insurer's unsuccessful appeal are recoverable. See *Track Mortgage Group, Inc. v Crusader Ins. Co.* (2002) 98 CA4th 857, 871, 120 CR2d 228 (allowing recovery of fees on appeal); *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 909 n17, 93 CR2d 364 (fees on appeal not recoverable); *McGregor v Paul Revere Life Ins. Co.* (9th Cir 2004) 369 F3d 1099, 1101 (predicting the California Supreme Court will allow recovery of fees on appeal). See also *Textron Fin. Corp. v National Union Fire Ins. Co.* (2004) 118 CA4th 1061, 1074, 13 CR3d 586 (when insured had contingency fee agreement, insured's attorney fee recovery was limited to amount specified by contract; insured cannot seek "reasonable value" of fees in excess of amount set by contract).

If the insured has a contingency fee agreement with its attorneys, the trier of fact must determine the percentage of the legal fees paid to the attorney that reflects the work attributable to obtaining the contract recovery. In *Cassim v Allstate Ins. Co*. (2004) 33 C4th 780, 812, 16 CR3d 374, the California Supreme Court set out the following method of calculation:

> To determine the percentage of the legal fees attributable to the contract recovery, the trial court should determine the total number of hours an attorney spent on the case and then determine how many hours were spent working exclusively on the contract recovery. Hours spent working on issues jointly related to both the tort and contract should be apportioned, with some hours assigned to the contract and some to the tort. This latter figure, added to the hours spent on the contract alone, when divided by the total number of hours worked, should provide the appropriate percentage.

The court held that no portion of legal fees attributable to the punitive damage award can be recovered as *Brandt* fees and that *Brandt* fees can never exceed the legal fees for the combined tort and contract recovery (in most cases, the court noted, the amount will be far less). 33 C4th at 812.

The *Cassim* court also held that the insured bears the burden of proof to demonstrate how fees for work attributable to both the tort and contract recoveries should be apportioned. Moreover, trial courts have discretion to disregard fee arrangements that appear to be designed to manipulate the calculation of *Brandt* fees for the insured's benefit. 33 C4th at 813.

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§10.126 3. Consequential Economic Loss

The insured may also recover consequential economic losses, such as loss of property in a foreclosure or forced sale. *Merlo v Standard Life & Acc. Ins. Co*. (1976) 59 CA3d 5, 16, 130 CR 416. See also *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 580, 108 CR 480 (loss of future earnings and profits); *Little v Stuyvesant Life Ins. Co*. (1977) 67 CA3d 451, 465 n3, 136 CR 653 (costs of borrowing to preserve assets or meet living expenses).

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§10.127 4. Punitive Damages

Punitive damages are not available for breach of contract. CC §3294(a). However, a cause of action for bad faith sounds in both contract and tort. *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 573, 108 CR 480. Thus punitive damages are potentially available if the insured can demonstrate bad faith, but proof of bad faith alone does not entitle the insured to an award of punitive damages. Although the same evidence may be relevant to prove breach of contract, bad faith, and malice, fraud, or oppression, an award of punitive damages is far from automatic even on a finding of bad faith. *Beck v State Farm Mut. Auto. Ins. Co.* (1976) 54 CA3d 347, 355, 126 CR 602.

To support an award of punitive damages, the insured must establish three basic levels of proof:

- First, the insured must demonstrate entitlement to policy benefits;
- Second, the insured must prove that the insurer's conduct amounted to "bad faith";
- Third, the insured must establish that the insurer's conduct constituted "oppression," "fraud," or "malice" within the meaning of CC §3294. In other words, the insured must make a distinct showing that the insurer acted with intent to vex, injure, or annoy, or with a conscious disregard of the rights of the insured. *Beck*, 54 CA3d at 355.

Finally, after the threshold levels of proof are made, the insured is required to introduce evidence establishing the defendant's financial condition. *Tomaselli v Transamerica Ins. Co.* (1994) 25 CA4th 1269, 1282, 31 CR2d 433.

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§10.128 a. Clear and Convincing Evidence Standard

If the jury finds, by clear and convincing evidence, that the insurer acted with "oppression, fraud, or malice," the insured may recover punitive damages. CC §3294; *Food Pro Int'l, Inc. v Farmers Ins. Exch.* (2008) 169 CA4th 976, 994, 89 CR3d 1; *Hangarter v Provident Life & Acc. Ins. Co.* (9th Cir 2004) 373 F3d 998. For example, in *Diamond Woodworks, Inc. v Argonaut Ins. Co.* (2003) 109 CA4th 1020, 1050, 135 CR2d 736, the court held that punitive damages were supported by the insurer's

> near reflexive denial of the severely maimed [employee's] employment status and entitlement to workers' compensation benefits, not to mention their subsequent long-term refusal to budge from that position, [and the fact that] the evidence was *consistent* with intentional fraud, and *not* consistent with mistake, honest error, negligence, [etc.].

Although the same evidence used to establish bad faith may be used to establish oppression, fraud, or malice, the higher standard of clear and convincing evidence is required to impose punitive damages. Thus, a "marginally sufficient case of bad faith is not likely to prove malice or oppression by clear and convincing evidence." *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc*. (2000) 78 CA4th 847, 909, 93 CR2d 364. Punitive damages are appropriate "when the tortious conduct rises to levels of extreme indifference to the plaintiff's rights, a level which decent citizens should not have to tolerate." *Food Pro Int'l, Inc. v Farmers Ins. Exch., supra*; *Tomaselli v Transamerica Ins. Co.* (1994) 25 CA4th 1269, 1287, 31 CR2d 433. However, punitive damages should not be allowed when the offending conduct is consistent with "a mistake of law or fact, honest error of judgment, over-zealousness, mere negligence or other such noniniquitous human failing." 25 CA4th at 1288 n14. See also *Food Pro Int'l, Inc. v Farmers Ins. Exch., supra*; *Patrick v Maryland Cas. Co*. (1990) 217 CA3d 1566, 1576, 267 CR 24 (claims handling that is "witless and infected with symptoms of bureaucratic inertia and inefficiency" does not add up to malice or oppression).

NOTE: An insured's egregious misconduct may justify punitive damages, but that liability may not be shifted to the insurer; only an insurance company's own egregious misconduct may justify an award of punitive damages. See *PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 316, 84 CR2d 455.

The "clear and convincing" evidentiary standard also applies to summary judgment or summary adjudication motions challenging punitive damage claims (see *Basich v Allstate Ins. Co.* (2001) 87 CA4th 1112, 1118, 105 CR2d 153) and to motions for nonsuit challenging a claim for punitive damages (see *Stewart v Truck Ins. Exch.* (1993) 17 CA4th 468, 482, 21 CR2d 338).

NOTE: Under CC §3294(b), a corporate broker may be held liable for punitive damages if the plaintiff proves that an officer, director, or managing agent of the broker authorized or ratified the wrongful conduct for which the damages are awarded. In *Barton v Alexander Hamilton Life Ins. Co.* (2003) 110 CA4th 1640, 1644, 3 CR3d 258, the court held that such authorization or ratification had to be proved by clear and convincing evidence. The Use Notes to CACI 3943 and related instructions now expressly state that this higher burden of proof applies to the findings of corporate ratification or authorization.

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§10.129 b. Constitutionality of Punitive Damages

Several recent cases have dealt with the constitutionality of punitive damage awards. In *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 418, 155 L Ed 2d 585, 601, 123 S Ct 1513, the United States Supreme Court held that due process required courts to evaluate whether an award of punitive damages was excessive in light of the following "guideposts":

- The degree of reprehensibility of the defendant's conduct;
- The disparity between the actual or potential harm suffered by the plaintiff and the punitive damages awarded; and
- The difference between the punitive damages awarded by the jury and penalties authorized or imposed in comparable cases.

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§10.130 (1) First Guidepost: Reprehensibility of Defendant's Conduct

In *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513, the court explained that reprehensibility of the defendant's conduct is the "most important indicium of the reasonableness of a punitive damage award." 538 US at 419, 155 L Ed 2d at 602. The issue of reprehensibility requires the court to examine:

- Whether the harm caused was physical as opposed to economic;
- Whether the tortious conduct evinced an indifference to, or a reckless disregard of, the health or safety of others;
- Whether the target of the conduct had financial vulnerability;
- Whether the conduct involved repeated actions or was an isolated incident; and
- Whether the harm was the result of intentional malice, trickery, or deceit, or mere accident.

See also *Simon v San Paolo U.S. Holding Co., Inc.* (2005) 35 C4th 1159, 1172, 29 CR3d 379 (defendant's acts showed low degree of reprehensibility); *Major v Western Home Ins. Co.* (2009) 169 CA4th 1197, 1223, 87 CR3d 556 (insurer acted with oppression).

Repeated misconduct is more reprehensible than an individual act of malfeasance. 538 US at 423, 155 L Ed 2d at 604; *Johnson v Ford Motor Co.* (2005) 35 C4th 1191, 1202, 29 CR3d 401. Similar conduct need not be identical, but courts must ensure that it "replicates the prior transgressions." *Johnson,* 35 C4th at 1204. Evidence of wide-ranging, dissimilar business practices cannot be used to show reprehensibility because a "defendant should be punished for the conduct that harmed the plaintiff, not for being an unsavory individual or business." *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 423, 155 L Ed 2d 585, 604, 123 S Ct 1513. However, a refusal to defend an insured may be considered more than a single event, if it consists of a series of acts or course of conduct committed over a period of time. *Century Sur. Co. v Polisso* (2006) 139 CA4th 922, 965, 43 CR3d 468.

A defendant cannot be punished for its conduct in other states that is lawful in those states and that does not impact the plaintiff. *BMW of N. Am. v Gore* (1996) 517 US 559, 572, 134 L Ed 2d 809, 824, 116 S Ct 1589. However, evidence describing out-of-state transactions may be relevant to the determination of the degree of reprehensibility of the defendant's conduct. 517 US at 574 n21, 134 L Ed 2d at 825 n21.

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§10.131 (2) Second Guidepost: Disparity Between Harm Suffered by Plaintiff and Punitive Damages Awarded

In *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513, the United States Supreme Court declined to establish a bright line, mathematical formula or ratio of punitive to compensatory damages, but the Court did explain that although awards generally will not exceed a single-digit ratio between punitive and compensatory damages, a particularly egregious act which results in a small amount of economic damages may permit a higher ratio. The court further explained that, conversely, when compensatory damages are substantial, a lesser ratio—perhaps only 1:1—can reach the outermost limit of the constitutional guarantee. 528 US at 425, 155 L Ed 2d at 605.

California courts following *State Farm* have demonstrated that the numerical ratio discussed will not be rigidly followed. For example, in *Simon v San Paolo U.S. Holding Co., Inc.* (2005) 35 C4th 1159, 29 CR3d 379, the California Supreme Court disagreed with the statement in *Diamond Woodworks, Inc. v Argonaut Ins. Co.* (2003) 109 CA4th 1020, 1057, 135 CR2d 736, that, "in the usual case," the United States Supreme Court's decisions establish an "outer constitutional limit" of approximately four times the compensatory damages. The *Simon* court stated (35 C4th at 1182):

> We understand the court's statement in *State Farm* that "few awards" significantly exceeding a single-digit ratio will satisfy due process to establish a type of presumption: ratios between the punitive damages award and the plaintiff's actual or potential compensatory damages significantly greater than 9 or 10 to 1 are suspect and, absent special justification (by, for example, extreme reprehensibility or unusually small, hard-to-detect or hard-to-measure compensatory damages), cannot survive appellate scrutiny under the due process clause.

The *Simon* court went on to hold that a punitive damage award of 340 times the compensatory damage award qualified as a "breathtaking" multiplier far outside the "single-digit neighborhood" suggested by *State Farm*. *Simon,* 35 C4th at 1183. The court ruled that when an award of punitive damages is constitutionally excessive, the appropriate order is for an absolute reduction, rather than a conditional reduction with the alternative of a new trial. 35 C4th at 1187. In *Simon,* the court reduced the punitive damages to $50,000, just exceeding the largest single-digit ratio amount, which the court stated was "not extraordinary for fraudulent conduct," but not so minor that it could be "completely ignored" by the defendant because even a prosperous company would ordinarily take measures to prevent the recurrence of a $50,000 net loss. 35 C4th at 1189.

In *Textron Fin. Corp. v National Union Fire Ins. Co.* (2004) 118 CA4th 1061, 1084, 13 CR3d 586, the appellate court held that the second "guidepost," consideration of the disparity between a plaintiff's actual harm and the punitive damage award, must be limited to the amount awarded for the tort claims supporting the punitive damage, and exclude any sum the plaintiff received for breach of contract. *Major v Western Home Ins. Co.* (2009) 169 CA4th 1197, 1224, 87 CR3d 556 (*Brandt* fees (see §10.125) are tort damages and may be properly considered, along with emotional distress damages, in determining if ratio of punitive damages to tort damages is excessive). See also California Real Property Sales Transactions §13.118 (4th ed Cal CEB 2007).

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§10.132 (3) Third Guidepost: Difference Between Punitive Damages Awarded and Authorized Penalties

Although the "third guidepost" requires a court review of the difference between the punitive damages awarded by the jury and penalties authorized or imposed in comparable cases, in *Century Sur. Co. v Polisso* (2006) 139 CA4th 922, 959, 43 CR3d 468, the appellate court held this was not intended to be a factor for the jury's consideration. The court, therefore, found no error in the use of BAJI 14.72.2, which does not address comparable civil sanctions, nor was it error to reject a special jury instruction on that issue. In addition, the court held evidence of civil sanctions was irrelevant for the jury's consideration and was properly excluded. 139 CA4th at 958. Further, in its review of the punitive damage award, the appellate court held that the maximum $10,000 fine imposed by Ins C §790.035 for each willful act of insurer misconduct was "not particularly useful" when the insurer engaged in a course of conduct over a 5-year period that involved many prohibited acts. 139 CA4th at 967.

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§10.133 (4) Aggregate Disgorgement of Profits Theory Prohibited

In *Johnson v Ford Motor Co.* (2005) 35 C4th 1191, 29 CR3d 401, the court held that an award of punitive damages may not be based on an aggregate disgorgement of profits theory. Although repeated acts of similar misconduct and the profitability of that conduct is relevant to the issue of reprehensibility and although disgorgement of profits earned from the wrongful act committed against the plaintiff is permissible, calculating punitive damages in an individual tort case by the profits made through similar torts against hundreds or thousands of other individuals "creates possibilities for unfairness—to the defendant and other possible claimants both—which may be of constitutional dimension." 35 C4th at 1208.

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§10.134 (5) Evidence of Defendant's Net Worth Admissible

To serve the goals of punishment and deterrence, a punitive damage award must be large enough to deter future bad conduct, without exceeding the amount necessary for punishment. *Century Sur. Co. v Polisso* (2006) 139 CA4th 922, 967, 43 CR3d 468; *Simon v San Paolo U.S. Holding Co., Inc.* (2005) 35 C4th 1159, 1185, 29 CR3d 379. Thus, in *Century Surety,* the court held that evidence of the defendant's net worth was properly admissible in the punitive damage phase of the trial. 139 CA4th at 960. Further, the court found that a punitive damage award of 3.2 percent of the defendant's net worth was appropriate, because a smaller award "would not amount to much more than a slap on the wrist." 139 CA4th at 967. See also *Bardis v Oates* (2004) 119 CA4th 1, 26, 14 CR3d 89 (punitive damage award of less than 1 percent of defendant's net worth "tantamount to a slap on the wrist").

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§10.135 C. Duty of Good Faith Is Mutual; No Cause of Action for "Reverse Bad Faith"

The duty of good faith between insurer and insured is mutual, and counsel for the insured must recognize that, as the insured's agent, this duty shapes counsel's conduct as well as the insurer's in all matters concerning resolution of the underlying claim. Although the insured cannot be held liable for tort damages for "reverse bad faith" (*Kransco v American Empire Surplus Lines Ins. Co*. (2000) 23 C4th 390, 402, 97 CR2d 151), the insured's fraudulent claim can be asserted as a defense to contract claims against the insurer (*Agricultural Ins. Co. v Superior Court* (1999) 70 CA4th 385, 82 CR2d 594). In addition, the insurer may file suit or a cross-complaint against the insured for fraud and seek damages (70 CA4th at 400), including punitive damages (70 CA4th at 404).

PRACTICE TIP: Whether counsel represents the claimant or the insurer, if a dispute leads to litigation, the attorney's letters, conversations, and other interactions, even after suit has been filed, may become evidence. See *White v Western Title Ins. Co.* (1985) 40 C3d 870, 885, 221 CR 509. Counsel should realize that he or she may be a witness and, accordingly, take care not to say or write anything that he or she would not wish to see enlarged as a trial exhibit.

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§10.136 D. Genuine Dispute Doctrine

The "genuine dispute" doctrine, also called the "genuine issue" doctrine, is a rapidly evolving area of bad faith law. Bad faith liability cannot be imposed if there is a genuine dispute over the insurer's liability under the policy. If an insurer denies or delays payment of policy benefits because it has a genuine dispute with its insured about the existence of coverage or the amount of the insured's claim, the insurer is not liable for bad faith, even though it may be liable for breach of contract. *Wilson v 21st Century Ins. Co.* (2007) 42 C4th 713, 723, 68 CR3d 746; *Bosetti v United States Life Ins. Co.* (2009) 175 CA4th 1208, 1237, 96 CR3d 744; *McCoy v Progressive W. Ins. Co.* (2009) 171 CA4th 785, 793, 90 CR3d 74; *Brehm v 21st Century Ins. Co.* (2008) 166 CA4th 1225, 1237, 83 CR3d 410; *Chateau Chamberay Homeowners Ass'n v Associated Int'l Ins. Co.* (2001) 90 CA4th 335, 347, 108 CR2d 776; *Fraley v Allstate Ins. Co.* (2000) 81 CA4th 1282, 1292, 97 CR2d 386. The doctrine may be applied when the genuine dispute is based on legal or factual disputes. *Wilson, supra*; *Chateau Chamberay,* 90 CA4th at 348. However, if the dispute is based on a conflict of expert opinions, the doctrine will not apply if any of the following are true (90 CA4th at 348):

- The insurer misrepresented the nature of the investigation;
- The insurer's employees lied during depositions or to the insured;
- The insurer dishonestly selected its experts;
- The insurer's experts were unreasonable; or
- The insurer failed to conduct a thorough investigation.

NOTE: A mistaken withholding of policy benefits, such as an inadvertent failure to indemnify, may qualify under the genuine dispute doctrine, but the doctrine does not encompass the insurer's duty to defend, which is a much broader duty. *Century Sur. Co. v Polisso* (2006) 139 CA4th 922, 950, 43 CR3d 468 ("Even if there were genuine coverage issues at the time the claim was tendered, there was no genuine dispute as to [the insurer]'s duty to defend under the policy").

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§10.137 E. No Cause of Action for Breach of Fiduciary Duty

Insureds cannot base claims on an alleged breach of fiduciary duty. See, *e.g., Vu v Prudential Prop. & Cas. Ins. Co.* (2001) 26 C4th 1142, 1150, 113 CR2d 70 (while "special and heightened" duties characteristic of insurer-insured relationship "are akin to, and often resemble, duties which are also owed by fiduciaries, the fiduciary-like duties arise because of the unique nature of the insurance contract, *not* because the insurer is a fiduciary"); *Tran v Farmers Group, Inc.* (2002) 104 CA4th 1202, 1212, 128 CR2d 728 ("an insurer's breach of its 'fiduciary-like duties' is adequately redressed by a claim for breach of the covenant of good faith and fair dealing implied in the insurance contract"). See also *Griffin Dewatering Corp. v Northern Ins. Co.* (2009) 176 CA4th 172, 207, 97 CR3d 568; *Love v Fire Ins. Exch*. (1990) 221 CA3d 1136, 1147, 271 CR 246; *Henry v Associated Indem. Corp.* (1990) 217 CA3d 1405, 1418, 266 CR 578.

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§10.138 F. Unfair Competition Claims Under Bus & P C §17200

The Unfair Competition Law (UCL) (Bus & P C §§17200-17210) has been held to apply to insurance companies providing homeowners' policies, automobile policies, life insurance policies, and title insurance policies. Although it has not yet been applied to an insurer providing professional liability insurance, there appears to be no reason why it could not be applied.

The UCL provides equitable relief for unlawful, unfair, or fraudulent business practices, including nonstatutory theories such as fraud and breach of the covenant of good faith and fair dealing. *Quelimane Co. v Stewart Title Guar. Co.* (1998) 19 C4th 26, 77 CR2d 709 (title insurer); *State Farm Fire & Cas. Co. v Superior Court* (1996) 45 CA4th 1093, 53 CR2d 229 (homeowners' insurer); *Smith v State Farm Mut. Auto. Ins. Co.* (2001) 93 CA4th 700, 113 CR2d 399 (auto insurer, although finding the complaint failed to allege an unfair business practice); *Massachusetts Mut. Life Ins. Co. v Superior Court (Karges)* (2002) 97 CA4th 1282, 119 CR2d 190 (life insurer). See also Ins C §1861.03. Notably, relief under the UCL does not require individualized proof of deception, reliance, or injury. *Fletcher v Security Pac. Nat'l Bank* (1979) 23 C3d 442, 452, 153 CR 28; *Bank of the West v Superior Court* (1992) 2 C4th 1254, 1266, 10 CR2d 538; *Massachusetts Mut. Life Ins. Co. v Superior Court (Karges)* (2002) 97 CA4th 1282, 1288, 119 CR2d 190. Remedies include injunctive relief, civil penalties, and restitution of property or money obtained as a result of the alleged unfair business practice. Bus & P C §§17203, 17206.

Compensatory damages or attorney fees are not available to private litigants under the UCL. *Korea Supply Co. v Lockheed Martin Corp.* (2003) 29 C4th 1134, 1144, 131 CR2d 29; *Cortez v Purolator Air Filtration Prods. Co.* (2000) 23 C4th 163, 173, 96 CR2d 518; *Cel-Tech Communications, Inc. v Los Angeles Cellular Tel. Co*. (1999) 20 C4th 163, 179, 83 CR2d 548. Moreover, a court cannot order disgorgement into a fluid recovery fund—*i.e.,* any residue remaining after payment of individual claims—under the UCL. See *Kraus v Trinity Mgmt. Servs.* (2000) 23 C4th 116, 124, 96 CR2d 485 (fluid recovery fund, consisting of defendants' illegal profits, "organized and administered for the purpose of providing financial assistance for the advancement of legal rights and interests of residential tenants in the City and County of San Francisco," is unavailable under UCL). Restitution is limited to profits or money in which the individual has a vested or unconditional interest. *Korea Supply Co. v Lockheed Martin Corp.* (2003) 29 C4th 1134, 1149, 131 CR2d 29; *Pegasus Satellite Television, Inc. v DirecTV, Inc.* (CD Cal 2004) 318 F Supp 2d 968, 979.

The UCL will not support a private right of action against an insurer based solely on a violation of the Unfair Insurance Practices Act (UIPA) (Ins C §§790-790.15). *Manufacturers Life Ins. Co. v Superior Court (Weil Ins. Agency)* (1995) 10 C4th 257, 283, 41 CR2d 220. In *State Farm Fire & Cas. Co. v Superior Court* (1996) 45 CA4th 1093, 1108, 53 CR2d 229, however, the appellate court held that although an insured cannot base a UCL claim on violations of the UIPA, an insured can base a UCL claim on allegations of common law fraud and bad faith, even though the underlying acts might also violate the UIPA. The court held that common law claims for fraud and bad faith "remain as a firm legal basis on which an insured may rely to seek redress against an insurer [under the UCL]." However, in *Textron Fin. Corp. v National Union Fire Ins. Co.* (2004) 118 CA4th 1061, 1070, 13 CR3d 586, a different appellate court found that an insurer's use of misleading documents and misrepresentation of both the terms of the insurance policies and the insurer's obligations under them "are the type of activities covered by the UIPA," and thus could not form the basis for a UCL claim.

NOTE: In *Cel-Tech Communications, Inc. v Los Angeles Cellular Tel. Co.* (1999) 20 C4th 163, 184, 83 CR2d 548, the supreme court disapproved as overbroad the definition of "unfair" used in *State Farm*, but the court did not disapprove of its holding that common law fraud and bad faith can support a UCL claim. Nevertheless, the *State Farm* case and the *Textron* case do not appear to be reconcilable. The supreme court will ultimately have to decide this issue.

In *Hangarter v Provident Life & Acc. Ins. Co.* (9th Cir 2004) 373 F3d 998, the Ninth Circuit held that an insured who no longer had a contractual relationship with the insurer and could not demonstrate a "real or immediate threat of an irreparable injury" did not have standing to pursue a federal action for injunctive relief under the UCL, even if the

insured would have been able to pursue the claim in state court. 373 F3d at 1021. See also *Superior Dispatch, Inc. v Insurance Corp.* (2010) 181 CA4th 175, 194, 104 CR3d 508 (insured who suffered no cognizable injury or loss of money or property as a result of unfair competition did not have standing under UCL); *Weston Reid, LLC v American Ins. Group* (2009) 174 CA4th 940, 951, 94 CR3d 748 (UCL claim failed when insured could not state cause of action for negligence, bad faith, or other statutory violation). For additional discussion, see California Liability Insurance Practice: Claims & Litigation §28.29 (Cal CEB 1991).

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§10.139 G. Other Statutory Violations

Insureds no longer have standing to assert a violation of Ins C §790.03(h), the provision of the Unfair Insurance Practices Act (UIPA) (Ins C §§790-790.15) that describes and prohibits unfair claims settlement practices. See *Moradi-Shalal v Fireman's Fund Ins. Cos.* (1988) 46 C3d 287, 250 CR 116 (insured cannot base private cause of action solely on violation of Ins C §790.03). See also *Manufacturers Life Ins. Co. v Superior Court (Weil Ins. Agency)* (1995) 10 C4th 257, 41 CR2d 220 (insureds cannot use Bus & P C §17200 to plead cause of action based on violation of Ins C §790.03(h), because to do so would undermine *Moradi-Shalal*).

NOTE: Although Ins C §1861.03(a) has made insurers subject to all of California's antitrust, unfair competition, and unfair business practices statutes, it does not itself create a private remedy for damages. *Maler v Superior Court* (1990) 220 CA3d 1592, 1597, 270 CR 222. It remains to be seen whether remedies prescribed for certain unfair business practices by express legislation, such as the Consumers Legal Remedies Act (CC §§1750-1784), apply to the insurance industry.

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11

Litigation: Suing and Defending Brokers

Frederic W. Trester
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§11.1 I. INTRODUCTION

Real estate transactions are fertile ground for lawsuits as parties seek to achieve the best deal possible. To get a better price, property owners may hide or play down facts that have an adverse effect on the value and desirability of the property. They may also simply forget about problems with the property, such as a leak that occurred during a year with above-average rainfall. Buyers and tenants may be rushed, fail to perform due diligence, or simply not understand how to protect themselves. In California, real estate deals have been made "user friendly" despite their complexity, so that the principals rarely engage attorneys to guide them through the process. Instead, they rely on real estate brokers and salespersons who sometimes lack the skills, experience, and knowledge needed to adequately represent a client.

Claims typically seen in broker litigation include negligence, fraud and deceit (misrepresentation and concealment), breach of fiduciary duty, and claims for various statutorily imposed duties. In recent years, plaintiffs have added claims of intentional interference with economic advantage, infliction of emotional distress, and unfair business practices. See §§4.40-4.51, 7.23. Because the vast majority of litigation involving brokers arises from these types of claims, this chapter focuses on these areas. It lays out the process of investigating the claim and identifying potential parties (see §§11.2-11.17), the nature of such claims and defenses thereto (see §§11.18-11.71), the procedures to follow in prosecuting and defending the claims (see §§11.72-11.88), and theories of damages (see §§11.89-11.106). Discussion of trial tactics and strategies is contained in chap 12 and discussion of expert witnesses is in chap 13.

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§11.2 A. Investigating the Claim

Prior to agreeing to represent a party in litigation, an attorney should make a thorough investigation of the facts surrounding the party's complaint. In order to form a sound opinion regarding whether a party should pursue litigation, plaintiff's attorney must interview the potential client (see §11.3), review the transactional documents (see §11.5), interview available witnesses (see §11.8), and visit the subject property (see §11.10). The attorney can then determine whether in fact the client has been damaged, and whether the damage resulted from another party in the transaction.

It is also necessary to review the dispute resolution provisions of the contracts. In a typical California Association of Realtors® (CAR) purchase agreement, including the CAR Vacant Land Purchase Agreement, Residential Purchase Agreement, and Residential Income Purchase Agreement, prelitigation mediation is required before an arbitration or litigation is pursued. Failure to do so may result in a loss of the attorney fees otherwise recoverable under the contract. See *Lange v Schilling* (2008) 163 CA4th 1412, 78 CR3d 356; *Frei v Davey* (2004) 124 CA4th 1506, 22 CR3d 429; *Leamon v Krajkiewcz* (2003) 107 CA4th 424, 132 CR2d 362. For more on CAR, see §1.8. See chap 6 on alternative dispute resolution, and §§7.21-7.24 on commission disputes between brokers and principals.

NOTE: Many commercial real estate contracts do not contain mediation provisions.

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1. Interviewing the Client

§11.3 a. Claimant

The plaintiff's attorney should determine the sophistication level and history of the client as it relates to real estate. Counsel should determine:

- Whether the claimant has been involved with any real estate transactions in the past;
- Whether, in past real estate transactions, the claimant was represented by licensed brokers or salespersons;
- Whether the claimant has a real estate license, contractor's license, or other related business experience or education;
- What was important to the claimant as a buyer, tenant, or property owner; and
- What type of property the claimant was seeking (*e.g.,* a fixer-upper, property in a turn-key condition, or development property).

Counsel should also obtain a detailed chronology from the claimant that provides details of all communications and events related to the transaction, including meetings, telephone conversations, written communications, and inspections of the property. Especially important is whether the claimant kept notes of any of these conversations, and if so, whether the notes were made contemporaneously with the conversations or sometime later.

PRACTICE TIP 1: A client's notes are often considered hearsay and may be inadmissable at trial. See Evid C §1200. However, notes may be used at trial to refresh the client's recollection. Evid C §771. See California Trial Practice: Civil Procedure During Trial §11.65 (3d ed Cal CEB 1995).

PRACTICE TIP 2: After gathering information, including the client's goals, narrative, and timeline, counsel should prepare a letter to the client summarizing and referencing the information. This practice serves to protect counsel from a potential malpractice claim if facts and positions "change" during the course of the litigation.

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§11.4 b. Defendant

Because many real estate contracts require parties to attempt to resolve disputes through mediation, parties often have the ability to investigate disputes prior to the start of litigation. Counsel for a potential defendant may investigate the allegations made by the claimant using pre-litigation demand letters or communications with the claimant's counsel. Defense attorneys should immediately make contact with plaintiff's counsel and extract as much information as possible to review with the defendant. A claimant's counsel who is truly interested in resolving a matter should have no difficulty in providing defense counsel with this information. Defense counsel can also try to determine, from early discussions with claimant's counsel, his or her level of experience and preparation.

Defense counsel (as well as claimant's counsel) should obtain the client's file and ensure that the client preserves all of the original documents. Counsel should instruct the client not to write on the originals as it will later be hard to determine when notes were made. Counsel should have a working copy and a production copy made of all documents and have the client preserve the originals in a safe place. Counsel should impress on the client that all documents should be provided to the attorney so that the attorney is not later surprised by additional documents produced in litigation. Counsel should also fully explain the realities and costs of litigation to the client at the earliest opportunity so that the client has a full understanding of responsibilities and expectations.

Defense counsel should review all available documents, identify and interview all available witnesses who have knowledge of relevant facts, and evaluate the claim. See §§11.2-11.8. If counsel knows that any witness is represented by counsel, all communications must be made through counsel. See Cal Rules of Prof Cond 2-100.

WARNING: Counsel must determine whether it is appropriate to have its client contact other parties who are represented by attorneys. The dangers in doing so include inadvertent admissions, or at least opportunities by the opposing party to claim that the client made admissions, or a contention that counsel asking his client to contact the represented party was an indirect communication with a represented party in violation of Cal Rules of Prof Cond 2-100. See California Civil Discovery Practice §2.34 (4th ed Cal CEB 2006).

PRACTICE TIP: To avoid disputes with clients over the location of original documents, counsel should keep a copy of all relevant documents and return the original file to the client to keep in a safe place. Documents in the file should be numbered and dated when and if produced in the litigation. Before returning the original file to the client, counsel should carefully review the documents to observe whether, for example, different ink appears on key disclosures or signature lines.

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§11.5 2. Reviewing Documents

Numerous documents are generated in the course of a real estate transaction, and counsel should attempt to obtain and review all of them. Counsel must determine who has possession of the documents and review them to see whether they are consistent with the client's recollection of the facts.

Some documents may only be available by subpoena and may not be available during the initial case evaluation. See §12.27 on document subpoenas. It is often helpful, however, to have the client contact the real estate brokerage to request a copy of the transaction file. If the client does this without raising an issue with respect to the claim, the broker may be willing to turn over the file since the client was a party to the transaction. Real estate brokers are required to maintain files for 3 years. Bus & P C §10148(a); 10 Cal Code Regs §2729. For additional discussion, see §3.55. For a discussion of discovery of electronic data, see California Civil Discovery Practice, chap 4 (4th ed Cal CEB 2006).

PRACTICE TIP: Have the client review the documents and prepare a chronology to refresh his or her recollection. The chronology should be prepared for counsel to maintain its confidentiality under the attorney-client privilege. See Evid C §952. Pertinent transaction documents may also be found in the escrow file. Typically, escrow holders will furnish clients with a copy of the file (excepting those particular documents relating solely to the other party) without a subpoena.

There are often two sets of files maintained by a broker: (1) the broker file; and (2) the salesperson's personal file. These files are not always consistent and counsel may find that they contain pearls of information.

It may be important to review the local building department's records to determine whether improvements were made without permits or any citations issued by any public entity against the current owner or any previous owner. It is also important to ask the property owner for any documents he or she obtained when purchasing the property, as well as all documents relating to repairs during his or her ownership. If the owner has made an insurance claim in the past, a claimant may subpoena the insurance records of the owner and the owner's insurance agent and insurance company.

The documents that were submitted to the multiple listing service (MLS), as well as multiple listing advertisements, Internet advertisements, and websites of real estate brokers, are also important to review to determine what representations were made, and whether the salesperson or broker advertises as a specialist in a particular area or neighborhood. For further discussion of the MLS, see §§1.11-1.14.

Counsel should also investigate whether the property was previously listed and obtain documentation from that broker to determine whether other disclosures were made in prior transactions or in prior attempts to market the property. Even if a property had not been previously listed, the owner may have interviewed other brokers and made statements to them concerning the property, resulting in admonitions by the nonlisting broker to the owner. See *Michel v Moore & Assocs.* (2007) 156 CA4th 756, 67 CR3d 797. The owner may have chosen to use another broker because of the admonitions given concerning disclosures by a previous more diligent real estate broker.

PRACTICE TIP: Part of any document review should include a review of the contract documents to determine whether attorney fees are awardable against the principals only or also against the broker. Typically the CAR Residential Purchase Agreement does not include the broker in its attorney fees provision. However, if there is an action that relates to compensation, attorney fees may be recoverable as between the property owner and the listing broker under the listing agreement. See *Hasler v Howard* (2004) 120 CA4th 1023, 16 CR3d 217.

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§11.6 a. Initial Document List

The types of documents that exist will depend on the transaction at issue, but they will generally include:

- Transaction files from all parties;
- Brokers' and parties' notes;
- MLS records (see §1.11-1.14);
- Escrow files;
- Public entity files, including a history of construction permits taken out on the property;
- Inspector files;
- Loan files;
- Photographs and videos;
- Disclosures Regarding Real Estate Agency Relationship (see CC §2079.16; *Huijers v DeMarrais* (1992) 11 CA4th 676, 14 CR2d 232; §§3.8, 3.25);
- Appraiser's files;
- Loan broker's files;
- Lender's files;
- Title insurer's files;
- Print and electronic advertisements;
- E-mails exchanged between parties; and
- Computer files.

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§11.7 b. Additional Documents for Residential Transactions

Counsel should examine all documents that relate to disclosures regarding the property as well as those documents that advise principals of their respective duties, rights, and obligations. In a residential transaction, the most important documents generally include:

- Transfer Disclosure Statement (TDS) required for residential transactions under CC §1102-1102.17 (see §§3.42, 3.78);
- Visual Inspection Disclosure required under CC §2079 in residential transactions in which a seller is not required to fill out a TDS (see §§3.2, 3.42);
- Seller Property Questionnaire;
- Buyer's Inspection Advisory and/or Buyer's and Seller's Statewide Inspection Advisory;
- Real Estate Purchase Agreement, including any counteroffers (see §§2.51-2.56);
- Natural Hazard Disclosure Statement required under CC §§1103-1103.14;
- Disclosures for condominium transfers required under CC §1134;
- Documents in the purchase of a condominium, such as minutes and covenants, conditions, and restrictions (CC&Rs);
- Disclosure and Confirmation of Real Estate Agency Relationships required under CC §2079.14 (see §3.8);
- Preliminary Title Report;
- Buyer's loan applications;
- Home Inspection Report;
- Reports or writings prepared by any inspectors who examined the property on behalf of the buyer, particularly the pest control report; and
- Appraisals performed in connection with the purchase.

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§11.8 3. Identification of Witnesses

Counsel should attempt to identify and interview all available witnesses prior to initiating litigation. These witnesses include all real estate brokers and salespersons, buyers, tenants, property owners, home inspectors (including the physical inspector, soils inspectors, geotechnical inspectors, and other engineering inspectors), contractors, neighbors, loan brokers, escrow and title officers, and managers of the real estate brokerages involved.

These interviews will provide a more complete picture. For instance, the owner may not have known about a defect or may have other reasons explaining why something was not disclosed. Brokers may contradict the buyer's testimony concerning conversations about investigations and disclosures. Interviewing neighbors may be important to determine what information the property owner knew prior to the transaction. Maintenance people may have records showing repairs or maintenance made to the property.

NOTE: The identity of certain witnesses may not be known to the claimant until after the litigation commences and responses to discovery requests are obtained.

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§11.9 4. Investigation of Potential Defendants

Counsel should check the status of the broker's or salesperson's license with the Department of Real Estate (DRE). See chap 9; Bus & P C §§10175-10177.4. See also *Amvest Mortgage Corp. v Antt* (1997) 58 CA4th 1239, 68 CR2d 457. The license status of any other professionals involved in the dispute should also be researched. This may include contractors; pest control, roof, and mold inspectors; geotechnical and structural engineers; arborists; surveyors; and architects.

WARNING: The claimant and the claimant's attorney must be careful not to threaten any disciplinary action in order to gain an advantage in a civil proceeding or to influence the settlement. See Cal Rules of Prof Cond 5-100.

Counsel should verify whether the broker is a member of the National Association of Realtors® (NAR). Any broker who is a member of a local board of realtors is automatically a member of NAR. In the event that the broker is a member of NAR, the NAR Code of Ethics and Standards of Procedure is relevant to the broker's standard of care. See §§1.7, 3.14-3.16, App A; *Norman I. Krug Real Estate Invs. v Praszker* (1990) 220 CA3d 35, 42, 269 CR 228; *Pepper v Underwood* (1975) 48 CA3d 698, 714, 122 CR 343, disapproved on other grounds in *Stout v Turney* (1978) 22 C3d 718, 730, 150 CR 637.

If a buyer purchased the property and then "flipped it" in a short period of time for a substantial profit, counsel should investigate the listing broker's involvement with the buyer. It is important to learn whether the broker was the listing broker in the "flip," or whether the buyer ever promised the broker compensation in the event that the buyer resold the property at the time that the broker was representing the seller. Further, if the purchaser was a limited liability company, seller's counsel should investigate whether the broker was a member of the limited liability company, or whether any relatives of the broker were members. This may support a claim for secret profits. On secret profits, see §§3.35, 3.72-3.74; Bus & P C §10176.

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§11.10 5. Inspection of Property

It is difficult to litigate over property value or defects in property if counsel has not viewed the property and the neighborhood. Experts should also view the property and provide an opinion regarding liability and damages. Claimant's counsel will want the experts to examine the property to build evidence required to prove the claim. The defendant's attorney, on the other hand, may need experts to review the property to develop a defense. Examination of the property should take place after counsel has had an opportunity to obtain and review all available documents that reflect the history of the property and documents reflecting damages associated with the claim. See §11.5.

A claimant's attorney should retain an expert to determine whether there are defects and if it appears that the defects had previously been repaired. Some experts, for example, will testify that evidence of multiple patching reflects knowledge on the part of the owner of a leak. Defense counsel should ask for a premediation inspection of the property to provide access to experts.

PRACTICE TIP: Depending on the amount of the claimant's demand, counsel should determine whether to have experts at a premediation inspection. If the demand is small and counsel decides not to bring experts, an agreement should be entered between the parties to reserve the right for an expert inspection of the property in the future if the matter is not settled at mediation. This enables the parties to keep their costs down prior to mediation and prepare a vigorous defense if the dispute is not settled. An alternative approach, which may be useful in a case with a more substantial claim, is to err on the side of working up the case as much as possible so as to be very prepared for the mediation, including bringing experts to the mediation. Some practitioners report that as many as 70 percent of their cases settle at mediation.

Counsel should consider hiring a variety of experts, depending on the type of claim alleged. If there is a claim of leaks, a contractor or moisture intrusion specialist may be needed. Structural or geotechnical engineers may be required to analyze soils problems or defects which reflect distress in a structure (such as cracking, separations, or other movement). A contractor or cost estimator will be needed to determine the costs of repairs, and an appraiser may be necessary to ascertain the market value of the property. In the event that contamination or mold is suspected, a number of further experts may also be necessary, including a certified industrial hygienist, a hazardous material engineer, and if personal injury claims are being made, a toxicologist or allergist. See Handling Mold Litigation in California (Cal CEB Action Guide September 2007). Unless counsel is personally familiar with real estate industry custom and practice, the early involvement of a real estate expert should also be considered to provide input on such issues as broker standard of care, escrow practices, and customary due diligence to identify issues the attorney otherwise might miss. On using standard of care and other experts as consultants, see §§12.9, 13.14.

PRACTICE TIP: Given the expense of experts, counsel should carefully evaluate the potential claims and the different difficulties particular to some theories and types of damages. For example, proving personal injury arising out of claims of fungal exposure is extremely difficult because there currently is little scientific evidence showing a causal connection between fungal exposure and adverse effects on human health. As to property damage, a crucial issue is whether the claimant is entitled to fair market value of the item of property or the usually higher replacement value.

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B. Identifying Potentially Liable Parties

§11.11 1. Who May Be Liable

Claimant's counsel must identify all potentially liable parties, taking into consideration who has insurance coverage, who has the ability to pay a judgment, joint and several liability issues, whether some parties are subject to arbitration while others are not, and whether the contracts specify any shortened statutes of limitations. Consideration should be given to the following participants in the transaction as potentially liable parties:

- Principals in the transaction;
- Brokers and salespersons;
- Inspectors, *e.g.,* for failing to identify or report property defects, minimizing defects, giving the buyer a false sense of security about the condition of the property (see *Leko v Cornerstone Bldg. Inspection Serv.* (2001) 86 CA4th 1109, 103 CR2d 858 (allowing broker to pursue indemnity against home inspector because both had duty to inspect for defects));
- Title insurance companies, *e.g.,* for failing to discover and report a material title defect or failing to properly record an instrument resulting in lack of priority of a deed of trust (see California Title Insurance Practice (2d ed Cal CEB 1997));
- Notary publics, *e.g.,* for negligently acknowledging a document that was altered, for notarizing documents that were fraudulently prepared, or in identity theft situations;
- Escrow holders, *e.g.,* for breach of contract or breach of fiduciary duties;
- Mortgage brokers involved in procuring loans;
- Lenders, *e.g.,* involved in predatory lending practices or who failed to provide appropriate truth-in-lending disclosures (see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 12 (4th ed Cal CEB 2009));
- Appraisers, *e.g.,* who may have improperly inflated appraisals (but see *Soderberg v McKinney* (1996) 44 CA4th 1760, 1769, 52 CR2d 635, delineating types of claims allowed against appraisers by nonclients); or
- Others who may have conspired with brokers or salespersons or other parties to defraud a buyer, tenant, owner, or borrower.

PRACTICE TIP: Counsel should carefully consider the potential parties and refrain from the all-too-frequent reaction of including everyone tangentially related to the property as a defendant (or cross-defendant). Making the litigation larger, more complicated, and unwieldy is not always desirable or affordable. Nor is suing parties who really have not committed any misdeeds, errors, or omissions. Plaintiff's counsel may want to consider simplifying the claim by only suing the perceived "most culpable" defendant if he or she is financially viable, since joint and several liability applies to the majority of these claims. Defense counsel should also consider not filing cross-complaints against other parties already named in the suit (see §11.88A), as doing so may only serve to help the plaintiff.

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2. Liability Based on Broker's Form of Business

§11.12 a. Corporation

A claimant must determine the form of business under which the broker and any other defendants are operating: sole proprietorship, partnership (see Bus & P C §10137.1), or corporation.

A broker may form a corporation to insulate the designated officer (who individually holds a broker's license) from personal liability. See Bus & P C §10211; §8.30. If feasible, the corporation should obtain errors and omissions (E&O) insurance that covers not only the broker, but all employees and salespersons, for any claims arising out of their professional services. On E&O policies generally, see chap 10. It is also important for brokers to train their salespersons to recommend inspectors who are not only competent, but who also carry their own E&O insurance. Having insured inspectors avoids leaving the broker as the only insured party, a difficult situation since the damages in most broker cases are economic in nature, and liability is joint and several. CC §1431. Most brokers suggest to their salespersons that they recommend several different inspectors to their principals and allow the principal to choose which ones they wish to hire. On the relationship between brokers and salespersons, see §§1.3, 8.32-8.42.

The designated officer of a corporation is generally an improper party to join when the officer was not personally involved in the subject transaction. See *Walters v Marler* (1978) 83 CA3d 1, 35, 147 CR 655, disapproved on other grounds in *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551. Compare *Holley v Crank* (9th Cir 2004) 386 F3d 1248, 1255 (allowing liability of the designated officer in a discrimination suit).

If the broker is a small corporation or holds insufficient insurance, a claimant may consider, the viability of claims against the officers, directors, or shareholders based on an alter ego theory. See *Schoenberg v Romike Props.* (1967) 251 CA2d 154, 165, 59 CR 359. See also Counseling California Corporations §§3.78-3.86 (3d ed Cal CEB 2008). An officer who personally authorizes, directs, or participates in the wrongdoing will also be personally liable. See *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 785, 157 CR 392.

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§11.13 b. Partnerships

When a brokerage is a partnership, which is rare, the claimant should consider naming each partner individually in the lawsuit. All members of a partnership are bound by the fraud of any individual partner acting within the scope of his or her authority in a partnership transaction with an innocent third party, and can be liable for the injury caused by the fraud. *Stout v Turney* (1978) 22 C3d 718, 723 n6, 150 CR 637. See §8.32.

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§11.14 c. Sole Proprietorship

Some brokerages operate as sole proprietorships, which may be a less expensive method of operating if the brokerage consists of only one person. However, if the broker has any other salespersons working under his or her license, the broker is personally liable for any claims arising from the salesperson's conduct.

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§11.15 3. Vicarious Liability

Under the common law of agency, a salesperson operates as an agent of the broker, and the broker generally bears vicarious liability for the acts of the agent. See chap 3. Brokers may also be held liable for the acts of their employees performed within the scope of their employment under the common law theory of respondeat superior. *Gipson v Davis Realty Co.* (1963) 215 CA2d 190, 209, 30 CR 253 (salesperson's negligence in car accident). Liability is not limited to negligence, but it may include malicious acts and other intentional torts. *Alhino v Starr* (1980) 112 CA3d 158, 174, 169 CR 136. For purposes of tort liability under respondeat superior, a salesperson is considered a broker's agent, regardless of whether the salesperson would be classified as an independent contractor for other purposes. See *Grubb & Ellis Co. v Spengler* (1983) 143 CA3d 890, 895, 192 CR 637.

If, however, the alleged wrongful act was demonstrably outside the salesperson's scope of employment and what was permissible by the brokerage, the brokerage might be able to avoid liability for the salesperson's actions (*e.g.,* a salesperson selling non–real estate investments without the knowledge or consent of the broker, or a salesperson soliciting and arranging for loans when the brokerage is only involved in the sales of real property). See §§3.56-3.58 on a broker's duty to supervise salespersons and the establishment and implementation of policies, rules, and procedures for overseeing transactions requiring a real estate license.

PRACTICE TIP: Brokers should consider modifying their independent contractor agreements with salespersons to specifically identify the parameters of the services provided by them. For brokerages that are members of CAR, this may require amending the CAR form Independent Contractor's Agreement, which tends to incorporate all services for which a real estate license is allowed.

For discussion of real estate salespersons as independent contractors, see §§8.32-8.42.

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§11.16 a. Tort Liability

Generally, an employee is considered to have committed a tort during the course of employment if the act was either required by or incident to the employee's duties, or the misconduct could have been reasonably foreseen by the employer. *Alhino v Starr* (1980) 112 CA3d 158, 173, 169 CR 136. In order to perform real estate services, a salesperson must not only have a license but must also be employed by a licensed broker. Bus & P C §10132. If the tort was committed by a salesperson in the course of licensed activities, the tort may fall under the broker's license and within the course and scope of employment based on DRE broker regulations (see chap 8). Even if the salesperson committed the tort in the course of performing real estate services without the broker's knowledge, it may fall under the broker's license and thus be within the scope of employment based on this regulatory scheme. See *Resnik v Anderson & Miles* (1980) 109 CA3d 569, 572, 167 CR 340.

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§11.17 b. Assumption of Liability

A principal may also adopt or ratify an agent's act or signature on a document expressly or by implication based on the principal's conduct. See *Behniwal v Mix* (2005) 133 CA4th 1027, 1040, 35 CR3d 320.

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§11.18 II. CLAIMS AND DEFENSES

Claims that arise in broker litigation can vary tremendously depending on the type of transaction involved and the gravamen of the dispute. Plaintiffs may allege claims for intentional interference with economic advantage, intentional infliction of emotional distress, unfair competition, and breach of contract. See §§4.41-4.51, 7.23. However, the majority of claims typically alleged in real estate broker litigation are based on:

- Negligence (see §§11.19-11.26);
- Breach of various statutorily imposed duties (see §§11.27-11.36);
- Fraud and deceit (misrepresentation and concealment) (see §§11.37-11.47); and
- Breach of fiduciary duty (see §§11.48-11.70).

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§11.19 A. Negligence

Negligence arises when a broker who owes the plaintiff a legal duty of care breaches that duty of care by act or omission, and the breach proximately causes damage to the plaintiff. See §§11.20-11.23. Depending on the nature of the claims and the contracts involved in the transaction, several defenses may be available to defeat the claim. See §§11.24-11.26.

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§11.20 1. Broker Duties

A broker owes a duty to all parties to a transaction to use reasonable care, skill, and diligence. *Smith v Rickard* (1988) 205 CA3d 1354, 1364, 254 CR 633; *Timmsen v Forest E. Olson, Inc.* (1970) 6 CA3d 860, 871, 86 CR 359; chap 3. See also the duties listed in CC §2079.16 (Disclosure Regarding Real Estate Agency Relationship). There are few cases in California that analyze a pure negligence theory against a real estate broker, since most cases usually include allegations of breach of fiduciary duty and constructive fraud, breaches of various statutory duties, negligent misrepresentation, or even negligent nondisclosure. See, *e.g., Ford v Cournale* (1973) 36 CA3d 172, 111 CR 334. However, examples of pure negligence include negligent recommendation of an inspector or vendor, negligence in analyzing whether a fact should have been disclosed (*e.g.,* a repaired problem or something impacting a neighborhood as opposed to the subject home), or failure to perform a competent inspection of the property. See *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383, discussed in §11.28.

The broker's duty of care, skill, and diligence can be breached through the broker's own conduct, or that of a salesperson or associated broker employed by the broker, such as by failing to perform the necessary research and investigation in order to acquire reasonably obtainable important information that will affect the principal's decision. See *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 73 CR2d 784 (failure to research title issues); *Wilson v Hisey* (1957) 147 CA2d 433, 305 P2d 686 (failure to advise title search on leased property). However, the cases treating this issue typically involve a claim for breach of fiduciary duty. For example, a listing broker would not owe a duty of research and investigation to the buyer, other than what is required in CC §§2079-2079.5. See *Robinson v Grossman* (1997) 57 CA4th 634, 643, 67 CR2d 380 (listing broker had no duty to buyer to independently verify disclosures made by seller).

A broker's careless setting of a sales price may constitute negligence. See *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 177 CR 882. A broker is negligent when giving a buyer a "broker's statement" containing information provided by the seller on the purported income and expenses for investment property which the broker made no attempt to verify, and recommending on that basis that the buyer purchase the property. See *Ford v Cournale, supra*.

A real estate broker's duties may be limited by the express provisions in the listing agreement and deposit receipt. See *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734 (fiduciary duty was defined and limited by terms of agency agreement so no duty to provide tax advice). *Carleton* may limit other duties when used in context with CAR forms such as the Buyer's Inspection Advisory or the Buyer and Seller's Statewide Advisory. The transaction forms in *Carleton* included exculpatory provisions that are similar to those that appear in some of the CAR forms. Although liability disclaimers may not be enforceable to prevent a fraud claim as a matter of law (see *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 55 CR3d 59), they should be admissible as evidence of warnings to a buyer or seller for comparative fault purposes, evidence of a lack of justifiable reliance in a fraud and deceit claim, and evidence of lack of reasonable reliance in a negligent misrepresentation claim.

In *Manderville*, the court of appeal reversed summary judgment in favor of brokers, noting that a right to investigate is not the same as an obligation to investigate. Moreover, under CC §1668 a party may not be contractually exempted from liability for intentional misrepresentation since exculpatory clauses are against public policy.

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§11.21 2. Negligent Drafting

Real estate brokers have a duty to all parties involved in a transaction to draft documents that clearly reflect the terms of an agreement. Negligence in drafting the purchase agreement and escrow instructions, which causes the principal to receive significantly less than the consideration bargained for, is actionable. *Perry v Robertson* (1988) 201 CA3d 333, 336, 247 CR 74. Negligent drafting may also be an unauthorized practice of law for which a broker may be held to the standard of an attorney. See Bus & P C §6125; *McKay v Longsworth* (1989) 211 CA3d 1592, 1596, 260 CR 250. This type of claim can also give rise to "tort of another" damages (a plaintiff may recover attorney fees from a defendant if the plaintiff is required to employ counsel to prosecute or defend an action against a third party because of the tort of the defendant, *e.g.,* environmental cleanup responsibilities or removal of old liens), which may ultimately lead to a claim against the broker for all of the attorney fees incurred by both parties in litigating the ambiguous provision. See California Attorney Fee Awards §9.4 (2d ed Cal CEB 1994).

In *Tackett v Croonquist* (1966) 244 CA2d 572, 53 CR 388, a broker who drafted an ambiguous lease option, which included both a provision calling for an option at the end of the lease and a first right of refusal, was negligent. The ambiguous lease provision caused the seller/landlord to take the position that there was a first right of refusal, while the buyer/tenant took the position that it was a true lease option. The lease also erroneously identified the location of property to be received in exchange, leading to an error in valuation.

A broker who misrepresents the size of the property or fails to inform the buyer that the property contains less acreage than is represented in the sales documents is negligent. See *Overgaard v Johnson* (1977) 68 CA3d 821, 823, 137 CR 412. See also *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463 (buyer's broker negligently passed on incorrect information concerning lot's size without independent verification).

In *Salahutdin*, the broker was liable because she didn't tell the client she had not personally verified the information. Had she made that disclosure, the fact that she didn't check it out herself would not have mattered. Standard practice for a broker is not to verify this type of information, but to make it clear that he or she has not done so.

A broker who advises on areas outside the broker's knowledge and experience may also be negligent. If a broker undertakes a duty that was not owed and then performs such obligation in a negligent manner, there is liability for any losses resulting from such conduct. This could include undertaking to advise a client regarding tax considerations, and then doing so incorrectly. See *Santos v Wing* (1961) 197 CA2d 678, 684, 17 CR 457 (broker not liable because principal was advised to consult counsel). See also *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734 (no duty to give tax advice when contract says broker will not do so).

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§11.22 3. Standard of Care

Brokers are typically held to the higher standard of care of a professional, and they may be sued for falling below this standard. See *Montoya v McLeod* (1985) 176 CA3d 57, 65, 221 CR 353; *Brady v Carman* (1960) 179 CA2d 63, 68, 3 CR 612; CC §§2079.2.

In addition, the NAR Code of Ethics (see §11.9) may be admissible as evidence of the standard of care owed by the broker, provided that the broker is a member of NAR. See App A; *Norman I. Krug Real Estate Invs. v Praszker* (1990) 220 CA3d 35, 42 n2, 269 CR 228; *Pepper v Underwood* (1975) 48 CA3d 698, 714, 122 CR 343, disapproved on other grounds in *Stout v Turney* (1978) 22 C3d 718, 730, 150 CR 637. See also §§1.7, 3.14-3.16.

Typically, however, the standard of care in most cases is established by an expert witness. See chap 13 on standard of care expert witnesses.

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§11.23 4. Duties to Third Parties

Brokers have a fundamental duty to deal honestly and fairly with all parties in a transaction. CC §2079; *Norman I. Krug Real Estate Invs. v Praszker* (1990) 220 CA3d 35, 42, 269 CR 228. See §§3.45-3.47. This duty usually translates into duties to disclose information which may be material to the buyer or tenant, the property owner, and others involved in the transaction, such as a lender. *Zikratch v Stillwell* (1961) 196 CA2d 535, 16 CR 660. The broker's disclosure duty to his or her client is a fiduciary duty and arises on the creation of the principal-broker relationship (*i.e.,* even before the purchase contract is created). *Exxess Elecronixx v Heger Realty Corp.* (1998) 64 CA4th 698, 75 CR2d 376. Material facts include any facts that might influence the price the principal is willing to pay or receive, including the principal's willingness to sell or buy. *Rattray v Scudder* (1946) 28 C2d 214, 169 P2d 371; *Fisher v Losey* (1947) 78 CA2d 121, 177 P2d 334. See §§3.39-3.42.

A broker who has no agency relationship with any party to a transaction but who nevertheless misleads a prospective purchaser may still have liability to the prospective purchaser. See *Nguyen v Scott* (1988) 206 CA3d 725, 735, 253 CR 800 (listing broker who failed to transmit written purchase offer to principal and bought property himself at lower price, breached duty of honesty and truthfulness to prospective purchaser).

Several cases have addressed a listing broker's duties to a buyer based on a general duty of disclosure. See *Lingsch v Savage* (1963) 213 CA2d 729, 736, 29 CR 201; *Easton v Strassburger* (1984) 152 CA3d 90, 104, 199 CR 383. *Easton* was clarified and codified in CC §§2079-2079.5. See also §11.28. A broker acting as a property manager may also have obligations to tenants similar to that of a property owner, to warn tenants of defects in property under a premises liability theory. See *Merrill v Buck* (1962) 58 C2d 552, 561, 25 CR 456.

In determining whether there are duties owed to third parties, a court will weigh factors such as:

- The extent to which the transaction was intended to benefit the third party;
- The foreseeability of the harm;
- The degree of certainty that the third party would be harmed;
- The moral blame attached to the broker conduct; and
- The policy of preventing future harm.

See *Biakanja v Irving* (1958) 49 C2d 647, 650, 320 P2d 16.

The broker's duty may not always be extended to third parties, even when the damages are foreseeable. In *FSR Brokerage, Inc. v Superior Court* (1995) 35 CA4th 69, 41 CR2d 404, a court found that the broker owed no duty to guests of a buyer when a deck collapsed and guests were injured. This rationale was extended in *Coldwell Banker Residential Brokerage Co. v Superior Court* (2004) 117 CA4th 158, 11 CR3d 564, which held that the children of a buyer could not sue a broker for alleged mold-related bodily injury claims. In each case, the courts held that the guests or children were not clients of the broker, and did not rely on any misrepresentation or concealment by the broker. Such rationales are extensions of *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 11 CR2d 51, and have also been extended to appraisers. See *Soderberg v McKinney* (1996) 44 CA4th 1760, 52 CR2d 635; *Christiansen v Roddy* (1986) 186 CA3d 780, 231 CR 72.

For more on broker duties to third parties, see §§3.71-3.87.

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B. Defenses to Negligence Claims

§11.24 1. Contractual Disclaimers and Exculpatory Clauses

Defense counsel representing brokers should carefully examine the documents to determine what disclaimers are provided. However, in the context of fraud actions, many disclaimers may violate public policy. See *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 1499, 55 CR3d 59 (broker could not rely on exculpatory provision to show lack of reliance on misrepresentation as a matter of law); *McClain v Octagon Plaza, LLC* (2008) 159 CA4th 784, 794, 71 CR3d 885 (landlord's misrepresentation regarding square footage was actionable despite disclaimer language in the lease). Contractual provisions that attempt to exempt someone from responsibility for fraud, whether willful or negligent, are unenforceable. In a negligence action, such disclaimers may be enforceable. CC §1668. See also *Shapiro v Hu* (1986) 188 CA3d 324, 332, 233 CR 470 ("as is" provision does not protect seller when seller, through fraud or misrepresentation, intentionally conceals material defects not otherwise visible or observable). See also discussion in §§2.54-2.56, 3.80.

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§11.25 2. Comparative Negligence

In a pure negligence case (as distinguished from a negligent misrepresentation case, which is a species of fraud and deceit), the plaintiff's own negligence may be considered as contributing to the damage incurred. See CACI 405, allowing reduction of damages by the percentage of plaintiff's fault. Comparative negligence can be found in a buyer's failure to conduct a more than cursory inspection of the property or failing to heed a broker's advice to have additional inspections made or to consult with an attorney or tax advisor. Additionally, parties to a contract may themselves be negligent in failing to carefully review the contract to determine if its terms are ambiguous.

A listing broker should consider raising defensively the negligence of the buyer's broker to reduce any recovery of the plaintiff or to apportion liability to the buyer's broker. Jury instructions allow for the apportionment of damages when the negligence of other parties was a substantial factor in causing harm to the plaintiff. See CACI 406.

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§11.26 3. Obvious Conditions

A broker may defend against a negligence claim by arguing that he or she had no duty to alert a plaintiff to a defect that was obvious. *McCollum v Friendly Hills Travel Ctr.* (1985) 172 CA3d 83, 217 CR 919 (travel agent had no duty to warn of dangerous conditions clearly obvious and apparent to travelers). See CC §2079.5 (a buyer or prospective buyer has a duty to exercise reasonable care to protect himself or herself, including those facts that are known to or within the diligent attention and observation of the buyer or prospective buyer). See also *Driver v Malone* (1970) 11 CA3d 746, 90 CR 98; *Lingsch v Savage* (1963) 213 CA2d 729, 736, 29 CR 201; *Carpenter v Hamilton* (1936) 18 CA2d 69, 62 P2d 1397.

A broker's duty may also be limited based on the principal's conduct and extensive knowledge, experience, and sophistication in real estate matters. See *Stevens v Hutton* (1945) 71 CA2d 676, 684, 163 P2d 479 (no duty to disclose facts if intelligent, well-informed principals manifest that they know all material facts or are willing to deal without knowing them).

A broker has no duty to call a homeowners association to inquire if any construction defect problems existed or if the association filed any lawsuit alleging construction defects. *Padgett v Phariss* (1997) 54 CA4th 1270, 63 CR2d 373.

In *Assilzadeh v California Fed. Bank* (2000) 82 CA4th 399, 98 CR2d 176, the broker, a dual agent, disclosed that a lawsuit for construction defects at the property had been filed and settled. The court found that the broker had satisfied its fiduciary duty by putting the buyer on notice of the need to investigate further and review the court files. 82 CA4th at 411. In essence, the court shifted the burden to the buyer to protect herself by investigating the lawsuit further once disclosure was made by the broker. See also *Pagano v Krohn* (1997) 60 CA4th 1, 70 CR2d 1.

There is no obligation on the part of a broker to explain the legal ramifications of a disclosed fact. *Sweat v Hollister* (1995) 37 CA4th 603, 609, 43 CR2d 399, disapproved on other grounds in *Santisas v Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830 (once flood plain was disclosed there was no duty to explain subsequent consequences to buyer).

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§11.27 C. Negligence Per Se

Because several statutes govern the conduct of real estate brokers, a claimant may pursue a number of statutory claims. Statutory theories of liability are permitted when a broker or salesperson breaches a specific statutory requirement or prescription, causing damage to a party. In a negligence per se claim, a defendant breaches either a statutory duty or the common law duty of due care, with the statute confirming the duty or prescribing the standard or extent of care required.

If a claimant is within the class of persons that a statutory provision was designed to protect, the courts may recognize a right of action using a suitable existing cause of action or a new cause of action analogous to an existing cause of action. For example, in *Pintor v Ong* (1989) 211 CA3d 837, 259 CR 577, the court affirmed an award of tort damages based on the defendant's violation of CC §2941 (duty of mortgagee to execute certificate or discharge). The plaintiff had pleaded and proved the statutory duty, breach of the duty, causation, and damages. The court held that there was no need to prove negligence, intentional tort, or tortious breach of the good faith covenant. 211 CA3d at 843.

California courts have limited the ability of an individual to maintain a private right of action under Restatement (Second) of Torts §874(a) (1979). No private right of action exists when there is a comprehensive regulatory scheme to address a problem, unless the statute specifically provides for a private right of action. See *Goehring v Chapman Univ.* (2004) 121 CA4th 353, 376, 17 CR 3d 39; *Crusader Ins. Co. v Scottsdale Ins. Co.* (1997) 54 CA4th 121, 125, 62 CR2d 620. See also *Bay Cities Paving & Grading, Inc. v Hensel Phelps Constr. Co.* (1976) 56 CA3d 361, 366, 128 CR 632; *Laczko v Jules Meyers, Inc.* (1969) 276 CA2d 293, 295, 80 CR 798.

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§11.28 1. Civil Code §§2079-2079.6: Inspection and Disclosure Duties

Under CC §§2079-2079.6, brokers bear a statutory duty to inspect the property that is the subject of a real estate transaction in which they are involved. The statutes are the legislative expression and clarification of a common law duty originally recognized in *Easton v Strassburger* (1984) 152 CA3d 90, 104, 199 CR 383. See CC §2079.12 for the statement of legislative intent to codify *Easton*.

Section 2079 provides that in sales transactions involving residential property comprising one to four dwelling units

> [i]t is the duty of a real estate broker or sales person, … to a prospective purchaser of residential real property comprising one to four dwelling units or a manufactured home… to conduct a reasonably competent and diligent inspection of the property offered for sale and to disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal, if that broker has a written contract with the seller to find or obtain a buyer or is a broker who acts in cooperation with that broker to find and obtain a buyer.

Section 2079.2 sets forth a "standard of care" defined as "the degree of care that a reasonably prudent real estate licensee would exercise, and is measured by the degree of knowledge through education, experience and examination, required to obtain a license."

The scope of the inspection is limited. Under CC §2079.3, it does not include

> an inspection of areas that are reasonably and normally inaccessible to such an inspection, nor 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 and, if the property comprises a unit in a planned development… a condominium… or a stock cooperative, … does not include an inspection of more than the unit offered for sale, if the seller or the broker complies with the provisions of [CC] §1368.

In addition, CC §1368 provides that certain documents must be given to a buyer of a condominium. These include the governing documents of the common interest development, operating rules such as articles of incorporation, any restrictions in the governing documents, operating budgets, the amount of regular and special assessments levied on the owner's interest, notices of any violations of the governing documents that have an impact on the unit, and a copy of a preliminary list of defects required under CC §1375 (providing for actions for damages against common interest developers).

For more on a broker's statutory duty to inspect and disclose, see §§3.38-3.42.

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§11.29 2. Civil Code §§1102-1102.17: Duty to Deliver Transfer Disclosure Statement

Civil Code §1102.3 requires that the "transferor" of any real property containing one to four dwelling units deliver to the prospective transferee the written statement set forth in CC §1102.6. This statement is commonly known as a Transfer Disclosure Statement (TDS). See California Real Property Sales Transactions §§6.29-6.37 (4th ed Cal CEB 2007). The statutory scheme makes the buying and selling brokers responsible for completing portions of the TDS based on their CC §2079 inspection; the broker who has "obtained the offer made by the transferee" is responsible for delivery of the TDS, unless the seller gives other written instructions for delivery. CC §1102.12. A broker's willful or negligent failure to deliver the TDS to the buyer can give rise to liability for "actual damages suffered" by the buyer. CC §1102.13. This does not, however, expand the measure of damages beyond what is permitted under CC §3343. See *Saunders v Taylor* (1996) 42 CA4th 1538, 50 CR2d 395.

NOTE: Counsel should be aware that CC §§1102-1102.17 do not require disclosures by the broker. Instead, disclosures are mandated by CC §2079 and common law. See §11.28.

Delivery of the TDS is a nonwaivable condition precedent to the buyer's duty of performance. See *Realmuto v Gagnard* (2003) 110 CA4th 193, 201, 1 CR3d 569. If the transaction is a sale, the TDS must be delivered as soon as practicable before transfer of title. CC §1102.3(a). If the transaction is a lease with an option to purchase, a ground lease coupled with improvements, or an installment sale land contract, then the TDS must be delivered as soon as practicable before making or accepting an offer. CC §1102.3(b). Similar transfer disclosure rules apply for a resale transaction involving manufactured homes and mobile homes when they are classified as personal property and intended for use as a residence. See CC §1102.3(a). Further, the delivery of a TDS may not be waived in an "as is" sale. See CC §1102.1(a); *Loughrin v Superior Court* (1993) 15 CA4th 1188, 19 CR2d 161.

Section III of the TDS states, "The undersigned [broker] based on the above inquiry of the seller(s) as to the condition of the property, and based on a reasonably competent and diligent visual inspection of the accessible areas of the property in conjunction with that inquiry, states the following:" Although no California cases have dealt specifically with this point, the language of the statement referencing "above inquiry" gives the broker the defense that the "inquiry" required is simply that contained in the seller's sections of the TDS (*i.e.,* section II thereof). See *Robinson v Grossman* (1997) 57 CA4th 634, 644, 67 CR2d 380 (no duty for listing broker to verify accuracy of seller's disclosure).

Although the listing broker has no duty to make further inquiry of the seller to verify that the disclosures are true, prudent practice dictates that the listing broker make such inquiry if there is an obvious inconsistency between what the broker notes in a visual inspection or knows about the property from other sources. At a minimum, the listing broker should disclose the inconsistency to the buyer in the broker's section of the TDS. The buyer's agent has a duty to make further inquiry to follow up on "red flags" (see *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 73 CR2d 784), or at least disclose the red flag to the buyer and counsel the buyer to make further inquiry.

The TDS is not required in certain transfers, including transfers pursuant to a court order, by a mortgagor or successor-in-interest who is in default, by a fiduciary in the course of an administration of a decedent's estate, between co-owners, between spouses, from a foreclosure sale or post-foreclosure sale, or transfers or exchanges to or from a government agency. CC §1102.2.

WARNING: Both CAR and Professional Publishing provide forms for brokers and salespersons to use as a checklist to be sure that full and complete disclosure of the condition of the property is made. These forms are a two-edged sword in that their use may assist in full disclosure, but a sloppy or incomplete form could be evidence of negligence. Further, such forms may require disclosures beyond the skill and knowledge of the broker or salesperson and may result in ill-founded statements or red flags that the broker knew or should have known that further inquiry is necessary.

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§11.30 3. Quasi-Contractual Theory

A claimant may consider a quasi-contractual theory (*i.e.,* that the statutory liability is a contract implied by law) to avoid limitations on tort remedies that might otherwise apply. See 3 Witkin, California Procedure, *Actions* §143 (5th ed 2008). In a quasi-contractual action based on the broker's statutory duty to deal honestly and fairly with all parties to the transaction, the court allowed a buyer, who had suffered no out-of-pocket loss, to recover secret profits gained by the listing broker. *Ward v Taggart* (1959) 51 C2d 736, 336 P2d 534. On secret profits, see §§3.35, 3.72-3.74; Bus & P C §10176.

If the statute contains procedural provisions in the nature of contract remedies, the court may treat the action as one in quasi-contract even if it is pleaded as a tort action. See 3 Witkin, California Procedure, *Actions* §§143, 664 (5th ed 2008). For instance, when provisions in a fire liability statute provide that the liability is a "debt" to be collected in the same manner as an obligation under a contract, the courts treat the action as a contract action for other purposes, despite how the action is pleaded. See *People v Zegras* (1946) 29 C2d 67, 172 P2d 883; *People v Wilson* (1966) 240 CA2d 574, 576, 49 CR 792 (statute of limitations).

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D. Defenses to Negligence Per Se

1. Defenses to CC §2079 Claims

§11.31 a. Inspection Was Reasonably Competent and Diligent

In defending against claims of negligent inspection of the property, a broker may argue that the defect alleged by the claimant was not within the scope of a "reasonably competent and diligent" visual inspection as required by the statute. See CC §2079; §§3.42, 11.28. Nor does the CC §2079 inspection "include or involve an inspection of areas that are reasonably and normally inaccessible to such an inspection" (CC §2079.3). *Wilson v Century 21 Great Western Realty* (1993) 15 CA4th 298, 307, 18 CR2d 779. If, for example, a home inspector's report shows that the inspector did not find a problem, then, arguably a broker could not be expected to find it, since the broker has less background and experience in construction than does the inspector, whose assessment of the property is broader in scope.

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§11.32 b. Statute of Limitations

A lawsuit for any duty imposed by CC §§2079-2079.24 must be brought within 2 years from "the date of possession, which means the date of recordation, the date of close of escrow, or the date of occupancy, whichever occurs first." CC §2079.4. The statute of limitations covers not only negligence claims, but also negligent misrepresentation claims. See *Loken v Century 21-Award Props.* (1995) 36 CA4th 263, 271, 42 CR2d 683. However, the limitations period does not apply to an intentional fraud claim. See *Williams v Wells & Bennett Realtors* (1997) 52 CA4th 857, 61 CR2d 34.

While CC §2079 applies to a licensee who "has a written contract with the seller to find or obtain a buyer, or is a broker who acts in cooperation with that broker to find and obtain a buyer," in *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 21, 73 CR2d 784, the court held that this language does not apply to a buyer's broker who stands in a fiduciary relationship with the buyer. Thus, the statute of limitations contained in §2079.4 cannot be raised by the buyer's broker as a defense.

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§11.33 c. Comparative Negligence; Open and Obvious Conditions

A buyer must "exercise reasonable care to protect himself or herself, including those facts which are known to or within the diligent attention and observation of the buyer or prospective buyer." CC §2079.5. A buyer is comparatively at fault (see §11.25), or there is no liability, if the condition is open and obvious (see §11.26). A buyer's broker's negligence may also be imputed to the buyer. See CC §2338.

Under the common law, neither the listing nor the buyer's broker has an independent duty to verify the accuracy of the property owner's disclosures. *Robinson v Grossman* (1997) 57 CA4th 634, 644, 67 CR2d 380. Further, it is incumbent on the purchaser to investigate and make its own decision after reviewing the required disclosures. *Robinson v Grossman*, *supra; Assilzadeh v California Fed. Bank* (2000) 82 CA4th 399, 414, 98 CR2d 176. A broker may also defend himself or herself by showing that the principal was informed that the information communicated came from another source, and had not been independently verified by the broker. *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 562, 29 CR2d 463.

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§11.34 d. No Duty Owed

Civil Code §2079 obligations apply only to the sale of residential real property comprising one to four dwelling units or a manufactured home; brokers do not owe a statutory inspection duty to purchasers of commercial property or residential property with more than four dwelling units. CC §§2079-2079.24; *Smith v Rickard* (1988) 205 CA3d 1354, 1361, 254 CR 633.

A broker has no duty to explain the legal or practical implications of disclosed facts. *Pagano v Krohn* (1997) 60 CA4th 1, 70 CR2d 1. See also *Sweat v Hollister* (1995) 37 CA4th 603, 609, 43 CR2d 399, disapproved on other grounds in *Santisas v Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830 (once flood plain was disclosed there was no duty to explain subsequent consequences to buyer). Nor is there a statutory or common law duty to discover and disclose matters regarding pending construction defect litigation that property owners failed to disclose when a visual inspection of the property provides no reason to conduct a further investigation. *Padgett v Phariss* (1997) 54 CA4th 1270, 63 CR2d 373; *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734 (no duty to explain tax consequences of transaction).

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2. Defenses to CC §1102 Claims

§11.35 a. Owner's Failure to Complete TDS

Several defenses relating to requirements associated with the Transfer Disclosure Statement (TDS) are available. The disclosures are required by the property owner, not the broker. CC §1102.3. Although the broker's disclosures are made on the TDS, the disclosure obligations are actually found in CC §2079 and common law, not CC §§1102-1102.17. If a broker or a salesperson is unable to obtain the completed TDS from the seller, the broker or salesperson is relieved of liability for failing to deliver the TDS to the buyer if the broker or salesperson receives the buyer's written assurance that the buyer has received the TDS or advises the buyer in writing of the right to receive the disclosure. CC §1102.12. The broker must maintain, for 3 years after the transaction closed, a record of actions taken to try to comply with the TDS requirement. CC §1102.12. Requirements relating to a broker's retention of documents are set forth in Bus & P C §10148. See §§3.55, 11.5.

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§11.36 b. No Personal Knowledge; Information Provided by Others

Under CC §1102.4(a), a defense is available to a real estate broker or salesperson against liability for any error, inaccuracy, or omission of any information delivered in the TDS if the error, inaccuracy, or omission was not within the personal knowledge of the broker or salesperson. A broker or salesperson will also not be liable if the misinformation was based on "information timely provided by public agencies or by other persons providing information as specified in subdivision (c)." Section 1102.4(c) provides that "delivery of a written or oral report or opinion prepared by certain experts is sufficient compliance" to qualify for the subsection (a) exemption from liability.

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§11.37 E. Fraud and Deceit

The most common claims made against real estate brokers are for fraud and deceit, as most brokers are sued for either (1) failing to provide a principal with information or (2) negligently or intentionally misrepresenting the information. Fraud is statutorily defined as either actual fraud or constructive fraud. Actual fraud is further defined as intentional misrepresentation, negligent misrepresentation, nondisclosure or concealment, and promissory fraud. CC §§1571-1574. Generally:

- Actual fraud is the deception by a party to a contract, or one acting with the connivance of a party, with the intent to deceive another party to the contract or induce that party to enter into the contract (CC §1572). See §§4.11-4.12, 11.38-11.39.
- Intentional misrepresentation is a suggestion as fact of something that is not true by one who does not believe it to be true. (CC §§1572(1), 1710(1)). For example, in *Storage Servs. v Oosterbaan* (1989) 214 CA3d 498, 262 CR 689, the listing broker, when asked by a prospective buyer whether a state agency was interested in buying the property, acted fraudulently by responding that the state was not interested, even though an authorized agent of the state had repeatedly expressed to the broker an interest in buying the property. See also §4.13.
- Negligent misrepresentation is defined as a positive statement, in a manner not warranted by the information of the person making it, of something that is not true, though he or she believes it to be true. CC §1572(2). For example, if a broker erroneously states to a buyer that property is a full ten acres, without making an adequate investigation to determine the acreage, there is a negligent misrepresentation. See *Byrum v Brand* (1990) 219 CA3d 926, 942, 268 CR 609. See also *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463 (discussion of negligent misrepresentation versus constructive fraud); *Wilson v Century 21 Great W. Realty* (1993) 15 CA4th 298, 306, 18 CR2d 779 (no negligent misrepresentation when broker made no positive statement). See also §4.14.
- Nondisclosure or concealment is the suppression of "that which is true by one having knowledge or belief of the fact." CC §§1572(3), 1710(3). See *Kallgren v Steele* (1955) 131 CA2d 43, 279 P2d 1027. See also §4.15.
- Promissory fraud is the making of a promise "by one without any intention of performing it." CC §§1572(4), 1710(4). See *Reton v J.D. Millar Realty Co.* (1933) 132 CA 708, 23 P2d 419. See also §4.16.
- The statutory definition of actual fraud also contains the catch-all of "any other act fitted to deceive." CC §1572(5). For example, in *Brady v Carman* (1960) 179 CA2d 63, 68, 3 CR 612, in response to a buyer's question about an easement, the listing broker gave evasive, misleading responses that discouraged further investigation, such as "nothing for you to worry about," and "the easement is not on your lot." Having undertaken to answer the buyer's question, the broker's failure to give a candid, full explanation of the easement's effect was considered fraudulent. See also §4.17.
- Constructive fraud occurs when a party, without fraudulent intent, misleads another by breach of a duty which results in an advantage to the person at fault (CC §1573). See §11.43.

For further discussion of remedies for fraud and nondisclosure in real property transactions, see California Real Property Remedies and Damages, chap 3 (2d ed Cal CEB 2002).

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1. Fraud

§11.38 a. Advantages of Pleading Actual Fraud

A successful claim of actual fraud provides certain advantages, including:

- Punitive damages may be awarded if the fraud was intentional (as opposed to a negligent misrepresentation or constructive fraud). CC §3294(a); *Simmons v Southern Pac. Transp. Co.* (1976) 62 CA3d 341, 368, 133 CR 42. See §§4.19, 11.103.
- A claimant who has proved fraud is entitled to apply to the Recovery Account of the Real Estate Fund to satisfy up to $50,000 of the judgment for each transaction involved, up to a total of $250,000 for a licensee. Bus & P C §§10471, 10474. For a discussion of the Recovery Account, see §§8.48, 9.37.
- A broker may be required to disgorge any commission paid. *Crogan v Metz* (1956) 47 C2d 398, 404, 303 P2d 1029, and fraud judgments are not dischargeable in bankruptcy. 11 USC §523(a)(2)(A).
- If the broker stood in a fiduciary relationship with the claimant, a judgment based on intentional fraud may allow for a broader measure of damages based on the benefit-of-the-bargain standard, rather than the out-of-pocket loss standard. On measure of damages, see §§11.89-11.106.

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§11.39 b. Disadvantages of Pleading Actual Fraud

Actual fraud is harder to prove than negligence. Difficulties include:

- Pleading actual fraud may give rise to a series of demurrers filed by the defense which can substantially increase the claimant's costs. Fraud must be pleaded with specificity, and sometimes the plaintiff may not have all the necessary facts at this stage of the litigation. Defendants are likely to demur to the fraud count to avoid any potential finding of intentional misrepresentation and exposure to punitive damages. Moreover, a finding of intentional misrepresentation and/or an award of punitive damages would jeopardize insurance coverage.
- An unsubstantiated claim of fraud, like a frivolous lawsuit, can alienate the trier of fact.
- If fraud is alleged without evidence, sanctions can be imposed under CCP §128.7. See California Civil Procedure Before Trial §1.6 (4th ed Cal CEB 2004).
- Collecting a judgment on a fraud cause of action may be difficult because there is no insurance coverage for intentional acts. See Ins C §533; California Liability Insurance Practice: Claims & Litigation §3.67 (Cal CEB 1991).

See also §4.27.

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§11.40 2. Deceit

To recover damages for deceit, claimants must show that the broker or salesperson intended to induce them to alter their position to their detriment or risk. See CC §1709. However, there is no requirement to show intent to deceive. *Ford v Cournale* (1973) 36 CA3d 172, 183 n10, 111 CR 334.

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§11.41 a. Intentional Deceit

Intentional deceit is a suggestion, made as fact, of something that is not true by one who does not believe it to be true. CC §1710(1). The more common claim for deceit is negligent misrepresentation, which is stating as a fact something that is not true when the defendant has no reasonable basis for believing it to be true. CC §1710(2). In *Banville v Schmidt* (1974) 37 CA3d 92, 98, 112 CR 126, a broker represented to the property owner that the property securing the buyer's promissory note was worth substantially more than the amount of the note, when in fact it was worth substantially less. The broker also advised the owner that the maker of the note was a financially substantial individual, when in fact he was not. The court found that the broker had intentionally and deliberately misrepresented the true value of the property and the financial condition of the maker of the note. 37 CA3d at 98.

WARNING: Brokers who advertise in a multiple listing service (MLS) (see §§1.11-1.14) are liable for damages caused by misrepresentation if a reasonable investigation would have revealed the truth or if the broker "reasonably should have knowledge" of the misrepresented fact. CC §1088.

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§11.42 b. Nondisclosure and Concealment

Fraud and deceit include the suppression of a fact when the broker either (1) has a duty to disclose it or (2) has given information of others which is likely to mislead without the omitted fact. CC §1710(3). See *Lingsch v Savage* (1963) 213 CA2d 729, 29 CR 201; *McPhetridge v Smith* (1929) 101 CA 122, 141, 281 P 419 (broker who failed to disclose lien on property committed fraud).

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§11.43 3. Constructive Fraud

Constructive fraud typically arises when a broker or salesperson breaches a fiduciary duty. Constructive fraud differs from actual fraud in that it is not necessary to show that the fiduciary had fraudulent intent. CC §1573(1). Accordingly, even negligent fiduciaries can be liable for constructive fraud. See *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 562, 29 CR2d 463. In breaching the fiduciary duty, the broker typically misleads the claimant to the claimant's loss and thereby gains an advantage. In *Schoenberg v Romike Props.* (1967) 251 CA2d 154, 59 CR 359, a listing broker represented to the property owner that the security offered for the buyer's promissory note was ample when, in fact, it was worthless. Even though the broker had no fraudulent intent, he had breached his fiduciary duty to the owner, which resulted in the owner being misled and the broker gaining his commission; thus he was liable for constructive fraud. 251 CA2d at 162.

Because intent is not an element of the tort, constructive fraud does not, in and of itself, support a prayer for punitive damages or for the recovery of a commission paid to the broker. See CC §3294. In addition, negligence-based fraud or deceit does not always result in a disgorgement of a commission. See *Tackett v Croonquist* (1966) 244 CA2d 572, 578, 53 CR 388 (there must be breach of duty of loyalty, intentional fraud, or bad faith before broker must give up commission).

Civil Code §1573 defines constructive fraud in the following disjunctive, unclear manner. Constructive fraud exists:

> 1. In any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him; or
> 2. In any such act or omission as the law specially declares to be fraudulent, without respect to actual fraud.

Constructive fraud appears on its face to be very similar to concealment law. The words "breach of any duty" in CC §1573 might initially create in a lawyer's mind the impression that constructive fraud can be linked to any breach of a statute, regulation, or common law rule that imposes a duty that prejudicially misleads another. That viewpoint, however, is not taken by most of the courts that have evaluated constructive fraud. The great bulk of cases in which constructive fraud claims were raised tethered constructive fraud to a violation of either a fiduciary duty or a confidential relation, even though §1573 mentions neither. Thus, actions for constructive fraud are usually against real estate brokers and salespersons. See, *e.g., Michel v Moore & Assocs.* (2007) 156 CA4th 756, 67 CR3d 797; *Warren v Merrill* (2006) 143 CA4th 96, 49 CR3d 122. For example, a broker may be held guilty of constructive fraud for informing the principals that a property fulfills their express requirements without properly examining whether that information is true.

In *Michel*, the court concluded that it was reversible error for a trial judge to dismiss the buyer's claim for negligent nondisclosure of property defects against its broker. The court explained that a cause of action for negligent nondisclosure presents different legal elements than either a claim for fraudulent concealment or a claim for violation of CC §2079—the claims on which the case went to the jury. Adopting the rationale of the decision in *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 26, 73 CR2d 784, the court noted that a broker can be professionally competent under §2079, which is premised on a negligence standard of care, but still not satisfy the greater duty of a trusted fiduciary. See also *Salahutdin v Valley of Cal., Inc., supra*.

See also discussion of constructive fraud in §§4.28-4.29.

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§11.44 F. Defenses to Fraud Claims

Generally, listing brokers have fiduciary relationships to property owners, buyer's and tenant's brokers have fiduciary duties to prospective buyers and tenants, and dual agents have fiduciary duties to both. CC §2079.16. See chap 3. Defense counsel must first determine whether the broker stood in a fiduciary relationship with the claimant. For example, a listing broker has a duty to disclose to the buyer material facts concerning the value and desirability of the property that are not apparent to the buyer on investigation. See *Lingsch v Savage* (1963) 213 CA2d 729, 736, 29 CR 201. Thus, the attorney needs to examine whether a duty to disclose existed. If the defect complained of was obvious or was within the diligent attention and observation of the buyer, then no duty to disclose arises. See §11.26.

PRACTICE TIP: Many attorneys confuse the duty to disclose with the reliance issue. The line between the issue of the nonfiduciary's duty to disclose and the issue of whether a plaintiff can establish justifiable reliance are somewhat blurred. As an example, under common law (as distinguished from duties imposed by CC §2079), a listing broker, and arguably a buyer's agent, would have no duty to disclose a crack readily observable in a wall of a property. Further, a buyer could not justifiably rely on a statement by the brokers that the property was in perfect condition or that the walls have no cracks. This same factual scenario would support the defense to the first element of a concealment claim, *i.e.,* duty to disclose, and the element common to concealment or misrepresentation, justifiable reliance.

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§11.45 1. No Justifiable Reliance

Often, brokers raise a defense that the buyer did not justifiably rely on the alleged nondisclosure or misrepresentation by the broker. For example, in *Carpenter v Hamilton* (1936) 18 CA2d 69, 62 P2d 1397, the court found that the defects complained of were obvious, and the buyer did not rely on the representations by the broker that the property was in good condition. Further, in *Stevenson v Baum* (1998) 65 CA4th 159, 75 CR2d 904 (which did not involve a broker), the buyer received a preliminary title report that illustrated that a utility easement was located on the property, so could not claim reliance on the owner's failure to disclose the easement. The same defense can be raised by a nonfiduciary listing broker.

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§11.46 2. Failure to Investigate

Buyers must investigate the property themselves and may not rely solely on the broker's or property owner's representation of the property. For instance, in Bank of America v Vannini (1956) 140 CA2d 120, 295 P2d 102, the owner brought an action against purchasers to recover money due on a contract to purchase a gold mine. The purchasers were contractually obligated to perform an investigation of the property and were thus under a legal duty to make such investigation. In legal effect, this amounted to an agreement that the purchasers were not to rely on the representations made by the owner but were to rely on their own investigation. However, the purchasers made no real investigation before exercising their option to purchase. The court found that when purchasers have a duty to investigate, they cannot properly rely to their detriment on any misstatements made concerning the nature of the property and thus cannot establish the reliance element of fraud. Compare *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 1499, 55 CR3d 59 (broker could not rely on exculpatory provision of contract to show lack of reliance on misrepresentation as a matter of law), and *McClain v Octagon Plaza, LLC* (2008) 159 CA4th 784, 794, 71 CR3d 885 (landlord's misrepresentation regarding square footage was actionable despite disclaimer language in lease).

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§11.47 3. Full Disclosure Made

Defenses to a breach of fiduciary duty or constructive fraud claim may prove more difficult due to case law that states that a fiduciary has broader duties to the client than a nonfiduciary broker. See, *e.g., Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 73 CR2d 784. However, in *Assilzadeh v California Fed. Bank* (2000) 82 CA4th 399, 98 CR2d 176, the court held that fiduciaries meet their obligation of disclosure when they disclose all information that they know. The court held that since the defendants had disclosed to the buyer that there had been a prior construction defect lawsuit involving the property, their disclosure duty was satisfied, despite the fact that the broker's salesperson was alleged to have told the buyer that installing a marble floor in the property would be no problem. Once disclosure of the suit was made, the buyer bore the duty to investigate further. 82 CA4th 416. See also *Pagano v Krohn* (1997) 60 CA4th 1, 70 CR2d 1 (no duty to elaborate on disclosed facts).

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§11.48 G. Breach of Fiduciary Duty

A broker and broker's employees, salespersons, and associate brokers owe fiduciary duties to the principal during the entire course of the agency relationship. *Batson v Strehlow* (1968) 68 C2d 662, 669, 68 CR 589; chap 3. The agency can be created without formalities and fiduciary duties can arise based on an oral agreement between the principal and broker, even before execution of a listing or commission agreement. See *Buehler v West Am. Fin. Co.* (1962) 201 CA2d 702, 705, 20 CR 190. They can also be limited by agreement. See *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734 (fiduciary duty was defined and limited by terms of agency agreement, so there was no duty to provide tax advice).

Fiduciary duties may continue after the sale of the property terminates the agency relationship when the duties include postclosing obligations related to the sale. *Menzel v Salka* (1960) 179 CA2d 612, 623, 4 CR 78.

NOTE: An agency is terminated by any of the following: (1) the expiration of its term; (2) the extinction of its subject; (3) the death of the agent; (4) the agent's renunciation of the agency; or (5) the incapacity of the agent. CC §2355. Unless the power of an agent is coupled with an interest in the subject of the agency, it is terminated by: (1) its revocation by the principal; (2) the death of the principal; or (3) the incapacity of the principal to contract. CC §2356. See §§3.11-3.13.

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§11.49 1. General Fiduciary Obligation

A real estate broker owes a principal the same obligation of diligent and faithful service that a trustee owes to the beneficiary of a trust. CC §2322(c); Prob C §§16002, 16004-16005, 16009; *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 161, 177 CR 882. See §3.18. The duties of a fiduciary include undivided loyalty, the duty to act with the utmost good faith and honesty toward the principal, the duty to disclose to the principal all facts within the broker's knowledge that are material to the transaction, the duty to inspect, and the duty to account for all funds held on behalf of the principal and avoid commingling the principal's funds with the broker's own funds. See *Sierra Pac. Indus. v Carter* (1980) 104 CA3d 579, 581, 163 CR 764; *Gray v Fox* (1984) 151 CA3d 482, 489, 198 CR 720; *Brown v Gordon* (1966) 240 CA2d 659, 666, 49 CR 901. For detailed discussion of these duties, see chap 3.

The duty of undivided loyalty includes the duty to avoid competing with the principal on matters related to the agency without the principal's authorization, and the duty to avoid obtaining an interest adverse to the principal without full disclosure of the facts. See §§3.21-3.70. The duty of full disclosure may include an obligation to inspect public records or permits (concerning title or property use) that exceeds the statutory duty to visually inspect the property under CC §2079 when there are "red flags" requiring further investigation. See *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 26, 73 CR2d 784; §§3.38, 3.64.

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§11.50 2. Dual Agency Issues

A dual agency is created when the property owner and buyer or tenant are both represented by the same broker; by different salespersons within the broker's office; or when one party's broker, through conduct in dealing with the other party, becomes the second party's agent for some purposes. See §§3.22-3.25. In a dual agency capacity, performing the duties to one principal may violate a fiduciary duty to the other; these opposing duties make dual agency a difficult balancing act. For example, in *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 164, 177 CR 882, a dual agent who failed to disclose to the property owner that the buyer was an investor intending to resell the property quickly (a fact that could indicate that the offer price was below market) violated his fiduciary duty to the owner. Nevertheless, dual agency is permitted in California providing the disclosure required by CC §2079.16 (residential transactions) is provided to the principals. See §11.52.

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§11.51 a. Unintended Dual Agency

An unintended dual agency may occur when, for instance, a buyer or tenant does not have a broker, and the listing broker works with both parties to put the deal together (*e.g.,* agreeing to convey the buyer's or tenant's counteroffer to the property owner). See *Smith v Rickard* (1988) 205 CA3d 1354, 1363, 254 CR 633; *Wright v Lowe* (1956) 140 CA2d 891, 896, 296 P2d 34. Brokers must be cautious to document their agency relationships. In a situation in which a buyer or tenant is unrepresented, the listing broker should confirm in writing that that party is not represented by the listing broker, but instead is acting as a principal. See discussion of unintended dual agency in §§3.26-3.28.

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§11.52 b. Written Disclosure Required in Residential Transactions

In all sales involving one to four dwelling units or a mobile home, a broker must make written disclosure of dual agency and obtain the principal's written acknowledgment. CC §§2079.13(d), 2079.16- 2079.17. See also *Brown v FSR Brokerage* (1998) 62 CA4th 766, 72 CR2d 828; §3.23. A failure to disclose dual agency or provide the statutory notices may have serious consequences. Acting as a dual agent without full disclosure and consent of the principals constitutes a breach of fiduciary duty. See *Sierra Pac. Indus. v Carter* (1980) 104 CA3d 579, 581, 163 CR 764. See also *Assilzadeh v California Fed. Bank* (2000) 82 CA4th 399, 414, 98 CR2d 176. Nondisclosure may also subject the broker to discipline by the DRE. See Bus & P C §10176(d). On discipline of brokers generally, see chap 9.

Civil Code §2079.16 provides that in a dual agency relationship, "the agent may not, without express permission of the respective parties, disclose to the other party that the seller will accept a price less than the listing price or that the buyer will pay a price greater than the price offered." The language of the statutory disclosure also provides a defense by stating that each party also has a responsibility to protect himself or herself (CC §2079.16):

> The above duties of the agent in a real estate transaction do not relieve a seller or buyer from the responsibility to protect his or her own interests. You should carefully read all agreements to assure that they adequately express your understanding of the transaction. A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.

See also *Assilzadeh v California Fed. Bank, supra* (buyer must investigate disclosed facts once made by broker or owner, even when broker is dual agent and thus has fiduciary relationship with buyer).

A broker who fails to have the property owner timely sign an agency disclosure, as required in CC §§2079.13 and 2079.16, is not entitled to a commission. *Huijers v DeMarrais* (1992) 11 CA4th 676, 14 CR2d 232. See *McConnell v Cowan* (1955) 44 C2d 805, 285 P2d 261 (owner allowed to rescind entire transaction and relieved from paying commission when agency disclosure not signed at the time of listing).

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§11.53 c. Broker as Principal

A licensed real estate broker who represents himself or herself in a transaction may not be entitled to a broker's commission. Bus & P C §10131 (defining "real estate broker" as one who acts on behalf of someone else). As such, any broker/principal claim for commission due may be unenforceable. *Horning v Shilberg* (2005) 130 CA4th 197, 203, 29 CR3d 717. But see *Steve Schmidt & Co. v Berry* (1986) 183 CA3d 1299, 228 CR 689 (corporate broker entitled to pursue commission when individual broker purchased property for own benefit). On issues surrounding the broker as principal, see §§3.30-3.34.

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3. Specific Fiduciary Duties

§11.54 a. Undivided Loyalty

A fiduciary owes a number of specific duties to the principal. See the detailed discussion of these duties in chap 3. A breach of any of these duties can result in a claim against a broker. One of the most important of the duties owed is the duty of undivided loyalty. CC §2322(c); Prob C §§16002, 16005. See §3.43. This includes a duty to avoid competing with the principal in matters related to the agency, unless the principal agrees otherwise, and to avoid obtaining an interest adverse to the principal without full disclosure of the facts.

PRACTICE TIP: If the principal agrees to an exception allowing the fiduciary to compete, the fiduciary should have the agreement reduced to writing.

A broker breaches its fiduciary duty of undivided loyalty when it acts as an agent for more than one party to a transaction without full disclosure to, and consent of, all parties. See *Sierra Pac. Indus. v Carter* (1980) 104 CA3d 579, 581, 163 CR 764. See also Bus & P C §10176(d); CC §§2079.12-2079.24; §§11.50-11.52. A broker breached his fiduciary duty by making only a partial disclosure, *i.e.,* by informing the owner that the broker was president of a corporation offering to buy the property, but failing to disclose that the broker and his wife were also shareholders. *Batson v Strehlow* (1968) 68 C2d 662, 68 CR 589. Similarly, a listing broker's failure to disclose to the owner that the prospective buyer would immediately relist the property with the broker for resale is an actionable breach of the duty of loyalty. *Menzel v Salka* (1960) 179 CA2d 612, 4 CR 78. See also *Roberts v Lomanto* (2003) 112 CA4th 1553, 1570, 5 CR3d 866, discussed in §3.13.

WARNING: Although a broker owes its principal the duty of undivided loyalty, the dual agency disclosure required under CC §2079.16 provides that "in representing both seller and buyer, the agent may not, without express permission of the respective parties, disclose to the other party that the seller will accept a price less than the listing price or that the buyer will pay a price greater than the price offered." On the difficult balancing act required of dual agents, see §§3.22-3.29, 11.50-11.52.

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§11.55 b. Duty of Good Faith

Another important fiduciary duty is duty of good faith, which requires that brokers act with the utmost good faith and honesty toward their principal. *Batson v Strehlow* (1968) 68 C2d 662, 674, 68 CR 589; *Gray v Fox* (1984) 151 CA3d 482, 489, 198 CR 720. Further, a listing broker, without the property owner's knowledge or consent, cannot suggest to a buyer that the owner is willing to accept less than he had stated. *Bate v Marsteller* (1959) 175 CA2d 573, 346 P2d 903. The duty also extends to the handling of client funds. *Holloway v Thiele* (1953) 116 CA2d 68, 72, 253 P2d 131; *Kinert v Wright* (1947) 81 CA2d 919, 925, 185 P2d 364. For a discussion of the duty of good faith, see §3.43. On a broker's duty to account for client funds and documents, see §§3.52-3.55.

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§11.56 c. Full Disclosure

A broker must disclose to the principal all facts within the broker's knowledge that are material to the transaction. *Gray v Fox* (1984) 151 CA3d 482, 489, 198 CR 720. See CC §2020; §§3.39-3.42. These disclosures include:

- All offers received. *Simone v McKee* (1956) 142 CA2d 307, 298 P2d 667.
- All material facts relating to the value or price of the property, including that the prospective buyer intends to sell the property shortly at a significantly higher price (see *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 177 CR 882) or the possibility that a higher price may be obtained at a later time or by marketing the property in a different way. *Smith v Zak* (1971) 20 CA3d 785, 98 CR 242. This issue often arises when brokers take "pocket listings," or single party compensation agreements, and fail to document their agreement with the owner that the property will not be put in the multiple listing service (MLS). On pocket listings, see §7.4. On the MLS, see §§1.11-1.14.
- Any secret profits, gratuities, or other benefits obtained in a transaction. *Kinert v Wright* (1947) 81 CA2d 919, 185 P2d 364; Bus & P C §10176(g). See also *Roberts v Lomanto* (2003) 112 CA4th 1553, 1570, 5 CR3d 866 (broker required to disgorge profit made on assignment of purchase contract, even though broker disclosed she would receive assignment fee, because amount of fee had not been disclosed); *Menzel v Salka* (1960) 179 CA2d 612, 4 CR 78 (secret profits); *Kroeker v Hurlbert* (1940) 38 CA2d 261, 101 P2d 101 (secret commissions). On secret profits generally, see §§3.35, 3.72-3.74.
- The broker's own direct or indirect interest in the transaction as a principal, *e.g.,* as an investor or as a relative of the other party, or a member of a corporate entity. See *Smith v Zak* (1971) 20 CA3d 785, 98 CR 242; *Batson v Strehlow* (1968) 68 C2d 662, 68 CR 589. See also Prob C §16004 (applicable to broker under CC §2322(c)). On brokers as principals and self-dealing, see §§3.30-3.34.

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§11.57 d. Duty of Inspection

The duty of inspection may include an obligation to inspect public records or permits (concerning title or property use) that exceeds the statutory duty to visually inspect a property under CC §§2079 and 2079.3. See *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 20, 73 CR2d 784. However, even under *Field*, there must be a red flag which would give rise to such an obligation to perform a broader investigation. *Field,* 63 CA4th at 22 n6. For further discussion of the duty to inspect, see §3.38.

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§11.58 e. Duty to Explain and Counsel

The broker's duty of full disclosure also includes the obligation to explain and provide counsel, in appropriate circumstances, to the principal. This involves an examination of the circumstances of the particular transaction, including the level of sophistication of the buyer, as well as the complexity of the transaction. For example, a mortgage broker has an obligation to explain the effect of interest, penalty, and balloon payment provisions, if the principal is unsophisticated and is relying on broker's expertise in negotiating complex loan provisions. See *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 783, 157 CR 392.

Note, however, that a broker does not have an obligation to inspect further once a full disclosure of facts is made to a buyer; or explain or elaborate on the practical ramifications of a factual disclosure; or explain the legal ramifications of a disclosed fact. See *Assilzadeh v California Fed. Bank* (2000) 82 CA4th 399, 98 CR2d 176; *Pagano v Krohn* (1997) 60 CA4th 1, 70 CR2d 1; *Sweat v Hollister* (1995) 37 CA4th 603, 609, 43 CR2d 399, disapproved on other grounds in *Santisas v Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830. See also *Umet Trust v Santa Monica Med. Inv. Co.* (1983) 140 CA3d 864, 873, 189 CR 922; *Alhino v Starr* (1980) 112 CA3d 158, 172, 169 CR 136. See the discussion of broker disclosures in §§3.39-3.42.

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§11.59 f. Accounting for Funds

Brokers must account for all funds held on behalf of the principal and avoid commingling. See CC §2322(c); Prob C §16009. See also Bus & P C §10176(e); §§3.52-3.55. Commingling primarily arises in property management situations, when a broker is required to maintain a buyer's deposit in connection with a purchase. Brokers have also been disciplined and sued for representing that they have received a check by a buyer to be used as a deposit and liquidated damages in the event of a breach, when in fact they did not receive the check. This can result in the broker having to make good the amount of any deposit if a buyer breaches and fails to make payment.

A broker also breaches his or her fiduciary duty by commingling the principal's funds with the broker's own funds. *Brown v Gordon* (1966) 240 CA2d 659, 49 CR 901. Commingling will also give rise to disciplinary actions by the DRE. See §§3.52, 9.10.

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§11.60 4. Constructive Fraud

Constructive fraud is the other side of the coin of breach of fiduciary duty. In other words, any breach of duty by a fiduciary, whether negligent or fraudulent, can be argued to be constructive fraud, which eliminates the need to demonstrate intent. See *Michel v Moore & Assocs.* (2007) 156 CA4th 756, 67 CR3d 797. However, in order to obtain punitive damages under CC §3294, a plaintiff must prove an intentional wrongdoing as well as malice, oppression, or fraud. The elements of constructive fraud are discussed in §11.43.

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§11.61 5. Burden of Proof

Once a claimant establishes a fiduciary relationship and alleges that the fiduciary gained an unfair advantage over the claimant, the burden shifts to the defendant broker to prove that fiduciary duties were not violated. See Prob C §16004 (applicable through CC §2322(c)); *Batson v Strehlow* (1968) 68 C2d 662, 675, 68 CR 589; *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 161, 177 CR 882. Pragmatically, however, a plaintiff still needs to meet the burden of proof with respect to the elements underlying the tort supporting the breach of fiduciary duty.

In addition, at least one case has held that a breach of fiduciary duty claim is equitable in nature and thus must be tried by the court, not the jury. See *Interactive Multimedia Artists, Inc. v Superior Court* (1998) 62 CA4th 1546, 73 CR2d 462.

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§11.62 H. Defenses to Breach of Fiduciary Duty Claims

The defenses usually raised to a breach of fiduciary duty claim are similar to those raised concerning a negligence claim or a fraud and deceit claim. The same affirmative defenses are also generally raised in all three types of claims, since most claims brought by buyers of real property for breach of fiduciary duty are attendant to negligent misrepresentation and negligence claims. These affirmative defenses include:

- The defendant's conduct satisfied the applicable standard of care (see §§11.10, 11.22, 11.28, chap 13);
- The contract between the parties contained applicable disclaimers and exculpatory clauses (see §§11.24, 11.67);
- The defendant's acts were mitigated or excused by the comparative negligence of the plaintiff (see §11.25);
- The conditions or defects complained of were open and obvious (see §11.26);
- The plaintiff unjustifiably relied on the defendant's statements or actions (see §11.45);
- The plaintiff failed to make adequate investigation of the alleged condition or defect (see §11.46); and
- The defendant made full disclosure of all known material facts to the plaintiff (see §11.47).

In addition, claims of breach of fiduciary duty may also be successfully defended if:

- The statute of limitations has run (see §§11.63-11.65);
- The plaintiff delayed in bringing action against the defendant, causing undo harm to the defendant (laches, see §11.66);
- The property was sold "as is" (see §11.68);
- The plaintiff waived its rights or is estopped from asserting its claim (see §11.69);
- The defendant has a right of setoff against the plaintiff's damages (see §11.70); and
- The plaintiff failed to mitigate potential damages (see §11.71).

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1. Statute of Limitations

§11.63 a. Fraud

The applicable statute of limitations is determined by the substance or gravamen of the action rather than the form of the pleading. *Giffin v United Transp. Union* (1987) 190 CA3d 1359, 1362, 236 CR 6. Breach of fiduciary duty claims are most often based in fraud. See §§11.54-11.61. The statute of limitations in a fraud action is 3 years and commences when the plaintiff discovers, either actually or constructively, all elements giving rise to the claim of fraud. CCP §338(d); *Allen v Sundean* (1982) 137 CA3d 216, 222, 186 CR 863.

PRACTICE TIP 1: Plaintiff's counsel may argue that the 4-year statute applies under CCP §343 if the fiduciary breach is based on something other than fraud. See *Hatch v Collins* (1990) 225 CA3d 1104, 1109, 275 CR 476. However, defense counsel may argue that a negligence cause of action should apply pursuant to CCP §339 governing the statute of limitations against other professionals. Although there is no California case law that specifically supports this line of reasoning, a valid argument can be made that the court should look at the underlying theory of the claim in determining which statute of limitations applies.

PRACTICE TIP 2: Defense counsel may consider advising their broker clients to insert a statute of limitations provision in their agreements. It can be included by an amendment to a listing agreement, a buyer's broker's agreement, or any other agreement creating an agency relationship. California courts have afforded contracting parties considerable freedom to modify the length of a statute of limitations, so long as the modification is reasonable. See, *e.g., Hambrecht & Quist Venture Partners v American Med. Int'l* (1995) 38 CA4th 1532, 1548, 46 CR2d 33. Such limitation provisions have been implicitly upheld in the home inspector context, although the courts seem reluctant to enforce them. See, *e.g., Moreno v Sanchez* (2003) 106 CA4th 1415, 131 CR2d 684 (1-year limitation in the contract completely vitiated the delayed discovery rule); *Silver v Boatwright Home Inspection, Inc.* (2002) 97 C4th 443, 451, 118 CR2d 475 (in dicta, questioning reasonability of the limitation period).

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§11.64 b. Nondisclosure of Material Fact

The statute of limitations for violations of the disclosure statutes (CC §§2079-2079.24) is 2 years. CC §2079.4. Although *Field v Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 24, 73 CR2d 784, states that the CC §2079.4 does not apply to a buyer's broker acting in a fiduciary capacity, §2079.4 may apply if the underlying theory is based on a mere negligent failure to perform a reasonably diligent visual inspection of the property. See §§3.42, 11.28. However, if the cause of action arises from a failure to follow up on an item that should have raised a red flag, then the courts will most likely follow the *Field* analysis.

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§11.65 c. Time of Commencing Action

A cause of action does not accrue against a fiduciary until the plaintiff actually discovers the act constituting a breach of fiduciary duty. *Eisenbaum v Western Energy Resources, Inc.* (1990) 218 CA3d 314, 324, 267 CR 5. During the agency relationship, the principal does not have a duty to diligently investigate to discover facts giving rise to the cause of action. *Hobbs v Bateman Eichler, Hill Richards, Inc.* (1985) 164 CA3d 174, 201, 210 CR 387.

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§11.66 2. Laches

Even if the plaintiff has filed suit within the period of the applicable statute of limitations, the doctrine of laches may bar relief. *Martin v Kehl* (1983) 145 CA3d 228, 241, 193 CR 312. Laches is an unreasonable delay in asserting a right that causes such prejudice to an adverse party as to render the granting of relief inequitable. *Adams v Young* (1967) 255 CA2d 145, 160, 62 CR 877.

Two components comprise the laches defense:

- The plaintiff unreasonably delayed in bringing suit. The period of delay taken into account for laches does not commence until the defendant begins to act in hostility to the defendant's continuing obligation and this repudiation of the trust has been brought home to the plaintiff (*Adams*, 255 CA2d at 160); and
- The lapse of time resulted in some prejudice to the defendant. *Nevarez v Nevarez* (1962) 202 CA2d 596, 603, 21 CR 70. Prejudice is never presumed. It must be affirmatively demonstrated by the defendant in order to sustain the burden of proof and the production of evidence on the issue. *Martin*, 145 CA3d at 240.

Laches is often used to defend against rescission actions. See *Williams v Marshall* (1951) 37 C2d 445, 455, 235 P2d 372 (15 months was not grounds for laches defense). Laches can be used to defend against a breach of fiduciary claim which has been held equitable in nature, citing *Interactive Multimedia Artists, Inc. v Superior Court* (1998) 62 CA4th 1546, 73 CR2d 462.

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§11.67 3. Exculpatory Clauses

Exculpatory clauses in contracts intended to preclude claims of justifiable reliance have been found invalid when used as a basis to defeat a fraud claim by way of summary judgment or demurrer. See CC §1668; *McClain v Octagon Plaza, LLC* (2008) 159 CA4th 784, 794, 71 CR3d 885; *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 1499, 55 CR3d 59.

PRACTICE TIP: It should be emphasized that these cases do not hold that exculpatory provisions cannot be used to defend against the element of justifiable reliance, but instead simply hold that they do not show lack of justifiable reliance as a matter of law. In *Manderville*, the court noted that the exculpatory provisions in a CAR form purchase agreement gave the buyer a "right" to perform investigations, but not the "obligation" to do them. As such, an argument can be made that these cases may be distinguished if the exculpatory clause is drafted to state that the buyer has an obligation (as opposed to a right) to investigate facts relating to the property and agrees to rely solely on such investigation, and not on any representations made by the property owner, broker, or salesperson. While there is no certainty that a court will allow such a provision to survive the prohibitions of CC §1668, counsel will have a better argument if the provisions are drafted in this manner rather than the way they are currently set forth in the CAR purchase agreement.

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§11.68 4. "As Is" Clauses

An "as is" clause simply means that the property is taken in the condition visible to or observable by the buyer. If an act of misrepresentation is made as to the condition, or a failure to disclose a fact which requires disclosure, the as is provision is ineffective. Thus, an as is provision basically tells a buyer that the owner is not warranting the condition of the property, and therefore protects an innocent owner and broker if defective conditions existed which were unknown to either.

An "as is" clause does not protect a broker who has actually perpetrated a fraud. First, a buyer can claim that since the broker is not a party to the contract, the as is provision does not apply to the broker. Second, CCP §1668 and case law demonstrate that an as is provision does not undercut the obligation to make full disclosure of material facts. *Herzog v Capital Co.* (1945) 27 C2d 349, 164 P2d 8; *Wilson v Century 21 Great Western Realty* (1993) 15 CA4th 298, 304, 18 CR2d 779 (nondisclosure in negligent misrepresentation claim not barred by as is provision).

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§11.69 5. Waiver and Estoppel

Waiver, which is a legal defense, and estoppel, which is an equitable defense, are often viewed interchangeably, but in fact they are distinct defenses. *Old Republic Ins. Co. v FSR Brokerage, Inc.* (2000) 80 CA4th 666, 678, 95 CR2d 583. Waiver is the intentional relinquishment of a known right after knowledge of the facts. *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 31, 44 CR2d 370. An intent to waive, expressed or implied, must be established by clear and convincing evidence. *Waller v Truck Ins. Exch. Inc., supra*. Unlike estoppel, waiver does not depend on any act of the opposing party. *Old Republic Ins. Co. v FSR Brokerage, Inc., supra*. Estoppel succeeds as a defense only if the defendant was prejudiced by plaintiff's conduct, *i.e.,* was induced to a position detrimental to itself. See *Wilcox v Ford* (1988) 206 CA3d 1170, 1180, 254 CR 138. Waiver is a question of fact, whereas estoppel is a question for the court. *Old Republic Ins. Co.*, 80 CA4th at 678. A delay may also be evidence of waiver of recision, but each case will stand on its own facts. *Williams v Marshall* (1951) 37 C2d 445, 456, 235 P2d 372; *Lobdel v Miller* (1952) 114 CA2d 328, 335, 250 P2d 357.

In *Honeywell v WCAB* (2005) 35 C4th 24, 37, 24 CR 3d 179, the court noted the four elements that must be present in order to apply the doctrine of equitable estoppel:

> (1) the party to be estopped must be apprised of the facts;
> (2) the party must intend that the conduct shall be acted upon, or must so act that the party asserting the estoppel had a right to believe it was so intended;
> (3) the other party must be ignorant of the true state of facts; and
> (4) the party to be estopped must rely upon the conduct to that party's injury.

The court's analysis of equitable estoppel in *Honeywell* is similar to a fraud analysis, although the party to be estopped may have also acted negligently. Negligence will suffice if the plaintiff owes a duty to the party asserting estoppel. *Honeywell,* 35 C4th at 37. Estoppel may arise from silence when there is a duty to speak. *Spray, Gould & Bowers v Associated Int'l Co.* (1999) 71 CA4th 1260, 1268, 84 CR2d 552. Typically, waiver and estoppel arise in a real estate transaction when there is discussion with respect to the date the escrow will close which one party believes extends the date. A property owner may waive any fixed date set forth in the contract if the buyer or tenant can show the owner intended to allow the buyer or tenant more time to close the transaction. See *Galdjie v Darwish* (2003) 113 CA4th 1331, 7 CR3d 178. See also *Warren v Merrill* (2006) 143 CA4th 96, 113, 49 CR3d 122 (estoppel prevented defendant from using statute of frauds defense).

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§11.70 6. Setoff

The right of setoff is the right by a defendant to credit amounts owed to the defendant against any award made against the defendant. A setoff defense may be afforded by other types of loss. See, *e.g., Sangster v Paetkau* (1998) 68 CA4th 151, 171, 80 CR2d 66. As an example, a right of setoff arises when the person claiming to be defrauded as a result of the tort of another is entitled to recover damages owing to his or her loss of time, attorney fees, or other expenditures. *Prentice v North Am. Title Guar. Corp.* (1963) 59 C2d 618, 620, 30 CR 821. Such damages may constitute a basis for asserting them as a setoff. See also *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551.

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§11.71 I. Mitigation

An injured plaintiff must reasonably attempt to mitigate or lessen all damages. *Kent v Clark* (1942) 20 C2d 779, 783, 128 P2d 868. Because of the right to affirm the contract, however, a buyer does not need to resell the property purchased as a mitigation effort. *Harold v Pugh* (1959) 174 CA2d 603, 609, 345 P2d 112. If the buyer does resell the property, however, it can be a form of mitigation. See *Kruse v Miller* (1956) 143 CA2d 656, 661, 300 P2d 855.

EXAMPLE: When a buyer sues for damages to property, the buyer must take reasonable efforts to make repairs or lessen ongoing damages (*e.g.,* by fixing a water leak which continues to cause additional damages, such as mold or loss of structural support). Unless the plaintiff could not afford to perform repairs, a defendant may claim that the failure to mitigate should limit the amount of damages.

See also *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 747, 37 CR3d 699, which held that the doctrine of avoidable consequences did not bar a prospective home buyer (who sold his existing home sooner than he would have otherwise, due to intentional fraudulent concealment by his broker) from recovering lost appreciation on the home he sold.

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§11.72 III. COMPLAINT, OBJECTIONS, AND DISPOSITIVE MOTIONS

When there is a dispute regarding the purchase and sale of real property, a party to the transaction may seek to hold the brokers liable for professional errors and omissions. Liability for negligence (see §§11.19-11.36) or breach of fiduciary duty (see §§11.48-11.71) may be asserted. A fiduciary's failure to disclose a material fact may also be considered constructive fraud. See §§11.43, 11.60. Errors attributed to brokers may arise from, among other things, failures to disclose, misunderstandings regarding the available uses of property, failures to properly draft documents, and failures in marketing property.

Facts and legal assertions must be selected and described simply in the complaint that frames the controversy. See §11.73. To the extent the facts do not appear to support a legal theory, objections to the complaint and its component causes of action may be taken by demurrer. CCP §430.10. See §11.78. To the extent there are assertions that are inconsistent or inadequate to what is otherwise a cognizable cause of action, objection may be made by motion to strike particular portion of the complaint. CCP §§435, 436. See §11.83.

Certain facts must simply be acknowledged, such as the identity of the parties (see §11.74) and the location of the property (see §11.75). Such matters generally determine where and by whom the complaint is filed and may be the subject of preliminary legal skirmishing.

This discussion provides an overview of the legal process. Discussion of trial tactics and strategies is contained in chap 12 and discussion of standard of care expert witnesses is in chap 13.

For more information on trial procedure, see California Real Property Remedies and Damages (2d ed Cal CEB 2002); California Civil Procedure Before Trial (4th ed Cal CEB 2004); California Civil Discovery Practice (4th ed Cal CEB 2006); California Trial Practice: Civil Procedure During Trial (3d ed Cal CEB 1995); California Expert Witness Guide (2d ed Cal CEB 1991).

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§11.73 A. Complaint

After informal requests for redress, and after prelitigation arbitration or mediation have been considered or attempted without satisfactory result, litigation may be the final resort. A complaint must then be filed in the appropriate court.

The claims against and the defenses for a real estate broker can fairly bristle with technical considerations, many of which should be considered at the pleading stage. For the plaintiff, this may avoid time and expense and risk of preclusion of claims in law and motion. For the defendant, this allows early consideration of the best defenses, including those that may be dispositive in law and motion.

For a discussion of alternative dispute resolution procedures, see chap 6. For further discussion on drafting complaints, see California Civil Procedure Before Trial (4th ed Cal CEB 2004), chap 15. On responses to the complaint, see §§11.78-11.88.

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§11.74 1. Parties

Every action must be prosecuted in the name of the real party in interest, with exceptions specified in CCP §369 and CC §1368.3. CCP §367. In a suit involving real estate brokers, the identity of the plaintiff or plaintiffs is usually not controversial. Any dissatisfied buyer, tenant, or property owner may assert a claim. But legal entities may also be parties to a real estate transaction, in which case other considerations arise, such as the legal standing of the business. CCP §430.10(b).

Any partnership or unincorporated association may sue and be sued by the name it has assumed or by which it is known. CCP §369.5(a). If the claimant is a partner, the attorney should ascertain whether the partner is a general partner with the authority of the partnership to sue.

Generally, all persons materially interested in the subject matter of an action must be joined as either plaintiffs or defendants whenever feasible. See Comment to CCP §389. A defect or misjoinder of parties in a real estate case may result in a demurrer under CCP §430.10(d) if the complaint claims that an individual broker, rather than the brokerage, is vicariously liable for a real estate salesperson's conduct. A real estate brokerage must have an individual with a broker's license, but the individual does not, as an individual, have vicarious liability if the salesperson's principal is an entity. *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551. On the other hand, when a salesperson is a defendant, the salesperson's brokerage should invariably be named. This is because a salesperson must be supervised by a broker. Thus, if the salesperson is liable, it may be claimed that the brokerage is vicariously liable. Bus & P C §10132. See §§11.15-11.17.

Typically, salespersons are independent contractors. Their status as such does not interfere with the broker's vicarious liability for the salesperson's wrongful conduct in a transaction. The salesperson is still considered the agent and employee of the broker, so that the broker has vicarious liability for the salesperson's real estate activities. *Grubb & Ellis Co. v Spengler* (1983) 143 CA3d 890, 895, 192 CR 637.

For further discussion on ascertaining, joining, and naming parties in complaints, see California Civil Procedure Before Trial (4th ed Cal CEB 2004), chap 14.

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§11.75 2. Jurisdiction and Venue

Concurrently with the questions of subject matter and personal jurisdiction, counsel should consider the appropriate venue for the action (see generally CCP §§392-403) and the steps that must be followed to effect proper service of process in the action (CCP §412.20). Since lawsuits involving real estate are generally local, the appropriate forum is usually a state court, rather than a federal court.

Personal jurisdiction of the California courts is generally not an issue when the subject matter of the complaint involves property located in California. Particularly in cases such as those for quiet title, when the property at issue is not in the claimant's possession, jurisdiction is usually in rem and the action must then be prosecuted where the property is sited. See CCP §760.050. However, all assertions of state court jurisdiction, whether personal, in rem, or quasi in rem, must be evaluated according to the minimum contacts standard delineated in *International Shoe Co. v Washington* (1945) 326 US 310, 90 L Ed 95, 66 S Ct 154. See *Shaffer v Heitner* (1977) 433 US 186, 212, 53 L Ed 2d 683, 703, 97 S Ct 2569. If the property is not in the state where the action is pending, the court may lack jurisdiction of the subject matter. CCP §430.10(a). For further discussion of personal jurisdiction, see California Civil Procedure Before Trial (4th ed Cal CEB 2004) §§6.60-6.106.

A federal court may be appropriate in the relatively uncommon dispute that involves a federal question, such as under the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617). See 28 USC §1331. But much more commonly, the question or questions in dispute will be answered by application of state laws. And if the parties are all from the same state, there is no federal jurisdiction based on diversity. For further discussion of diversity jurisdiction, see Civ Proc Before Trial §§7.48-7.81.

The proper venue for an action depends on the causes of action alleged. For the recovery of real property or the determination of any right or interest, and for injuries to real property, the proper venue is the county where the subject real property is located. CCP §392. If the action simply arises out of tort or contract, however, other venues may be available. Such actions may often be brought in the county where the defendant resides, where the injury occurred, or where the contractual obligation was to be performed. See CCP §395. For further discussion of venue, see Civ Proc Before Trial, chap 8.

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§11.76 3. Causes of Action

The body of a complaint consists of allegations or statements of fact "in ordinary and concise language" that constitute each cause of action. CCP §425.10(a)(1). Causes of action that arise in broker litigation can vary tremendously, depending on the type of transaction involved and the gravamen of the dispute. While claims for intentional interference with economic advantage, intentional infliction of emotional distress, unfair competition, and breach of contract (§§4.41-4.51, 7.23) may be alleged, the majority of claims typically alleged in real estate broker litigation are based on:

- **Negligence.** Negligence can take many forms and is perhaps the most common theory of liability. It is also the easiest to allege and ultimately to prove. If a broker's duty can be articulated, and that duty was not fulfilled, resulting in damage to the plaintiff, then negligence is properly stated, whether or not a species of fraud may also be alleged. For further discussion of negligence theories against real estate brokers, see §§11.19-11.26.
- **Negligence per se**. Statutory theories of liability are permitted when a broker or salesperson breaches a specific statutory requirement and causes damage to a party. In a negligence per se claim, a defendant either breaches a statutory duty, or breaches the common law duty of due care with the statute confirming the duty or prescribing the standard or extent of care required. For further discussion of claims for breach of statutory duties, see §§11.27-11.36.
- **Fraud and deceit.** Fraud or intentional misrepresentation may be pleaded if the facts indicate that a broker or salesperson meant to deceive or cause harm in communications regarding the transaction. Often in real estate transactions, large sums of money may be at stake, so the temptation may be there for deliberately misleading a party to the transaction or someone involved in facilitating the transaction, such as a lender or guarantor. But care in pleading is required because particularity in alleging the circumstances indicating fraud is required. For further discussion of claims based on fraud and deceit, see §§11.37-11.47.
- **Breach of fiduciary duty.** The duties of a fiduciary include undivided loyalty, the duty to act with the utmost good faith and honesty toward the principal, the duty to disclose to the principal all facts within the broker's knowledge that are material to the transaction, the duty to inspect, and the duty to account for all funds held on behalf of the principal and avoid commingling the principal's funds with the broker's own funds. For further discussion of claims based on a breach of these duties, see §§11.48-11.71.

Contract issues can and do arise frequently in the real estate context, as brokers are often employed so that a purchase and sale agreement may be concluded. But confusion in the complaint should be avoided by noting that the broker who facilitated or negotiated the transaction usually is not a contracting party and therefore is not liable for breach of contract. The broker may be liable alone or with others in the aftermath of a contract breach, but a broker's tortious conduct is separate from the contractual breach, and should be kept so in pleadings.

In addition to these causes of action, which generally apply to most disputes, particular theories may also be appropriate, depending on particular circumstances, such as an action to quiet title to real property, for declaratory relief, injunctive relief, and other theories. See California Real Property Remedies and Damages (2d ed Cal CEB 2002).

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§11.77 4. Damages

Each complaint must contain a demand for judgment for the relief to which the pleader claims he or she is entitled. CCP §425.10(a)(2). If money or damages are demanded, the amount must be stated. CCP §425.10(a)(2). For further discussion of damages, see §§11.89-11.106.

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B. Anticipating and Making Objections to Complaint

§11.78 1. Common Bases for Demurrer

A demurrer can be used at the pleading stage of litigation to challenge the legal sufficiency of the complaint. See CCP §§430.10-430.80, 589, 591. *Smeltzley v Nicholson Mfg. Co*. (1977) 18 C3d 932, 136 CR 269. See also California Civil Procedure Before Trial, chap 23 (4th ed Cal CEB 2004). In an action involving a real estate broker, the grounds for demurrer most often include:

- Another action is pending between the same parties on the same cause of action (CCP §430.10(c));
- The pleading does not state facts sufficient to constitute a cause of action (CCP §430.10(e));
- The pleading is uncertain (CCP §430.10(f)) ("uncertain" includes ambiguous and unintelligible); and
- In an action founded on a contract, it cannot be ascertained from the pleading whether the contract is written, oral, or implied by conduct (CCP §430.10(g)).

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§11.79 a. Another Action Pending

An objection under CCP §430.10(c), that there is another action pending between the parties, may arise in the real estate context, for example, when the transaction at issue is a lease, and an unlawful detainer action has been initiated. If the action was initiated by a broker and the lessee claims that the broker's misconduct invalidates the landlord's claim, any actions involving both tenant and broker would seem properly the subject of just one action.

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§11.80 b. Insufficient Facts; Uncertain Claim

By far the most common demurrers to a complaint involving real estate matters are failure to state facts sufficient to constitute a cause of action, under CCP §430.10(e), and uncertainty, under CCP §430.10(f). These two bases for demurrer are often alleged simultaneously. The objections are frequently directed at mistakes in drafting the complaint; a cause of action may exist but is not clearly set out, so a demurrer is proper, but leave to amend will most likely be granted.

Fraud allegations frequently draw demurrers based on insufficient facts and uncertainty. Claims of nondisclosure are conducive to claims of fraud, whether intentional or negligent misrepresentation. But pleading such theories requires specificity, identifying who made the misrepresentation, with what statements, when, and where. *Committee on Children's Television, Inc. v General Foods Corp.* (1983) 35 C3d 197, 216, 197 CR 783. If the main allegation is that a defective condition, like a roof leak, was not disclosed, it is usually not enough to assert that the nondisclosure constitutes malice or oppression or reckless conduct in conscious disregard of the claimant's rights. A defendant may challenge such assertions as conclusions without the factual detail required for fraud claims. Claims of intentional misrepresentation are grounds for claiming punitive damages above and beyond compensatory damages claimed. A defendant has a strong interest in eliminating liability for such extra damages.

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§11.81 c. Statute of Limitations

On occasion, a demurrer is sustained and leave to amend is not granted, such as when it is evident from the face of the complaint that the statute of limitations has expired. The 2-year limitation period under CC §2079.4 applies to a broker's and a salesperson's statutory duties of disclosure. Note, however, that if fraud is also alleged, a 3-year limitations may be applicable, under CCP §338(d). See §11.63.

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§11.82 d. No Contractual Relationship

Real estate transactions are often document intensive, starting with a written purchase and sale contract. Nevertheless, if the complaint alleges breach of contract but fails to state whether an oral or a written agreement is the basis for the suit, a demurrer under CCP §430.10(g) is appropriate.

But note that the contract action is normally not appropriate against the broker and salesperson because they are not usually parties to the purchase and sale transaction, having only facilitated or negotiated it. For the most part, acting as broker or salesperson is not primarily a contractual undertaking. Brokers and salespersons generally agree to help with matters in the future, if a property suitable for the principal is identified, for instance, after which negotiations on the principal's behalf may take place. These activities are not subject to precise delineation ahead of the transaction, so that they may be specified in writing. Hence a demurrer to a claim of written contract may be properly sustained without leave to amend.

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§11.83 2. Common Bases for Motions to Strike

A motion to strike is used to challenge pleading defects not vulnerable to challenge by demurrer. A motion to strike may be directed against a whole pleading or any part of it. CCP §435(b)(1). For example, a motion to strike can be used to reach procedural defects or to eliminate part of a cause of action or count (*e.g.,* a claim for punitive damages) even though the rest of the cause of action would stand against a general demurrer. For further general discussion regarding motions to strike, see California Civil Procedure Before Trial, chap 24 (4th ed Cal CEB 2004).

In cases involving real estate brokers, a claimant may be tempted to allege a contract breach in order to recover attorney fees. However, attorney fees are not normally recoverable unless a contract allows them or a statute provides for their award to the prevailing party. CCP §1021.

Fee shifting may occur when attorney fees are recovered under the "tort of another" doctrine. Damages, which may include fees, are recoverable if a claimant is forced to protect his or her rights by litigation against a third party. The attorney fees in such cases are considered damages that, but for the tort or wrongful conduct of the party sued, would not have been incurred against another. See §11.21. The tort of another doctrine does not apply in the typical nondisclosure dispute involving real estate brokers and salespersons, even though one or more other defendants may be involved. One or more tortfeasors in the typical dispute may allegedly be jointly and severally liable, rather than one litigant being liable for causing separate litigation with another.

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§11.84 C. Motion for Summary Judgment or Summary Adjudication

A motion for summary judgment must be granted if all the papers submitted show that there is "no triable issue as to any material fact." CCP §437c(c); *Aguilar v Atlantic Richfield Co.* (2001) 25 C4th 826, 850, 107 CR2d 841. See *Estate of Pitzer* (1984) 155 CA3d 979, 986, 202 CR 855. In the case of a broker, the evidence submitted usually includes documentation of the transaction which, because it is usually extensive, may raise factual questions that prevent summary disposition.

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§11.85 1. Testing the Pleadings

A motion for summary judgment may be used to test the pleadings. While a demurrer also tests the pleadings, the plaintiff is commonly given leave to amend a defective complaint so that the demurrer does not end up being dispositive. See §11.78. The rule is different on a motion for summary judgment. If a complaint fails to frame a supportable theory of liability, then summary judgment may be granted. *Tsemetzin v Coast Fed. Sav. & Loan Ass'n* (1997) 57 CA4th 1334, 1342, 67 CR2d 726 (response to summary judgment motion may not create issues outside pleadings and is no substitute for amendment to pleadings).

If a legal theory is well pleaded, but not supported by facts, then summary judgment may be granted. In *Assilzadeh v California Fed. Bank* (2000) 82 CA4th 399, 98 CR2d 176, a broker had provided the seller, a bank, with an opinion of a proper listing price, indicating that construction defect litigation in which the property was involved could adversely affect its market value. The buyer, to whom the price opinion had not been provided presale, argued that it was evidence the bank knew of undisclosed adverse conditions. Summary judgment was granted because the construction defect litigation was disclosed, and there was no evidence that the seller had further information. The broker's price opinion was only an opinion, not an undisclosed fact. 82 CA4th at 411.

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§11.86 2. Statute of Limitations

In some situations, summary disposition of a case involving a broker may be relatively simple and hence not so costly, such as when summary judgment may be based on the special 2-year statute of limitations set out in CC §2079.4. See §11.64. The 2-year limitations period for claims of nondisclosure was upheld in *Loken v Century 21-Award Props.* (1995) 36 CA4th 263, 42 CR2d 683. But the applicability of this limitations statute is one of the few areas in which the more typical factual disputes over documents and events are absent.

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§11.87 3. No Factual Dispute

When nondisclosure is claimed, there is the possibility of using the documentation of the transaction to show that no factual dispute exists because all material information was disclosed in one document or another. But often the documents themselves are the source of dispute and cannot be used as the sort of undisputed evidence required for summary judgment. One reason for factual disputes over what the documentation discloses is the technical nature of the issues. Full disclosure may not be accomplished if technicalities are not understood by one side or the other in the transaction. This one-sided knowledge may occur, for example, if the property owner knows that the property is subject to subsidence owing to the use of fill dirt in the past. The use of fill dirt is disclosed, and there is the further, and truthful, disclosure, that the fill dirt was properly compacted. If subsidence is not specifically mentioned in the documentation, a dispute may arise that is unlikely to be resolved by summary judgment based on the documentation.

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§11.88 4. Third Party Liability

A broker may obtain summary judgment based on the liability of others who are indirectly involved in the transaction. The liability of a third party may break the chain of causation claimed to lead to the broker's liability; the broker is not liable because another party's failure to fulfill its duty was the cause of harm. Both the aggrieved party and the broker may be left in ignorance of the undisclosed problem, leaving the broker arguably without liability. For example, if a condition allegedly not disclosed could only be revealed if set out in the report of the professional who inspected the property, then the inspector's failure to make disclosure is arguably the sole cause of the buyer's injury, and summary judgment in the broker's favor is appropriate. See CC §1102.4.

In *Padgett v Phariss* (1997) 54 CA4th 1270, 63 CR2d 373, the court upheld summary judgment in the brokers' favor. The brokers did not disclose soil subsidence, which was not evident from a visual inspection. They did not disclose litigation, of which they were unaware, regarding the subsidence. The court held that the brokers did not have a heightened duty to discover the litigation, which would have indicated the subsidence, but held rather that they had fulfilled their duty of investigation under CC §2079.3.

For a general discussion of the use of summary judgment and summary adjudication motions, see California Civil Procedure Before Trial, chap 36 (4th ed Cal CEB 2004).

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§11.88A IV. CROSS-COMPLAINT FOR INDEMNITY OR CONTRIBUTION

Indemnity is an important consideration especially in real property misrepresentation and nondisclosure actions, because several persons involved in the transaction may be liable. See *e.g., Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383. Indemnity may be defined as the obligation of one party to make good a loss or damage incurred by another party. This obligation may be expressly provided for by contract, it may be implied from a contract not specifically mentioning indemnity, or it may arise from the equities of the parties' relationship. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 628, 119 CR 449. Thus, indemnity is either contractual or equitable. *Gardner v Murphy* (1975) 54 CA3d 164, 168, 126 CR 302.

Indemnity is usually asserted in a cross-complaint by a defendant against a co-defendant or another party involved in the transaction. See CCP §428.10(b); *Paragon Real Estate Group v Hansen* (2009) 178 CA4th 177, 180, 100 CR3d 234 (allowing buyer's broker to cross-complain for equitable indemnity against seller's broker); *Leko v Cornerstone Bldg. Inspection Serv.* (2001) 86 CA4th 1109, 103 CR2d 858 (allowing broker to pursue indemnity against home inspector). Indemnity is sometimes asserted in a complaint. 178 CA4th at 180. On theories of indemnity and contribution and how they are applied in real property disputes, see California Real Property Remedies and Damages §§3.89-3.89E (2d ed Cal CEB 2002).

WARNING: Defense counsel should carefully consider whether to file cross-complaints against other parties already named in the suit (see §11.11), because a cross-complaint may only serve to assist the plaintiff in pursuing its case against all defendants. The best strategy might be to file a separate action after the underlying action is over, but statutes of repose or laches might bar such action if the underlying action is appealed. In some situations, insurance considerations may suggest that resolving the dispute globally in one action is more efficient and practical.

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V. MEASURE OF DAMAGES

§11.89 A. General Rules

In broker liability cases, the measure of damages is often as important as any other issue. Damages, in most cases, are determined by the applicability of CC §3333 and §3343. Broker cases invariably involve claims of fraud, breach of fiduciary duty, and negligence and may also involve other tort claims or breach of contract. Generally:

- **Fraud.** Civil Code §3333 (benefit-of-the-bargain) damages apply when there is a fiduciary relationship between the parties, and CC §3343 (out-of-pocket) damages apply when there is no fiduciary relationship. The California Supreme Court noted in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, that

  > [i]n fraud cases involving the "purchase, sale or exchange of property," the Legislature has expressly provided that the "out-of-pocket" rather than the "benefit-of-the-bargain" measure of damages should apply. This section does not apply, however, when a victim is defrauded by its fiduciaries. In this situation, the "broader" measure of damages provided by [CC §§]1709 and 3333 applies (citations omitted).

- **Breach of fiduciary duty.** Including claims of fraudulent breach, the tort measure of damages of CC §3333 applies. Section 3333 provides for recovery of an amount that will "compensate for all the detriment proximately caused" by the breach. See *Fragale v Faulkner* (2003) 110 CA4th 229, 235, 1 CR3d 616; *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463.
- **Negligence.** Generally speaking, a person rendering services is liable for negligence if the damage or injury is foreseeable. *Biakanja v Irving* (1958) 49 C2d 647, 320 P2d 16. This rule applies to real estate brokers with respect to their duties toward principals in a transaction, whether or not they are in contractual privity. *Merrill v Buck* (1962) 58 C2d 552, 25 CR 456; *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383. The measure of damages in agency situations is all damages proximately caused by the negligence. CC §3333; *Smith v Rickard* (1988) 205 CA3d 1354, 254 CR 633.
- **Breach of contract.** The measure of damages is governed by CC §3300, which authorizes recovery under a benefit-of-the-bargain standard. In fraud cases, recovery is limited to out-of-pocket losses, or to lost profits if the principal acquired the property for profit or gain. CC §3343. Lost profits are unavailable if the property was purchased for residential purposes. See *Stout v Turney* (1978) 22 C3d 718, 728 n12, 150 CR 637.

For additional discussion of the measure of damages, see California Real Property Remedies and Damages (2d ed Cal CEB 2002); California Attorney's Guide to Damages (2d ed Cal CEB 2004).

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§11.90 1. Civil Code §3333: Benefit-of-the-Bargain Damages

Damages recoverable under CC §3333 are known as "benefit-of-the-bargain" damages, and award the expectancy interest of the plaintiff, which is the difference between the price paid and the value of the property as represented. By definition, damages under CC §3333 are greater than those afforded by CC §3343.

At least one appellate court has ruled that the benefit-of-the-bargain standard should be applied if the plaintiff's action against a fiduciary broker establishes intentional misrepresentation. See *Fragale v Faulkner* (2003) 110 CA4th 229, 235, 1 CR3d 616. As discussed in §§11.96-11.97, the California Supreme Court has not yet ruled on this question.

EXAMPLE: If the actual value of the property was $1 million and its value was fraudulently represented as $1.25 million, the plaintiff's damages would be $250,000, regardless of what the plaintiff paid for the property. The damages seek to compensate the plaintiff for what he or she expected would be the value of the property.

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§11.91 2. Civil Code §3343: Out-of-Pocket Damages

Damages under CC §3343 are referred to as "out-of-pocket" damages and award the difference between the price paid and the actual fair market value of the property at time of sale.

EXAMPLE: If the value of the property at the time of the transaction was $1 million, but the buyer, because of the fraud, actually paid $1.25 million, the buyer's damages are $250,000 because the buyer paid (*i.e.,* is "out-of-pocket") that much more than the property's value. If the value of the property (measured on the sale date) was greater than or equal to the price paid by the buyer, the buyer suffered no general damages under CC §3343(a), although there may be other damages the buyer may recover.

Civil Code §3343 also permits recovery of lost profits for a defrauded seller (CC §3343(a)(3)) as well as a defrauded buyer (CC §3343(a)(4)). With respect to buyers, the statute specifically provides that lost profits are recovered only if

- The property is acquired for use or resale at a profit;
- The buyer reasonably relied on the fraud in entering into the transaction and in anticipating profit; and
- The loss of profits was proximately caused by reliance on the fraud.

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§11.92 3. CC §1709: Tort Damages

Civil Code §1709 provides that a defendant who willfully deceives the plaintiff, with an intent to induce the plaintiff to alter his position to his injury or risk, is liable for "any damages" the plaintiff suffers. Although the statute provides for damages, it does not provide a way of measuring the harm to the plaintiff; however, it is considered to be a benefit-of-the bargain measure of damages. In real property fraud cases that do not involve fiduciary or confidential relations, CC §3343 generally applies without reference to CC §1709. See *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 747, 37 CR3d 699; *Overgaard v Johnson* (1977) 68 CA3d 821, 137 CR 412. The statute may be combined with CC §3333, however. See *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352.

Civil Code §§1571-1573 applies to broker disputes involving a contract, at least insofar as rescission is concerned. The tort-based statutes (CC §§1709-1710) form an independent basis for imposing liability and provide the plaintiff with alternative causes of action. The possibility exists, however, that in a real property action a fraud claim might not depend on the existence of a contract between the plaintiff and the defendant; in that event, CC §§1709-1710 may be the only statutes that apply. See, *e.g., Ward v Taggart* (1959) 51 C2d 736, 336 P2d 534 (no contract with real estate broker).

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§11.93 4. Alternative or Economic Damages

In *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 37 CR3d 699, a plaintiff used a dual agent to purchase a residence which had judgments and liens in excess of the purchase price. Based on continued reassurances by the broker that the property owners were negotiating the removal of the liens and expected to close the sale, the plaintiff sold his existing home. He was then informed that the lienholder would not compromise and the purchase could not go forward. The plaintiff then placed his sale proceeds in an interest-bearing account and continued to look for another property for a year before concluding he had been priced out of the market. The trial court instructed the jury on both CC §3343 and CC §3333 (although, under the fiduciary rule, only a CC §3333 instruction should have been given), and the plaintiff was awarded damages for lost appreciation and loss of use of his prior home. Noting that strict adherence to either formula would not adequately compensate the plaintiff or accomplish justice when a fiduciary's fraud is a substantial cause of damage, the court affirmed the award by reverting to the principle that basic tort damages would govern (135 CA4th 749):

> Tort damages are awarded to fully compensate the victim for all the injury suffered. There is no fixed rule for the measure of tort damages under CC §3333. The measure that most appropriately compensates the injured party for the loss sustained should be adopted. [Citations omitted.]

It is interesting to note that the jury found the plaintiff to have 5 percent comparative fault, presumably for selling his former home without a contingency that the new home's purchase would be consummated. See §11.33 on comparative negligence.

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§11.94 5. Cost of Repair Not a Damages Measure

The "cost of repair" is not a recognized damage formula, and reference to the cost of repair in discussions of damage measures can be misleading and inaccurate. Cost of repair may become a factor in determining expectancy interest in an award against a fiduciary agent for intentional fraud, but it is not related to market value in any other way. It merely helps determine the "as represented" valuation.

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B. Application of General Rule

§11.95 1. Is There a Fiduciary Relationship?

Confusion often arises over which measure of damages to use. Generally speaking, when the defendant stands in a fiduciary agent relationship to the plaintiff, the principal is entitled to the broader measure of CC §3333 damages. Damages arising out of a nonfiduciary agent's relationship to the plaintiff are generally governed by CC §3343. See *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 565, 29 CR2d 463 (citing *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551); §§11.90-11.91.

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§11.96 a. Negligent Versus Intentional Misrepresentation

In *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352, the California Supreme Court carved an exception to the general fiduciary damages rule by holding that when a fiduciary is liable for *negligent misrepresentation*, the out-of-pocket rule of CC §3343 will apply. At the same time the court noted: "While the measure of damages under §3333 might be greater for a fiduciary's intentional misrepresentation, we need not address that issue here." 10 C4th at 1249. This statement is interesting because existing authority fairly well agrees that intentional fraud by a fiduciary requires use of CC §3333 (often cited together with CC §1709). See *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 565, 29 CR2d 463, which discusses suggestions that a benefit-of-the-bargain measure of damages is appropriate when the fiduciary's misrepresentation is intentional, and an out-of-pocket measure of damages is applicable when the misrepresentation is negligent.

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§11.97 b. Constructive Fraud

In *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463 (decided prior to *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352), a court of appeal awarded the plaintiffs the broader CC §3333 damages, even though the plaintiffs brought an action for negligent misrepresentation. The court held that "there is no clear line establishing when a fiduciary's breach of the duty of care will be merely negligent and when it may be characterized as constructive fraud. However, a breach of a fiduciary duty usually constitutes constructive fraud." *Salahutdin,* 24 CA4th at 563. The *Salahutdin* court, like the *Alliance Mortgage* court, did not address whether intentional misrepresentation could result in benefit-of-the-bargain damages under CC §3333.

WARNING: It should be noted that in *Alliance Mortgage Co. v Rothwell, supra,* the supreme court referred to *Salahutdin* as involving a fiduciary's negligent misrepresentation and cited its own decision in *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 198 CR 551 for the premise that only out-of-pocket damages are available in such cases. Nevertheless, *Alliance'*s apparent distinction between negligent and intentional misrepresentation as having an effect on the measure of damages for brokers in a fiduciary relationship should not be hastily embraced. The narrow facts alleged in *Alliance* deal with damages for lenders. It is unclear how a lender might claim a measure of damages greater than the out-of-pocket measure because the lender is typically satisfied with its security interest, rather than the bargain of a hypothetical greater market value. The combined application of both CC §§1709 and 3333 in intentional fraud cases may be the key, however, because §1709 provides that anyone guilty of willful deceit is liable for "any damages" that the injured party suffers. See §11.93.

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§11.98 2. Damage Elements Must Be Pleaded and Proved

Failure to place in evidence the specific components of a damage formula can be fatal. Proof of the correct measure of damages is a required element of the claim. See *Saunders v Taylor* (1996) 42 CA4th 1538, 1542, 50 CR2d 395; *Fragale v Faulkner* (2003) 110 CA4th 229, 1 CR3d 616.

PRACTICE TIP 1: Additional damage elements including proximate causation, reliance, and nonspeculative damages must be affirmatively shown and argued. Each measure may also carry with it additional damages. See §11.100. Counsel should always review CACI instructions on causes of action and damages as this is the framework the trial judge will rely for discovery and argument on damages. In fact, late amendment at trial by the plaintiff can best be attacked not by the label on the cause of action, but on whether it carries with it different or larger damage claims prejudicial to the defendant.

PRACTICE TIP 2: It is often helpful to draft a special verdict on the damage elements so that a jury finding becomes of record, and not subject to appeal except as to possible sufficiency of evidence. On special verdicts, see §12.23.

Examples are helpful in describing the different damage measures to the trier of fact. The price paid or value parted with is determined by the amount actually paid by the damaged party. The value of the property as represented, however, may differ. A representation may have been made to a buyer by a fiduciary that the property is worth more than its actual fair market value on the purchase date. In that case, the higher value as represented by the fiduciary may be used to calculate the difference under CC §3333.

Pleadings are relevant only insofar as a claim which survives to trial is a claim involving intentional fraud. The court will look behind the label of the pleadings to the actual allegations in determining the applicable procedural issues, such as a statute of limitations. See *Loken v Century 21-Award Props.* (1995) 36 CA4th 263, 42 CR2d 683; *Ventura County Nat'l Bank v Macker* (1996) 49 CA4th 1528, 57 CR2d 418. A motion to amend at trial to conform to proof should be made before jury instructions require decision as to the appropriate damages formula.

For further discussion regarding damages arising out of suits for fraud and nondisclosure, see California Real Property Remedies and Damages §§3.43-3.60 (2d ed Cal CEB 2002).

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§11.99 C. Valuation

The actual value the defrauded party received and parted with is determined as of the date the fraud occurred, which is usually the date of sale. *McCue v Bruce Enters., Inc.* (1964) 228 CA2d 21, 39 CR 125. Normally date of loss is equivalent to close of escrow. However, in *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463, the court held that damages can be assessed as of date of discovery, or even as late as trial. The court reasoned that applying the difference as of the date of the transaction would defeat the goal of compensation for the entire loss when discovery of the fiduciary's constructive fraud did not occur until years after purchase of the property. 24 CA4th at 568.

Salahutdin cites cases that on closer reading demonstrate that the holding is a departure. In *Pepitone v Russo* (1976) 64 CA3d 685, 134 CR 709, property was lost by foreclosure caused by a broker's failure to disclose an acceleration clause in a second deed of trust. The court reversed the application of the CC §3343 measure of damages and indicated that lost future profits might have been recoverable, although not claimed. 64 CA3d at 690 n3. But *Pepitone* does not apply a different date of loss or discuss appreciation damages. See also *Walsh & Hooker v Fay* (1963) 212 CA2d 450, 28 CR 16 (date of loss is date of discovery of fraud).

In *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 37 CR3d 699, the applicable date for measuring loss was at issue. Defendants contended that CC §§1709 and 3333 did not authorize appreciation damages because damages caused by fraud are determined as of the date when the fraud took effect, not by a later increase or decline in value. The court held that because the rising value of the property that the plaintiff intended to purchase with the sale proceeds was foreseeable, the plaintiff could recover lost appreciation. The court also noted that allowing recovery for lost appreciation would provide a significant deterrent to brokers and salespersons in the future. 135 CA4th at 752.

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§11.100 D. Additional Damages Recoverable

Civil Code §3343 allows a plaintiff to recover any additional damages arising from the transaction, including the following:

- Amounts actually and reasonably expended in reliance on the fraud;
- Compensation for loss of use and enjoyment of the property to the extent that the fraud proximately caused that loss;
- If the plaintiff was the property owner, compensation for profits or other gains that might reasonably have been earned by use of the property had the plaintiff retained it; and
- If the plaintiff was the buyer or tenant, compensation for any loss of profits or other gains that were reasonably anticipated and would have been earned from the use or sale of the property had it possessed the characteristics fraudulently represented by the defendant. Lost profits, however, may not always be recovered. See §11.102.

When faced with "reliance damages," counsel should compare the categories of damages claimed by the plaintiff. Even under the broadest measure of CC §3333, the plaintiff cannot recover *inconsistent types* of damages. For example, if a sale was not consummated, a buyer cannot recover lost profits *plus* the expenses he or she would have had in consummating the transaction in order to get to a profits position. The plaintiff would have had to incur those expenses in any case, to get into a position to make a profit.

Nothing in CC §3343 may either:

- Permit the plaintiff to recover any amount measured by the difference between the value of property as represented and its actual value; or
- Deny to anyone having a cause of action for fraud or deceit any legal or equitable remedies to which such person may be entitled.

Reliance damages are those incurred in reliance on the fraud and are recoverable only if the damages have a causal connection with the fraudulent misrepresentation or nondisclosure. *Gagne v Bertran* (1954) 43 C2d 481, 275 P2d 15; *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551.

For a discussion of additional damages recoverable for, *e.g.,* personal injuries and emotional distress, interest, punitive damages, and attorney fees, see California Real Property Remedies and Damages §§3.53-3.56 (2d ed Cal CEB 2002). See also §§4.41-4.51.

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§11.101 1. Amounts Actually and Reasonably Expended

Actual expenditures of time and money are recoverable as additional damages if they were incurred in reliance on the fraud. *Stout v Turney* (1978) 22 C3d 718, 726, 150 CR 637. Such expenditures may include:

- Labor (see *Hartong v Partake, Inc*. (1968) 266 CA2d 942, 969, 72 CR 722 (plaintiff's reasonable hourly wages were representative of loss of time));
- Repairs and improvements (see *Buist v C. Dudley DeVelbiss Corp.* (1960) 182 CA2d 325, 333, 6 CR 259 (cost of improvements damaged by undisclosed ancient slide in area of underground water)); and
- Expenses (see *Cory v Villa Props.* (1986) 180 CA3d 592, 603, 225 CR 628 (escrow fees, moving expenses, building permits, telephone connections and charges, mileage expenses, fences, yard cleaning, garage materials, door locks, shrubbery, taxes, rent, and labor)).

For further discussion of claims for labor, repairs and improvements, and expenses, see California Real Property Remedies and Damages §§3.49-3.51 (2d ed Cal CEB 2002).

The plaintiff must prove that the broker's acts and omissions were a "substantial factor" in causing the harm (See CACI instructions). From that point, the burden switches to the defending broker, but many arguments can be made to limit exposure as part of the chain of causation concept. Thus, even if the measure of damages is under the broader measure of CC §3333, the important aspect of the statute is the language allowing recovery only for "all the detriment proximately caused thereby".

The defending broker should posit hypotheticals if there is an expert witness and use examples in argument to a jury in an effort to argue that there was superseding causation or a lack of mitigation by the plaintiff, for example. These concepts apply even if in finding liability, the court finds that the harm caused by the broker was "a substantial factor" under the elements of a cause of action. Defending a broker, particularly when he or she is a fiduciary, and worst case, a dual agent, is very difficult from a liability perspective if anything went wrong in the transaction. But liability alone is not the end of the inquiry and a good defense attorney will go beyond it in planning the defense presentation.

Lack of mitigation by the plaintiff should always be pleaded in an answer. Practically speaking, there are often many opportunities for a claimant to prevent or mitigate harm without resorting to the "guaranty" implied by the presence of a broker with fiduciary duties, and suing instead. But failure to pursue these alternatives needs to be documented in some way other than through mediation or settlement discussions, which are privileged, in order to preserve the ability to introduce evidence on this issue at trial.

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§11.102 2. Lost Profits

Under CC §3343(a)(3), a defrauded property owner can recover for profits or other gains that might have been earned if the property had been retained. Also, CC §3343(a)(4) provides for recovery by a defrauded buyer of the loss of profits and other gains that could have been earned if the property had been as represented, as long as (*Stout v Turney* (1978) 22 C3d 718, 727, 150 CR 637; *Cory v Villa Props.* (1986) 180 CA3d 592, 603, 225 CR 628):

- The property was acquired in order to generate profits or to resell at a profit (CC §3343(a)(4)(i));
- The buyer reasonably relied on the fraud in buying the property and anticipating such profits (CC §3343(a)(4)(ii)); and
- The lost profits were proximately caused by the fraud and the buyer's reliance on it (CC §3343(a)(4)(iii)).

With respect to a buyer's action for fraud, the buyer must actually acquire the property before recovering lost profits. *Kenly v Ukegawa* (1993) 16 CA4th 49, 55, 19 CR2d 771 (action by prospective buyer against owner); *Nguyen v Scott* (1988) 206 CA3d 725, 740, 253 CR 800 (action by prospective buyer against broker).

These loss-of-profits provisions give CC §3343 some aspects of a benefit-of-the-bargain measure of damages, but the statute itself declares that it does not authorize recovery of the difference between the value of the property as represented and its actual value. CC §3343(b)(1); see *Stout v Turney* (1978) 22 C3d 718, 726, 150 CR 637.

For further discussion of lost profits, see California Real Property Remedies and Damages §3.52 (2d ed Cal CEB 2002).

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§11.103 3. Punitive Damages

Punitive damages may be awarded if it is shown, by clear and convincing evidence, that the broker's misconduct was oppressive, fraudulent, or malicious. CC §3294; *Haigler v Donnelly* (1941) 18 C2d 674, 117 P2d 331; *Simone v McKee* (1956) 142 CA2d 307, 298 P2d 667. Punitive damages are unavailable for breach of contract—even if the breach is willful and even if the contract creates the fiduciary obligation. CC §3294; *Crogan v Metz* (1956) 47 C2d 398, 303 P2d 1029. Punitive damages may be available, however, for breach of fiduciary duty (a noncontract claim) on proof of oppression, fraud, or malice. CC §3294.

The standard for misconduct may differ depending on whether the broker has a fiduciary or nonfiduciary relationship with the plaintiff, and is entirely determined by the factual circumstances. Depending on those factual circumstances, a broker may incur punitive damages for behavior less flagrant than would justify a punitive damages award against either a nonprofessional or a nonfiduciary. See, *e.g., Ward v Taggart* (1959) 51 C2d 736, 336 P2d 534.

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§11.104 4. Attorney Fees

The general "American Rule" (CCP §1021) is that each party bears its own attorney fees. There are two general exceptions (excluding statutory authorized fee awards): (1) fees awardable under a contract clause (see §11.105) and (2) fees awarded under the Prentice Doctrine (*Prentice v North Am. Title Guar. Corp.* (1963) 59 C2d 618, 28 CR 146), also known as "tort of another" fees (see §11.106).

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§11.105 a. Attorney Fees Provided for in Underlying Agreements

Under CC §1717, contractual attorney fees are deemed mutual and are awarded by the court to the prevailing party after trial on a cost motion. The scope of permissible recovery has been analyzed in cases dealing with the reading of CCP §1021 and CC §1717 together, to allow the parties to agree that contractual fees can also apply to actions arising from torts. Thus, the wording of the fee clause is critical.

In *Xuereb v Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 5 CR2d 154, the court was faced with defendants who had prevailed on tort causes of action at trial but had been denied recovery of their attorney fees and costs under the contract. In overturning the ruling on attorney fees, the court noted that the attorney fee provision allowed fees and costs to the prevailing party if a suit or other legal proceeding arose from the agreement. The language was broad enough to encompass both contract and tort claims.

Generally, a broker is not a party to the purchase agreement. Thus, a broker cannot be considered a possible "prevailing party" under a fee clause unless the broker is expressly specified to be included in the fee clause. See, *e.g., Super 7 Motel Assocs. v Wang* (1993) 16 CA4th 541, 20 CR2d 193. Thus, two analyses of the fee clause become primary in litigation involving brokers. Counsel should examine (1) whether the broker is included within the fee clause and (2) how broadly the fee clause is worded. Does it extend to "any actions arising out of… " (and thereby including tort claims)? What is the agreed scope: does the clause extend just to claims on the contract, the transaction, or the property itself?

In most standardized listing agreements, the scope of the attorney fee clause will be limited to commission disputes. If in fact the fee clause in a listing agreement is much broader, the property owner may potentially have two fee clauses (in the listing agreement and the purchase agreement or lease) to rely on in a dispute with the listing broker.

In *Hasler v Howard* (2004) 120 CA4th 1023, 1027, 16 CR3d 217, the wording of the attorney fees provision was pivotal; the court stated: "Instead of covering any action or lawsuit arising from the listing agreement, the provision here only applies to actions 'regarding the obligation to pay compensation' under the listing agreement." A tort action for fraud, breach of fiduciary duty, and breach of duty to disclose did not satisfy the explicit language in the listing agreement. Compare *Pacific Preferred Props. v Moss* (1999) 71 CA4th 1456, 84 CR2d 500, in which the court, on the basis of references to the broker in various sections of the purchase contract, found that the broker was a party to the contract and awarded attorney fees to the prevailing party seller.

Another aspect of contractual attorney fees litigation is that of the limitations inherent in CCP §998 settlement offers (see §12.12), which can cut off accrual of fees to the claimant if the offer is not accepted and the defense receives a verdict or a ruling that is more favorable than the settlement offer. Broker's counsel should always consider a §998 offer as a litigation tactic, not just to preserve the right to recover expert witness fees but even more importantly, to cut off any potential contractual fee liability. See *Scott Co. v Blount, Inc.* (1999) 20 C4th 1103, 86 CR2d 614. The court can award the prevailing party its pre-offer fees, but the defendant is entitled to post-offer fees if the plaintiff did not do better at trial than the defendant's offer. These results are then calculated into who is the "prevailing party" for purposes of regular costs. Thus, §998 offers can cut off the running of contractual fees even if the offer is rejected.

PRACTICE TIP: The CAR contract forms and those promulgated by many brokerage firms do not include the brokers in the attorney fees provision (which is expressly applicable only to the buyer and seller). But some forms, such as that in *Xuereb v Marcus & Millichap, Inc., supra,* expressly include the broker. Counsel should read them carefully, as the issue of potential liability for the other parties' fees can dramatically change the dynamics of the litigation.

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§11.106 b. Tort of Another or Prentice Fees

Fees recoverable under the "tort of another" theory have two significant differences. First, the fees claimed must be pleaded and proven at trial, not by posttrial motion. If not, plaintiff cannot recover them. Second, the fees must have been incurred by the claimant in proving that the broker was the sole cause of the need to defend or prosecute claims against another party. As stated in *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 57, 6 CR2d 602:

> The rule of *Prentice* [*v North American Title Guar. Corp.* (1963) 59 C2d 618, 30 CR 821] was not intended to apply to one of several joint tortfeasors in order to justify additional attorney fee damages. If that were the rule there is no reason why it could not be applied in every multiple tortfeasor case with the plaintiff simply choosing the one with the deepest pocket as the "*Prentice* target." Such a result would be a total emasculation of Code of Civil Procedure Section 1021 in tort cases.

See also *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 198 CR 551, in which the California Supreme Court disapproved the portion of *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655 that upheld a fee award, but found a partial exception in holding that the buyer's attorney fees incurred in a specific performance action against the property owner (brought in reliance on the broker's misrepresentation) were recoverable.

Thus, as when arguing lack of mitigation and similar chain of causation theories (see §11.101), the defending broker can argue that he or she was not the *sole* cause of the third party litigation, regardless of whether his acts and omissions are found to be a "substantial factor" in harm to claimants. See *Behniwal v Mix* (2005) 133 CA4th 1027, 35 CR3d 320 (listing broker sued on "third party tort theory" and prevailed against claim for attorney fees because owners had ratified forged counteroffer signed by broker).

Another interesting aspect is presented in *Heckert v MacDonald* (1989) 208 CA3d 832, 256 CR 369. The *Heckert* court found that the broker's nondisclosure of defects to the buyer, instead of harming the property owner by causing the buyer to sue him, actually enhanced the purchase price the owner received, which would have been lower had the defects been disclosed. Thus, the court found no harm and no broker liability under "tort of another."

See also discussion of contractual attorney fees in §4.7.

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12

Trial Tactics and Strategies

Martha L. Caron

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.1 I. INTRODUCTION

§12.1 I. INTRODUCTION

Many counsel are litigators; few are trial attorneys. This is partly due to the high rate of settlements, which is a goal to be encouraged. But settlements are often premised on costs of litigation as the significant motivating factor, instead of exposure. Also, the opportunity to meaningfully assess litigation costs is often not undertaken until after the dollars are spent.

Success in litigation requires an understanding of how a case is likely to develop, in order to anticipate worthwhile expenditures. Experienced trial counsel can predict with a great deal of accuracy the likely procedural and strategic developments in most cases, regardless of underlying fact patterns.

The main difficulty of preparing for trial is the necessity for dual thinking: strategizing in the trial mode of evidence and advocacy, while always being prepared for settlement opportunities. The hardest challenge is, from the very beginning of the matter, not allowing oneself to be lulled into deviating from preparing the case for trial, despite constant hopes of settlement. Succeeding in this challenge usually means a favorable settlement in the end.

This chapter is general in approach and contains hard-won advice on representing clients at trial. For more detailed discussion of pretrial strategy and procedures, see California Civil Procedure Before Trial (4th ed Cal CEB 2004); California Civil Discovery Practice (4th ed Cal CEB 2006); California Trial Practice: Civil Procedure During Trial (3d ed Cal CEB 1995); and California Expert Witness Guide (2d ed Cal CEB 1991). The discussion of strategy and tactics covered in this chapter is divided into three distinct time periods:

- Trial preparation appropriate at the time the trial date is set (see §§12.2-12.18);
- Trial preparation within 30 days of trial (see §§12.19-12.29); and
- Trial (see §§12.30-12.39).

With adequate planning, direction, and supervision, a significant portion of trial preparation can be performed by a paralegal.

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§12.2 II. TRIAL PREPARATION ONCE TRIAL DATE IS SET

The old adage of preparing the opening statement first (rather than the closing argument) as an outline of the case is true. There are several preparation strategies critical to being a successful trial attorney. Each of these strategies depends on mastering the facts first, allowing later reference to them without a recapitulation from memory. Starting a witness book early and using it for depositions is also beneficial. The witness book has a section for each anticipated witness containing information relevant to that person, *e.g.,* resume, addresses, reports and inspections, associated documentary evidence such as signed documents, and, eventually, deposition transcripts, examination outlines, and notes. Organizing both testimonial and documentary evidence are equally important. It is recommended that each key document be scanned and organized for later extraction, reprinting, or review. For instance, a brokerage case might have electronic document subfolders titled "Transaction Documents," "Escrow Documents," "Physical Inspection Reports," or other categories dictated by the issues. This electronic archival system makes any document—those received as well as those generated by counsel— easily and instantly accessible at any time. The most recent version of Adobe Acrobat Professional software is a highly recommended tool for trial counsel. The software allows users to organize a series of documents or parts of documents; code, stamp, and date documents; as well as perform a global search over multiple documents. For more on the use of witness books, see Effective Introduction of Evidence in California §3.8 (2d ed Cal CEB 2000).

WARNING: Counsel should be aware that scanning, redacting, and other functions of electronic archival systems may leave sensitive portions of documents that counsel may have thought were protected vulnerable to detection by computer professionals (often called "forensic experts"). For a cautionary tale involving the inadvertent disclosure by counsel of a large settlement between litigating parties, see *ConnectU, Inc. v Facebook, Inc.* (D Mass June 3, 2008, No. 07-10593-DPW) 2008 US Dist Lexis 43801.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.3 A. Calendaring

§12.3 A. Calendaring

As soon as a trial date is set, counsel should generate a pretrial checklist by chronological date in a countdown to trial. Some attorneys create their own checklists and tailor them to each county in which they practice, while others utilize one of several legal software calendar programs marketed to attorneys. In either case, all time frames and citations to statutes and local rules must be double-checked to ensure that critical deadlines are not missed. The printed pretrial calendar should be posted in clear view, as well as integrated into daily calendar management software. (This doubles as a critical malpractice avoidance routine.)

It is also important at this time to confirm, both orally and by letter, the trial date for witnesses and especially for any experts who need to know right away. Prior to trial setting, inquire if there are any significant unavailability periods for anticipated witnesses so this can be taken into account for choice of trial date without having to later move to continue a trial date, which may not be granted. Once a date is set, counsel should immediately send out a letter specifying the trial date, asking all potential witnesses to schedule around it. It is also desirable to use a subpoena as well. See §§12.26-12.27.

For more on calendaring, see California Civil Procedure Before Trial §§1.41-1.44 (4th ed Cal CEB 2004).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.4 B. Trial Books

§12.4 B. Trial Books

The use of tabbed 3-ring binders is indispensable for the organized litigator. The binders commonly used for trial are

- Witness book (see §§12.2, 12.21-12.22);
- Exhibit book (see §12.29);
- Jury book or jury instructions book (see §§12.6, 12.21-12.22); and
- General trial binder (see §12.5).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.5 1. General Trial Binder

§12.5 1. General Trial Binder

A trial binder can be organized by staff, but the attorney should have frequent and final review, as trial counsel must develop sufficient familiarity with the case to avoid fumbling at critical junctures. A good trial binder will be expansive, although it will not be used throughout trial. It is primarily referenced during the beginning and end trial procedures held outside the presence of the jury, following jury selection. Once trial begins, the exhibit and witness binders are used daily. The main trial book should include sections for:

- Operative pleadings;
- Pretrial orders;
- Motions to disqualify under CCP §170.6;
- In limine motions (see §12.25);
- Trial briefs;
- Statement of the case for a jury;
- Opening and closing statement notes;
- Final jury chart;
- Anticipated evidentiary objections;
- Short briefs on key legal points; and
- Any other categories to which counsel may need quick reference before the trial judge.

Experienced trial counsel develop their own method of trial preparation, which becomes a personal routine, and will usually start with the same trial binder with common sections intact, such as form in limine motions, evidentiary objections chart, and other materials that can be reused. When the case is concluded, the content of sections applicable to that matter are extracted and stored together. The trial binder is then ready for the next trial.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.6 2. Jury Book

§12.6 2. Jury Book

In jury trials, some trial counsel use a separate binder as a jury book, which contains:

- Proposed voir dire;
- Jury selection notes;
- Final jury chart;
- Proposed instructions;
- Jury instruction conference notes;
- Form of verdict; and
- Other relevant topics and documents.

A jury binder can be incorporated into the main trial book in a smaller trial. See also §§12.21-12.22.

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§12.7 C. Experts

If not previously considered, counsel should review the need for an expert when the trial date is set. Counsel should create a standing file of appropriate experts. This file can be augmented by materials and recommendations from other trial counsel.

Experts in brokerage litigation usually include:

- Standard of care experts (see chap 13);
- Property appraisers; and
- Specialty condition experts, such as engineers, roofers, general contractors, soils experts, etc.

The statutory scheme set out in CCP §§2034.210-2034.310 allows a litigant to demand simultaneous disclosure of experts. After the exchange of names and information has been made, any party who engaged in the exchange may submit a supplemental list of "any experts who will express an opinion on a subject to be covered by an expert designated by an adverse party to the exchange, if the party supplementing an expert witness list has not previously retained an expert to testify on that subject." CCP §2034.280. A recent opinion has cast doubt on the practice of supplemental disclosure of experts. See *Fairfax v Lords* (2006) 138 CA4th 1019, 41 CR3d 850 (involving former CCP §2034). The *Fairfax* court rejected the contention that it is a "prudent" tactic for a defendant to use the supplemental list statute to delay designation of any experts until after viewing the list put forth by the opposition, holding that this view is "simply inconsistent with the clear statutory requirement of a 'simultaneous' exchange." Given the holding of this case, the expert may have to be a reasonably *unanticipated* rebuttal witness to qualify for supplemental disclosure under CCP §2034.280. In a case involving possible broker liability, a standard of care expert (see chap 13) should always be included in the initial mutual exchange. It is also wise to include an appraiser, even if the plaintiff is not yet clear on his or her theory of damages.

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§12.8 1. Standard of Care Expert

Standard of care experts are especially important in broker litigation and may include other attorneys, brokers, or professional experts. Counsel should consult a standard of care expert early if guidance is needed on the development of the case. Apart from serving as a disclosed expert, such consultants can recommend discovery strategies, suggest the kind of information to be developed and where to get it, and otherwise assist in bringing the case to trial. Most qualified experts would prefer to be involved in that capacity, rather than be handed voluminous transcripts to read when it is too late to develop the crucial questions to be asked of a witness. See detailed discussion in chap 13.

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§12.9 2. Expert as Pretrial Consultant

Some attorneys do not select an expert until they are within 48 hours of the witness disclosure deadline, but this practice is incredibly risky. Engaging experts as early as possible serves to lock in that expert and prevent conflicts from developing, while providing the widest choices.

If the physical condition of the property is at issue, counsel should ensure that the experts chosen will have an opportunity to inspect the property. Since some opposing counsel may only allow one site inspection, counsel should ensure that experts attend the inspection.

For more on expert witnesses as consultants, see §13.14; California Expert Witness Guide (2d ed Cal CEB 1991).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.10 D. Timeline Tool

§12.10 D. Timeline Tool

It is highly recommended that counsel generate a chronological table of the events and significant case markers based on the underlying fact pattern from the *inception of the case*. The table can be divided into several columns, such as:

- Date;
- Event description; and
- Evidence (*e.g.,* supporting facts and documents).

The timeline table is a working document with information inserted in rows as the case proceeds. Counsel should flesh out the table after review of the client's documents, on review of document productions by others, and in finer detail after depositions. It can be added to at any time new facts are isolated or new evidence is identified to support an existing fact. In addition, the timeline tool may be expanded to chart out the basic elements of each claim and defense with appropriate reference to California Jury Instructions, as well as to add document and deposition references as they arise.

The information in the timeline table will help identify the proof needed for each event, and it assists in organizing the underlying facts in a comprehensible fashion. In addition, the table can be used as a trial tool for the trier of fact, with proper modifications. It also helps meet any argument that the standard of proof has not been met or that evidence has not been developed on a key point. In essence, the timeline table works as the statement of facts for a mediation brief, a trial brief, or other application.

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§12.11 E. Pretrial Discovery

Counsel should set any remaining key depositions when the trial date is confirmed and should also send out continuing written discovery requests. Continuing written discovery requests are underutilized as a way to make sure all documents and other evidence is properly requested before trial.

If the party represented has not yet been deposed, counsel should try to avoid immediate pretrial disputes by offering up the client for deposition in writing with a series of amenable dates. Although this seems counterintuitive (especially if opposing counsel has simply neglected to schedule a deposition), no competent judge will allow trial without the principals' depositions. Anticipating the deposition avoids squabbling over self-styled "failures to produce" witnesses and shows the court and opposing counsel one's conviction in the strength of the case by doing everything possible to move toward a firm trial date.

For more on pretrial discovery generally, see California Civil Discovery Practice (4th ed Cal CEB 2006).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.12 F. Settlement Offers

§12.12 F. Settlement Offers

In part, CCP §998 provides that:

> Not less than 10 days prior to commencement of trial or arbitration (as provided in Section 1281 or 1295) of a dispute to be resolved by arbitration, any party may serve an offer in writing upon any other party to the action to allow judgment to be taken or an award to be entered in accordance with the terms and conditions stated at that time. The written offer shall include a statement of the offer, containing the terms and conditions of the judgment or award, and a provision that allows the accepting party to indicate acceptance of the offer by signing a statement that the offer is accepted. Any acceptance of the offer, whether made on the document containing the offer or on a separate document of acceptance, shall be in writing and shall be signed by counsel for the accepting party or, if not represented by counsel, by the accepting party.

Counsel should set out a CCP §998 scenario by preparing a §998 offer when not under pressure. The offer must be in writing. *Saba v Crater* (1998) 62 CA4th 150, 72 CR2d 401 (oral offer to compromise on deposition record does not satisfy CCP §998 requirements). The offer should include all the salient points except for a monetary sum, which must be discussed with the client. Counsel should research the law on CCP §998 offers as a standing mini brief for the trial binder. See §12.5.

At least one §998 offer should be made prior to incurring any expert costs, to ensure that those costs are included in an award if the client is deemed the prevailing party at trial. Code of Civil Procedure §998(c)(1) permits expert witness fees to be recovered as costs when the prevailing party receives a judgment more favorable than an offer to compromise submitted under that section. It is an abuse of discretion for a court to refuse to award expert witness fees after a party made a good faith CCP §998 offer. *Thompson v Miller* (2003) 112 CA4th 327, 338, 4 CR3d 905 (when offering party obtains judgment more favorable than its pretrial offer, offer is presumed to have been made in good faith; opposing party has burden of proving otherwise).

Failure to specify in a §998 offer that the offer includes *all* recoverable fees and costs can constitute per se malpractice if the offer is accepted in a case in which contractual fees are also recoverable. The plaintiff may file an acceptance and still proceed with a motion for contractual fees and costs as the prevailing party in addition to those in the §998 offer. See, *e.g., Chinn v KMR Prop. Mgmt.* (2008) 166 CA4th 175, 82 CR3d 586.

The award of attorney fees and costs is the subject of numerous appellate opinions governing the timing of a §998 offer and determination of who is the prevailing party. See, *e.g., Acree v General Motors Acceptance Corp.* (2001) 92 CA4th 385, 112 CR2d 99; *Jackson v Homeowners Ass'n* (2001) 93 CA4th 773, 113 CR2d 363; *Scott Co. v Blount, Inc.* (1999) 20 C4th 1103, 86 CR2d 614. Under the *Scott* opinion, a §998 offer may cut off fee entitlement. If a defendant makes an offer in a case in which the plaintiff is entitled to fees, and the plaintiff does not do better at trial, the plaintiff is only entitled to fees up to the date of the offer (pre-offer fees) and the defendant is entitled to offsetting fees after the date of the §998 offer (post-offer fees), which can itself determine who is ultimately the prevailing party for purposes of awarding costs.

Counsel should also be familiar with how and when a §998 offer can be revoked. See *T. M. Cobb Co. v Superior Court* (1984) 36 C3d 273, 204 CR 143 (general contract law principles are applicable to §998 offers); *Gray v Stewart* (2002) 97 CA4th 1394, 119 CR2d 217 (plaintiff's offer to compromise was accepted, so plaintiff could not revoke offer); *Palmer v Schindler Elevator Corp.* (2003) 108 CA4th 154, 133 CR2d 339 (second offer, even if invalid, extinguishes first offer). A revoked offer will not trigger the cost-shifting provisions of CCP §998. *Marcey v Romero* (2007) 148 CA4th 1211, 56 CR3d 402.

PRACTICE TIP: In multi-party cases, counsel should prepare and serve separate §998 offers for each plaintiff or defendant, allowing each the opportunity to accept the offer individually. See *Menees v Andrews* (2004) 122 CA4th 1540, 1546, 19 CR3d 664 (offer that did not meet this requirement found invalid).

For more detailed discussion of CCP §998 settlement offers, see California Civil Procedure Before Trial, chap 47 (4th ed Cal CEB 2004).

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§12.13 G. Presentation Software

Some attorneys may still use large pasteboard charts to display information to the judge and jury, especially when cases are relatively minor and the issues are simple enough to present in this fashion. However, large charts are physically cumbersome to manipulate and have largely been replaced by presentation software such as Microsoft PowerPoint®. PowerPoint and similar programs have become indispensable trial tools. They are easily learned and produce powerful presentations.

The substance of a PowerPoint presentation, especially for purposes of the opening statement, should never be controversial and should be as undisputed in fact presentation as possible. As a side benefit, it also supports the trial attorney's ability to give a concise and riveting opening following counsel's outline of the case.

The opening statement presentation may be used to acquaint the jury upfront with a brief introduction to a damages issue; however, argument is not appropriate at this time, so slides should be limited to proof of losses as a matter of evidence only. The presentation can be made more contentious or persuasive for closing argument by rearranging and adding slides. For more on presentation software and other technology useful at trial, see Allen, *Technology and the Trial Attorney*, 25 CEB Civ Litigation Rep 140 (August 2003).

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§12.14 1. As Visual and Graphic Tool

In cases involving brokered sales of real property, the complaint is often for undisclosed property defects. The use of photographs as slides is a critical application of PowerPoint. In addition, the use of a timeline of events is also fundamental to a jury's understanding of the evidence. However, PowerPoint is more than a visual tool for a jury. It can incorporate photographs, charts, chronologies, and documents (which can include callouts or blowups of relevant language). Each is a separate slide, which can be organized together with other slides and moved around in any order. If key documents have been scanned during trial preparation (see §12.2), or preferably, as they are received during the discovery portion of the case, each document can be extracted to become a separate slide in a PowerPoint presentation.

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§12.15 2. As Organizational Tool

Organizing a PowerPoint presentation forces counsel to organize the presentation of a case. A good tactic is to reuse key slides in opening presentations, during introduction of evidence, and again in closing argument to emphasize points, *e.g.,* damage calculations or chronologies of events.

While the advantages of PowerPoint are many, it is also important not to overwhelm the trier of fact, especially a jury, with too much information in too rapid a fashion. PowerPoint slides should be kept as simple as possible and repeated as often as possible.

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§12.16 3. Court Procedures

Courts are still developing policies around the use of presentation software. Some judges may require that an entire printout of the presentation be delivered in advance to opposing counsel. Others consider the software presentation to be an opening statement, as if it were notes, and therefore only visuals (*e.g.,* photographs) need be disclosed, with the balance considered work product. Counsel must always consult local rules.

Counsel should anticipate that a court may require advance disclosure of the presentation (and should at least ask if this is the policy at the time of an issue or pretrial settlement conference). If required, such advance disclosure may appear unfair if opposing counsel's preparation of its opening statement is not also disclosed; however, advance disclosure has the benefit of forcing disclosure of whether opposing counsel will also use PowerPoint, or whether counsel using PowerPoint has an implicit advantage.

Counsel should check in advance with court personnel and the trial judge on availability of court technology tools. Some courts have "tech carts" available with overhead document readers, laptop attachments, video players, and other useful technical items, but their use may need to be reserved in advance. If at all possible, counsel should plan to have a tech-savvy assistant available to avoid being seen wasting time fumbling with equipment. If not, counsel should be familiar enough with PowerPoint or equivalent software to troubleshoot any problems that may arise. Ideally, the presentation will be completely set up in advance: installed on a laptop, connected to the courtroom visual display, and cued to the first slide, so that it can be started with a single keystroke. Using a remote control to activate the presentation during opening and closing arguments allows counsel to move freely in front of the jury.

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§12.17 4. Expert's Presentation

Expert witnesses may have their own software presentations for use during their testimony. The expert's presentation, including photographs taken during their physical inspection of the property, should be reviewed in advance. Similarly, if a handwriting expert is called for, the displays an expert uses in his or her testimony should be identified and made into slides.

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§12.18 H. Damage Calculations

The appropriate damages measure should be evaluated in advance. Is it a benefit-of-the-bargain or out-of-pocket measure? Or, are both measures appropriate, for instance in a buyer's action against both his or her fiduciary broker and the seller? Are "tort of another" damages recoverable? Is emotional distress an appropriate damage claim? This is a good subject for a standing mini brief to include in the trial book. See discussion of damages in §§11.89-11.106. For a discussion of the trial book, see §§12.4-12.6. On tort of another damages, see §§11.21, 11.83, 11.106.

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§12.19 III. TRIAL PREPARATION WITHIN 30 DAYS OF TRIAL

Pretrial written work should be completed at least a month before the date of trial. Absent a stipulation, discovery is closed and an issue conference is scheduled; the dates are usually mandated by local rules. Some jurisdictions require proposed voir dire, jury instructions, in limine motions, and other pretrial documents to be submitted or exchanged among counsel in advance. Some localities may also require a pretrial counsel readiness conference. Counsel should always consult local rules and custom.

Given any opportunity to inquire in advance, in a single assignment jurisdiction, counsel should determine what the judge's preferences are as to the marking and handling of exhibits, the use of computer-related equipment, the preparation of jury instructions, and any other area in which judges may imprint their own procedures. If not determined from the court directly, counsel should feel free to ask the court clerk, who is often quite helpful on these points. Since court clerks are responsible for keeping exhibits in order during trial, as well as other administrative tasks, they appreciate having exhibits ordered in advance. Counsel should also be aware that common courtesy is always appreciated. After a trial day, lingering for a few minutes to help the clerk reassemble the exhibits scattered over counsel tables and the witness stand is the right thing to do. Doing so ensures that counsel will know exactly where the exhibits are and which numbers are current without fumbling in front of the jury. There is the added bonus of having an invaluable ally in the court clerk if his or her assistance is needed.

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A. Written Preparation

§12.20 1. Trial Materials

To ensure that nothing material has been omitted, trial counsel should follow a practice of going through each case folder of pleadings and discovery, making sure that important pleadings, such as interrogatory responses and the latest complaint, are included in the trial binder. The file folder should have its contents checkmarked and be then stored in a box. Counsel may also print out copies of the indexes for these files and place them in the trial binder so that a document that must be retrieved can be quickly and easily located.

Original deposition transcripts, if not already in counsel's possession, need to be located or the custodian determined. If not previously ordered at the time of deposition (which may be an appropriate cost-saving measure in a case likely to settle), they should be ordered now. All deposition transcripts should be placed in a box for the court clerk so the judge has access to them if testimony is to be used from them. A condensed version of the deposition transcripts, if available from the court reporter, should be placed in the witness book under the appropriate tab for each anticipated witness, along with a standing legal memo on the permitted use of deposition transcripts.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.21 2. Drafting Jury Voir Dire

§12.21 2. Drafting Jury Voir Dire

Litigants have the right to examine and challenge potential jury members. A challenge may be made for "cause" (to excuse a juror for a permissible stated reason, such as bias or general disqualification of a juror to serve) or as a "peremptory challenge" (a challenge with no reason given). See CCP §§225-231.5.

Jury members may be examined by both the judge and counsel for each party in the case. A trial judge "should permit liberal and probing examination" by counsel "calculated to discover bias or prejudice," but the judge may prescribe "reasonable limits" for the questioning. Counsel is not generally required to presubmit questions to the judge. CCP §222.5. If counsel believes that its examination may run afoul of these limits or be deemed "improper," voir dire questions may be presubmitted to the judge as follows:

Party "A" requests of the Court voir dire of the jury in accordance with Rule 3.1540, California Rules of Court, and standard 3.25(c)(1)-(21) of the Standards of Judicial Administration recommended by the Judicial Council.

In addition to the foregoing, Party "A" requests the Court to ask the following questions and thereafter to allow counsel to ask supplementary questions pursuant to Section 3.25(e) of the Standards:

Thereafter, specific questions can be appended. Voir dire strategy is difficult to plan, so counsel must remain flexible enough to follow up with questions when a juror response may suggest bias. Prepared questions are good, but they are just an aid from which counsel must deviate when appropriate.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.22 3. Drafting Jury Instructions

§12.22 3. Drafting Jury Instructions

In California, the Judicial Council California Civil Jury Instructions (CACI) are the official approved instructions for civil trials. See Cal Rules of Ct 2.1050. CACI are available electronically, and instructions appropriate to the case should be reviewed in advance. See the Judicial Council website listed in the Directory.

The preliminary and concluding instructions are straightforward. The middle portion, for causes of action, are dictated by the pleadings and should reflect the final realities dictated by the development of evidence, motions to amend to conform to proof, and other variables. Drafting instructions related to damages can be extremely difficult. See §§11.89-11.106. Draft instructions should be included in the trial binder, jury book, or jury instruction book. See §§12.4-12.6. However, there are several considerations to keep in mind:

- Counsel should adhere to form instructions as much as possible and limit use of special instructions. Special instructions almost always raise objections from opposing counsel because they are perceived as being inherently biased. Instructions should be kept simple, with adequate authority to back them up.
- If jury instructions are required to be submitted in advance, counsel should not spend too much time worrying about the fine points; the instructions will evolve, and the advance instructions will never constitute the final instructions. As the trial unfolds, counsel may find that an instruction is perfectly illustrated by particular evidence in the case.
- Counsel should offer to confer with opposing counsel to get as much agreement in advance as possible. Such a conference will be required by the court at any rate; better to anticipate the event and get it out of the way early.
- When representing the plaintiff, include defense instructions for each of the affirmative defenses alleged in the answer to the complaint.
- When representing the defendant, include instructions for each claim and all damages alleged in the complaint.
- Counsel should not omit instructions which may be "more helpful" to the opposition. It is better to have a say in their drafting. Instructions should be as neutral as possible.

For more on choosing and drafting jury instructions and CACI, see California Trial Practice: Civil Procedure During Trial, chap 20 (3d ed Cal CEB 1995).

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4. Drafting Verdicts

§12.23 a. Special Verdicts

In defending brokers, a general verdict should almost never be used. The exception is for unusual circumstances: for example, if there are insurance considerations. A general verdict merely asks the jury to find ultimate liability and to fix a final sum as damages. If an insurance carrier is balking at covering claims based on fraud, a general verdict will eclipse any argument over which claim the finding was based on, which may or may not be advantageous to the client.

Developing a special verdict is an art form in itself. Start early and keep amending. It must flow in sequence. In defending, counsel should be as specific as possible to give the jury every chance to say no. Each cause of action section should include the requisite elements without repetition. Counsel should not forget such basics as proximate cause. Standard jury instructions should be used as a guide to the required elements.

The initial proposed special verdict form will be amended before it is ever used, but it is important to do as much in advance as possible.

Another consideration in drafting a special verdict is to ensure that findings have not been omitted or excluded that may be critical to whether the Department of Real Estate (DRE) takes action against a broker based on a civil judgment. An expert serving as a consultant can assist with this strategy. On experts as consultants, see §12.9. On DRE discipline actions, see chap 9.

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§12.24 b. General Verdict With Special Findings

As an alternative to a special verdict, counsel may choose to request special findings to accompany a general verdict. Whether to request special findings is a tactical issue that requires evaluating the impact they may have on the case. Special interrogatories structure the jury's decision-making process and act as a powerful device for organizing deliberations.

Unlike special verdicts, which require findings on every fact essential to the case (see §12.23), counsel may select special interrogatories that focus the jury's attention on critical elements that should be considered before reaching a general verdict. Special interrogatories may be useful when an element of a claim or defense should be given particular weight, if multiple plaintiffs or defendants could result in significantly different or confusing decisions on liability or damages, or if some other factor should be emphasized to assist the jury in its truthfinding process.

EXAMPLE: If a claim can be proved or disproved on either of two factual theories, A or B, a general verdict will be upheld if sufficient evidence supports either theory. If the jury establishes on special findings that it based its general verdict on finding A and not on finding B, an appeal can focus on the propriety of finding A. If finding A was inappropriate, a reversal may result, even if evidence existed to support finding B, which the jury rejected.

For more on verdicts generally, see California Trial Practice: Civil Procedure During Trial, chap 22 (3d ed Cal CEB 1995).

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§12.25 5. Preparing In Limine Motions

The term "motion in limine" refers to motions made shortly before the introduction of evidence at trial. They are usually filed in an attempt to regulate the introduction of evidence, although this is not their only purpose. Although motions in limine are commonly used, there is no statutory authority for them in either federal or state practice. Neither the Federal Rules of Civil Procedure nor the Federal Rules of Evidence refer to motions in limine. Rather, the motion derives from the court's authority to control the trial process. See, *e.g., Luce v U.S.* (1984) 469 US 38, 41, 83 L Ed 2d 443, 448, 105 S Ct 460. Such motions are an accepted part of federal practice. *U.S. v Cook* (9th Cir 1979) 608 F2d 1175, 1186. Although there is no specific authority for the motion in limine in the California Code of Civil Procedure, Cal Rules of Ct 3.112(d) recognizes the motion by providing that a motion in limine need not specify a hearing date because the scheduling of such motions is at the discretion of the trial judge. In addition, Cal Rules of Ct 3.20, which precludes the use of "local-local" rules in pretrial proceedings throughout the state, specifically exempts motions in limine. Cal Rules of Ct 3.20(b). Rule 3.20 recognizes that motions in limine are part of the trial proceedings. Schiavelli, *Effective Use of Motions In Limine*, 27 CEB Civ Litigation Rep 136 (Aug. 2005).

Counsel should have numbered in limine motions fully prepared and served prior to trial under local rules. In cases involving brokers, common motions in limine include:

- Defense motions making a standard bifurcation request for a separate phase on punitive damages should the jury find grounds. Otherwise, the jury could consider the defendant's assets as part of the case in chief before prima facie fraud is established. See CCP §3295(a).
- Requests for the exclusion of evidence. This will also flush out claims (or defenses) that seem outside the scope of the litigated issues but on which opposing counsel will not take a firm position until trial.
- Requests for a change in some procedural aspect of the trial.
- The raising of collateral estoppel issues as issue preclusion issues.
- Other subject matter that may have a significant impact on the conduct of the trial.

PRACTICE TIP: In limine motions should be brought only if the issue is critical to the very introduction of evidence or the conduct of the trial itself. Most judges, even in single assignment jurisdictions, will not know enough about the case to make a reasoned decision early in the case and will routinely deny motions in limine without prejudice to renewal. Clients should be counseled not to expect any favorable rulings until the judge begins to get the flavor of the case several days into the proceedings.

Attorneys should follow the rules of advance exchange of motions among counsel. It is better to give up any "surprise" element rather than face many in limine motions by opposing counsel with no preparation time.

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B. Subpoenas

§12.26 1. Witnesses

Witnesses are the life and blood of any trial, but counsel frequently try to avoid dealing with them. The best practice is to contact witnesses both personally and in writing. In any case, witnesses should be subpoenaed early, together with a letter explaining that they need not appear until called and providing for any witness fees. Explain to friendly witnesses that a subpoena is necessary because only then will the court forgive an absence for illness. The dates in the subpoenas should anticipate the order in which testimonial evidence will be presented.

Obviously, when representing a plaintiff, counsel should determine the starting lineup before trial. Is it always best to start with the plaintiff? Would it be better to first call the other parties as adverse witnesses, or will this confuse a jury that hasn't had time yet to absorb the story line?

The difficulty in dealing with witnesses is exacerbated by the uncertainty of setting a trial date and then scheduling witness appearances during trial. Counsel should consider using a form letter enclosure for subpoenas explaining the basics of the trial process for laypersons. Witnesses will appreciate at least knowing what counsel is dealing with and will perhaps feel more forgiving than hostile. Counsel should always try to personally interview friendly key witnesses and depose hostile witnesses early in the process.

PRACTICE TIP: If the trial is continued or does not proceed as scheduled, counsel should advise witnesses promptly and include an agreement form that they will honor the subpoenas for the new date. If there is any doubt, counsel should go to the expense of resubpoenaing witnesses. If the trial does proceed, counsel should consider an e-mail group for the witnesses to provide everyone with the most recent trial status each evening. Of course, blind copies of the e-mails should be sent to prevent witnesses from comparing testimony by e-mail in advance.

For more on compelling and examining witnesses, see California Trial Practice: Civil Procedure During Trial, chaps 4-5, 11 (3d ed Cal CEB 1995).

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§12.27 2. Nonparty Documents

Original documents in the hands of third parties may also be subpoenaed for trial (*e.g.,* promissory notes, deeds of trust, escrow or brokerage records). Judicial Council Form 982(a)(15.2) (CCP §2020.410). If counsel wishes to subpoena documents in the form of business records, the process must be started well in advance and directed to the proper court. In master calendar jurisdictions, the document subpoena process gets complicated, but records must be sent to the clerk in the presiding courtroom. In single assignment courts, records may be delivered directly to the trial courtroom.

Calling the custodian of the records to testify as to the identity of the documents should be avoided. Not only are the custodians inconvenienced and extremely unhappy by a required appearance, but also some judges will allow opposing counsel to expand the scope of cross-examination into unforeseen areas, citing the possibility that opposing counsel will simply recall the witness later and inconvenience him or her further. This situation can be avoided by eliciting in advance whether there will be objections from opposing counsel to documents and by extracting a stipulation to use copies without requiring authentication foundational evidence. Expect similar requests from opposing counsel.

Counsel should know before trial which evidence opponents are likely to challenge. The trial binder should contain a mini brief on authority and required foundational chain of custody issues. See §§12.4-12.6.

For more on compelling business records, see Handling Subpoenas (Cal CEB Action Guide May 2009).

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§12.28 C. Experts

Experts are witnesses too, and they should be treated with at least the same courtesy. Although experts by nature should be competent enough to handle themselves on the stand without preparation and to make their case most effectively on cross-examination, many attorneys do not know how to present an expert on direct examination. If counsel is the expert's sponsor, he or she should not stipulate to the expert's qualifications but should instead recite the qualifications before the jury in order to impress on them the expert's competency to testify. Counsel should be prepared to gently lead the expert in testimony. Too often, the expert is forced to solicit the correct question from an inexperienced attorney.

It is highly recommended that counsel prepare questions for the expert in advance (or pay the expert to prepare them). The questions should be nonobjectionable, sufficiently open-ended, but direct enough not to lead the witness. Experts are expected to give narrative responses, but counsel should present a coherent sequence to these soliloquies. On direct, counsel may ask for the ultimate opinion(s) but should also flesh them out by asking the expert how the conclusion was reached, so that the jury can understand and appreciate the reasoning process based on the evidence they have already seen and heard. It is then up to a qualified expert to defend his or her reasoning on cross-examination.

Effective preparation of an expert for testimony includes providing him or her with the transcript of the deposition or testimony from opposing experts so that he or she will know what to anticipate, as opposing counsel's direction will be clear from this reading and the expert may then have an opportunity to defuse the opposing experts' impact.

Note that some courts will include experts within the ambit of a witness exclusion order, so counsel may not have the benefit of having the expert attend testimony by witnesses for the opposing party. If that is the case, counsel should have comprehensive notes (taken by counsel, a second chair, or a paralegal) of the opposing experts' testimony to go over with the expert before he or she testifies. For more on expert witnesses, see chap 13.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.29 D. Exhibits

§12.29 D. Exhibits

Exhibit preparation is another difficult area for trial counsel. It is a boring chore, but very necessary. The best way to present documentary evidence is through binders. See §§12.4-12.6. The witnesses may refer to the original marked exhibit, but counsel should arrange for duplicates ordered in a binder for opposing counsel and for the bench. *Counsel must update their exhibit list every day after trial.* The list should include columns to track exhibit numbers, offering party, and whether the exhibit was admitted as evidence. Many judges will perform housekeeping chores while the jury is deliberating, including a roundup of admissibility document by document. Failure to keep track of exhibits could be disastrous. A chronological tool like that discussed in §12.10 is again handy and should include answers to questions like: What is each exhibit intended to prove? What witness will identify it? This approach also helps prepare for witness preparation.

Relying on the guidance of the judge and his or her staff, counsel should follow their instructions on marking exhibits in advance. Some judges want all exhibits premarked, while others will only mark them if used at trial. This system is personal to each courtroom.

Counsel should also attempt to agree in advance with opposing counsel on as many of the proposed documents to be admitted as possible. If all parties wish to include a document, even if for different reasons, much time is saved and objections eliminated.

Counsel's personal exhibit book should contain copies of the documents to be used (1) marked to highlight the issues pertaining to the case, (2) marked for cross-examination, and (3) tabbed and kept in the same consistent numerical order. Then, in preparing for witness examination, counsel can simply list the document numbers on which the witness will testify, specifying the necessary foundational witness to ensure admissibility.

PRACTICE TIP: Any objections to documents on the basis of lack of foundational evidence or authentication should be made sparingly, and only when it is very important. Since the demise of the "best evidence rule" (former Evid C §1500), document copies are commonly used and should be questioned only with good reason. If there are key documents with markup or handwriting issues, a demand to view the originals should be made during discovery. Objecting to use of copies may well result in archaic authentication procedures forced on both sides. Best practice is to stipulate to the use of copies before trial.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/12 Trial Tactics and Strategies/§12.30 IV. TRIAL

§12.30 IV. TRIAL

Most of the discussion in §§12.31-12.39 is premised on the assumption that counsel is proceeding with a jury trial.

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§12.31 A. Master Calendar

Some courts still assign trials through a master calendar department. If so, counsel should be prepared with a blank peremptory challenge to the judge assigned, if needed. It is good form to investigate in advance which departments are likely to be available. Sometimes, a challenge will result in an assignment to an even less appealing bench.

Master calendar has many disadvantages, and most courts seem to be moving away from this system. When counsel does not know who the judge will be, it is a good practice to always request or reserve a jury. The jury demand may be dropped at a later date. But in case a jury trial is ultimately determined to be the right way to go, counsel should not fail to make a timely jury fee deposit. Jury fee deadlines vary by county. See California Trial Practice: Civil Procedure During Trial §§2.32-2.35 (3d ed Cal CEB 1995).

If counsel does not know which department will hear the case, subpoenas should always be directed to the master calendar department. When assigned out to trial by the presiding judge after a master calendar trial call, counsel must remember to immediately notify all witnesses (including document custodian witnesses) of the newly assigned courtroom and advise the presiding department clerk that there may be witnesses appearing or documents arriving for another courtroom.

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B. Motions

§12.32 1. In General

The initial session in an assigned department will concern housekeeping, usually in chambers but not always. The judge will likely ask for a description of the case. Counsel should use this as an opportunity to educate the judge regarding the facts and the law. Be aware that the judge's calendar may not provide him or her the opportunity to read the trial briefs in advance, or he or she may not have recently tried a similar case. Be prepared for a fairly lengthy learning curve and opposing counsel's attempt to focus the judge on his or her client's position. Be prepared to promptly and adequately respond to all points raised by the opposition.

This initial session may also provide the first opportunity to view opposing counsel's pretrial work, if they have not complied with local rules. Counsel should refrain from pointing out any less-than-material and obvious violations of the rules and pretrial orders. The judge is not interested and may perceive this as bickering.

Counsel should be prepared with a list of numbered motions in limine if these are to be discussed in chambers. Judges vary in this practice. Some may direct counsel to file written submissions instead with the courtroom clerk and return the next day for argument. The initial session is also the time to address special needs or equipment issues.

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§12.33 2. Presenting Motions In Limine

Motions in limine, also referred to as motions to exclude, are requests for the trial judge to rule on evidentiary matters before trial begins. Literally translated from the Latin, "in limine" means "at the threshold." In limine motions are designed to keep the jury from ever hearing of matters that are so inflammatory, improper, or unfounded that they may leave an indelible impression on the jury that cannot be totally erased by either cross-examination or admonition from the court.

Motions in limine may be made informally in the trial judge's chambers before the jury panel is summoned. They may also be made in open court, but in either instance, counsel should ensure that a court reporter is present. Local rules should be consulted on the form for such motions and, in particular, for any requirements on service in advance of trial. In the absence of any controlling local rules, such motions can be made orally or in writing and need not be noticed or served in advance. See California Trial Practice: Civil Procedure During Trial §§7.7, 7.13-7.18 (3d ed Cal CEB 1995).

In limine motions, more often than not, are denied without prejudice when they involve the exclusion of evidence. Judges are uniformly reluctant to exclude evidence at the beginning of a trial and would rather handle the matter when it arises during trial. Nor should counsel expect in limine motions to be granted when they are dispositive. At a minimum, these motions are part of the process of educating the judge as to likely trial issues and the creation of a record on appeal. The best practice is to have all motions in writing and numbered sequentially.

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§12.34 3. Ongoing Objections and Motions

Counsel should file written objections, motions, and mini briefs on issues or rulings each and every morning in order to maintain the record, especially if counsel's position was overruled off the record. An oft heard refrain from trial judges is the admonition to save objections for later because the case must move on with the jury, or alternatively, the objection should be heard outside the presence of the jury and therefore saved until they are dismissed. If so, counsel must keep a running list of such objections in the trial book (see §§12.4-12.6). These notes can be used to place objections on the record verbally as soon as possible or to file a written statement with the courtroom clerk the next morning if no time has been allowed.

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§12.35 C. Statement of the Case

The jury panel has been called and potential jurors fill the courtroom. One of the issues counsel deals with prior to their appearance is what the judge will say about the case and who the players are. Counsel should also have a firm understanding at this point as to this judge's particular voir dire preferences. See §12.36.

Counsel's proposed statement of the case is more likely to be chosen to be read to the jury panel if kept to one page and is as neutral as possible. Since this is an informational statement only, there is no advantage to characterizing the case at this juncture. It is highly unlikely that anyone will remember or care what the statement said after the first day.

Counsel should include a page listing all parties and potential witnesses by name. Since judges will often ask potential jurors if they know any of these names, judges appreciate having a prepared list.

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§12.36 D. Voir Dire

Voir dire is the time for counsel to probe for any bias against the client, whether plaintiff or defendant. Some counsel use voir dire as an opportunity to ingratiate themselves with the jurors, but counsel should remember that at this point jurors know nothing about the case except for a brief impartial statement by the judge. Even the judge at this point will not understand the important nuances of the case and probably has denied all motions in limine without prejudice to be renewed as evidentiary objections rather than predetermined exclusions.

One possible tactic is simply to pass on the entire panel. In civil jury matters, one only needs to convince nine jurors to prevail. The key is to identify potential leaders, and then the followers. This can be accomplished by observing the effect that opposing counsel's lengthy and essentially useless voir dire has on individual members of the panel.

If possible, counsel should have an assistant at counsel table during voir dire as a note taker. As soon as possible, the notes should be assembled into a chart of the 12 impaneled members with their names, personal identifying information, and other important observations. To assist in reaching this goal, use a large chart by seat number during voir dire, together with post-its for each person seated there. If they don't remain in the box, rip off that post-it and start another. A copy of this jury chart should be kept at counsel table at all times.

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§12.37 E. Jury Instructions Conference

The importance of this proceeding cannot be overemphasized. It comes at the end of trial when the trial attorney is greatly fatigued. At the very least, a set of prepared jury instructions to be read to the jury and a special verdict form in final format are necessary when the jury retires to deliberate. Often these crucial aspects are jeopardized by the rush attendant to the conclusion of trial. The jurors want to get to work as soon as possible and the judge wants the courtroom used productively; also, there may be another matter waiting in the wings for his or her attention. Some judges will allow instructions to go into the jury room. Counsel should ascertain this preference upfront.

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§12.38 1. Timing of Conference

Jury instructions provide the framework for the evidence. The desired approach is to convince the judge to set an instructions conference prior to closing arguments. However, if the main body of the trial (that is, all but closing arguments) concludes midday, most judges will not allow the jury to be dismissed early or, worse yet, to sit idle during the process of selecting instructions. Counsel should try to reach an agreement with the court ahead of time.

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§12.39 2. Inadvertent Waiver of Objection to Instruction

The specific wording of instructions can be critical and often prove to be a bruising fight at the end of the trial. Failure to object to instructions—resulting in a waiver of the objection—is one of the more common errors seen on appeal. It is best to have a court reporter present in chambers (or in open court) when discussion of potential jury instructions takes place, even though the reporter's presence may irritate a judge. If a court reporter is not present, counsel must have a good system in place to track proposed objections. The presence of the court reporter relieves counsel from the burden of trying to keep track of ongoing discussion while remembering what objections to make later on the record. Also, in selecting wording for instructions, a judge may show his or her bias with regard to an outcome. If the discussion is off the record, it is lost.

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13

Standard of Care Experts

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Source: Real Property/California Real Estate Brokers: Law and Litigation/13 Standard of Care Experts/§13.1 I. IS A STANDARD OF CARE EXPERT NEEDED?

§13.1 I. IS A STANDARD OF CARE EXPERT NEEDED?

In actions involving real estate brokers accused of negligence or misconduct in the performance of their duties, it is important to understand when an expert witness is required and what testimony is needed in order to prove or defend issues of liability. Although testimony from many types of experts may be used at trial (*e.g.,* appraisers, engineers, contractors, and architects), most broker liability cases involve expert testimony as to whether the broker's conduct falls below that required by custom and practice. This testimony is provided by a standard of care expert witness. Although this chapter pertains primarily to the standard of care expert witness, much of the discussion can be applied to any expert witness. For further discussion on expert witnesses generally, see California Expert Witness Guide (2d ed Cal CEB 1991).

NOTE: The concept of "standard of care" is complex. For a general discussion, see Kapp, *Operating Room*, 32 Los Angeles Lawyer 26 (Nov. 2009).

A standard of care expert witness does not review the file and come to a conclusion as to what the ultimate facts are, who is credible, and who is not. That is the jury's job. Nor does the standard of care expert testify as to duty, because duty is defined by statutory and case law, and an expert witness does not instruct the jury as to the law. That is the judge's responsibility. As noted in *Summers v A.L. Gilbert Co.* (1999) 69 CA4th 1155, 1178, 82 CR2d 162, "There are limits to expert testimony, not the least of which is the prohibition against admission of an expert's opinion on a question of law."

PRACTICE TIP: Notwithstanding these limitations on expert testimony, standard of care experts quite often attempt to interject their opinions as to the ultimate facts or try to instruct the jury as to what the broker's duty is, rather than adhere to a straightforward description of custom and practice. Counsel should be alert to prevent the witness from instructing the jury on duty; however, by establishing industry custom and practice through the expert witness, counsel may indirectly provide input on the credibility of the other witnesses in the case.

A good expert sets the stage—explaining how transactions are normally handled in the industry, not only by brokers, but by buyers, sellers, lenders, escrows, and other third parties. The expert explains whether the transaction met the standard of care by conforming to custom and practice, and if not, how the deviation affected the parties. In *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383, the court held that, as a matter of law, a broker has a duty to conduct a careful, diligent inspection of residential property and to disclose material adverse defects of which he or she either is aware or should have been aware had he or she conducted a careful, diligent inspection. The custom and practice that an expert most often helps to establish, however, is whether the inspection the broker conducted satisfied that duty.

EXAMPLE: A broker, while inspecting the property, neglects to note large cracks in the driveway that might indicate a soil problem, or a freshly painted ceiling in a building where nothing else has been painted, which might hide a leak. An expert witness may testify that these physical conditions would have been red flags to a reasonably competent broker and that the failure to note the defects and call them to the attention of the buyer falls below the standard of care. On the other hand, an expert witness may also testify that, absent an obvious indication of a problem, it is not the custom and practice for a real estate broker to tear up tacked-down carpeting to check the floor underneath or attempt to crawl under a house to look for water leaks.

An expert witness is not necessary in every case involving a broker's standard of care. See, *e.g., Easton*, 152 CA3d at 105 (expert testimony not required concerning whether listing broker met standard of care by failing to determine whether property in question had history of soil problems). The conduct of the broker may be so obviously inappropriate that expert testimony is not needed to explain it to the jury. Thus, if a broker fails to properly disclose self-dealing, it is not necessary to have an expert witness testify that this falls below the standard of care. As noted in *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 163, 177 CR 882, "expert testimony is not required where a question is resolvable by common knowledge." Nonetheless, if counsel believes that the defense is likely to designate a standard of care expert in such a circumstance, prudence dictates that plaintiff's counsel should designate one as well.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/13 Standard of Care Experts/§13.2 A. Selecting the Expert

§13.2 A. Selecting the Expert

Unlike other areas of litigation in which an expert witness may be used, real estate litigation is unique in that standard of care experts are not limited to real estate licensees. For example, in a medical malpractice case involving an allegedly improperly performed open heart surgery, the expert witness would almost certainly be a cardiovascular surgeon. In a real estate broker standard of care case, counsel may choose anyone who meets the Evidence Code standard of special knowledge, skill, experience, training, or education sufficient to qualify as an expert on the subject to which his or her testimony relates. See Evid C §720(a). This level of expertise most often includes:

- An experienced licensed real estate broker or salesperson;
- An attorney who has represented and advised real estate licensees, has been active in the real estate industry and is familiar with custom and practice, has perhaps acted as in-house counsel for a real estate brokerage firm or similar real estate related business, or otherwise by nature of experience meets the required test; or
- A professor of real estate finance or marketing.

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§13.3 1. Qualifications

While the initial threshold to qualify as an expert witness is not difficult to meet (see Evid C §720(a)), failure to select an expert with specific qualifications renders that expert weak on cross-examination, especially if the opposing party's expert has superior qualifications in those areas. The jury will be instructed to consider qualifications; if the retained expert does not measure up to the opponent's expert, the client will suffer.

Real estate brokerage is an extremely broad area of practice with numerous subspecialties. A lawyer handling a matter involving a real estate dispute should only retain an expert who has expertise in the particular area of real estate brokerage at issue. It is inappropriate to use a real estate broker whose expertise is limited to the purchase and sale of single-family residences in a dispute involving commercial real estate. A good criteria for selecting real estate experts is the same standard expected in legal malpractice cases: a member of the profession (or in the case of a real estate expert, sufficient experience in the area) in the same or similar locality under similar circumstances. See *Wright v Williams* (1975) 47 CA3d 802, 809, 121 CR 194.

EXAMPLE: In a dispute involving a residential transaction, if the choice of expert is between an attorney with expertise in nonresidential real estate matters or a real estate broker with expertise in residential real estate matters, the real estate broker is more likely to provide more practical insights than the attorney. On the other hand, an expert who has both the requisite real estate credentials and is familiar with litigation and trial practice can add value in many ways. Assuming that the level of experience of the potential experts is substantially the same, the issue of choosing between a broker and a lawyer will turn more on issues of credibility and expense. See §§13.8-13.9.

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§13.4 2. Prior Contact With Opposition

Counsel should determine whether the expert has had previous contact with a representative of the opposing party. Counsel seeking an expert may contact many experts while looking for the one they eventually choose. Each of the experts to whom counsel has talked, to the extent that he or she has received confidential information, may be precluded from acting as an expert for the other side. While obviously unethical to do so, some attorneys may engage in the practice of contacting every possible expert witness who might be testifying in an attempt to "poison the water" for the other side. Counsel should take notes of discussions with each proposed expert and, until they have actually been retained, avoid apprising them of information which might be considered confidential.

Before hiring an expert that has been previously interviewed or employed by the opposition and to whom confidential information may have been disclosed, counsel must obtain written consent of the former employer or interviewer. Failure to do so may result in exclusion of the testimony or report (*Fox v Kramer* (2000) 22 C4th 531, 93 CR2d 497) or even in counsel's disqualification from the case (*Shadow Traffic Network v Superior Court* (1994) 24 CA4th 1067, 1079, 29 CR2d 693).

When the proposed expert is an attorney, the expert may also be subject to disqualification if a "substantial relationship" exists between the expert's current engagement and the representation of the former client. *Brand v 20th Century Ins. Co./21st Century Ins. Co.* (2004) 124 CA4th 594, 602, 21 CR3d 380. If the relationship between the attorney and the former client is shown to have been direct, *i.e.,* the attorney was personally involved in providing legal advice and services to the former client, "it must be presumed that confidential information has passed to the attorney" and the attorney expert may be disqualified. 124 CA4th 604. See §13.13.

Moreover, courts will conclusively presume that confidences were exchanged between the attorney and client, necessitating disqualification, whenever the nature of the prior representation would have permitted their exchange. An exception may apply if the attorney can establish that there was no opportunity to receive confidential information, and that the current employment does not involve any former work on the same matter. *Brand*, 124 CA4th at 603, citing *City Nat'l Bank v Adams* (2002) 96 CA4th 315, 327, 117 CR2d 125.

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§13.5 3. Timing the Selection

While experts may be retained at any time, counsel must decide the appropriate timing to select the expert witness. Retaining an expert sufficiently in advance of the designation date gives counsel an opportunity to select among several experts, to interview and meet with them, judge their demeanor, and determine how they are likely to come across in deposition and on the witness stand. It also provides an opportunity for the expert to become familiar with the facts of the case and to form a proper opinion.

PRACTICE TIP: Some counsel avoid hiring an expert if they anticipate that the case may settle before the expert designation date, and thus wait until the last possible minute before retaining an expert in order to avoid the costs. While this may save litigation expenses, more often than not it is false economy. Frantically searching databases and making telephone calls to find someone who may technically qualify as an expert in a case may leave counsel in a position of going to trial with a less than effective expert.

Designation of an expert is a representation to the court and to the opposition that the expert is prepared to give meaningful testimony at deposition or at trial. See CCP §2034.260(c); California Expert Witness Guide §10.1 (2d ed Cal CEB 1991). Because defense counsel may attempt to take the deposition of the plaintiff's expert as soon after designation as possible, an expert should have time to adequately prepare. Waiting until the last possible moment to retain expert witnesses not only deprives them of the opportunity to prepare, but also means that counsel is deprived of the opportunity to utilize the experts as consultants in posturing the case and preparing discovery. See §§12.9, 13.14.

While it seems almost unnecessary to state the obvious, counsel should retain and obtain the consent of the expert before designation. Merely having worked with an expert before obviously does not mean that expert has given a blanket consent to future work. To designate without his consent is a fraud on the court and grounds for State Bar discipline.

For requirements regarding disclosure of expert witnesses, see CCP §§2034.010-2034.730. See Expert Witness, chap 10.

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§13.6 4. Additional Duties

A standard of care expert can be retained for purposes other than testifying at trial. Counsel may use the expert for assistance in understanding issues beyond the strict areas to which the expert will testify (*e.g.,* duty, as opposed to custom and practice). The expert can help educate counsel regarding how the industry itself functions so that counsel may better understand the case. See §§12.9, 13.14. In determining whether to retain an expert, counsel should consider the expertise, credibility, and expense. Of course, in any given case, one of these factors may become more important than the others.

For further discussion regarding selecting an expert, see California Expert Witness Guide §§7.16-7.29 (2d ed Cal CEB 1991).

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§13.7 5. Professional Witness or Practicing Professional?

There are different categories of expert witnesses: (1) brokers or lawyers who occasionally testify as expert witnesses in their area of specialization; (2) brokers or lawyers who testify on an almost full-time basis; and (3) brokers or lawyers who are primarily academics. Each has positive and negative attributes. A well-recognized authority may have great credibility as an expert, but may not have previously testified, resulting in a lack of experience on how to perform in a deposition or while testifying on the stand. Likewise, a lack of familiarity with the litigation process may limit his or her ability to assist counsel in trying the case. An experienced expert witness, however, will sometimes erroneously view his or her role as being that of an advocate, giving an opinion on everything; rather than as an expert, evaluating the facts and testifying as to standard of care. On the other hand, a broker or lawyer who spends substantially all of his or her time testifying as an expert risks losing touch with current developments and current standards. A real estate broker who has not sold a house for 10 years, for example, may not be in a position to testify effectively as to the standard of care concerning a more recent development such as toxic mold or mortgage broker standard of care in the area of subprime mortgages. In considering using a "professional" expert, counsel must be satisfied that the expert has stayed current with the standards and practices in the field. Also, counsel should consider the kinds of cases in which the expert has testified and the nature of the testimony. Inconsistencies with testimony given in previous litigation must be avoided.

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§13.8 6. Credibility

The credibility of experts is largely predicated on their professional experience. Experience, however, will not matter if the jury simply does not believe the expert's testimony. Credibility is determined by several factors:

- **How the opinion is framed**. Any particular case is seldom, if ever, one-sided. While occasionally a broker's conduct may be clearly reprehensible (see *Jorgensen v Beach 'N' Bay Realty, Inc.* (1981) 125 CA3d 155, 164, 177 CR 882), in most cases the defendant broker was merely someone who made a mistake that caused damage to the plaintiff and, for that reason, is responsible. Trying to portray a likeable, sympathetic defendant as evil is less convincing to the jury than portraying the broker as simply someone who should be held responsible for a mistake. Likewise, if a broker who did a poor but acceptable job is described as having been the model agent, the jury will have credibility issues with the expert. Liability does not depend on whether the defendant did a wonderful job, but on whether the broker did an ordinary job. *Ishmael v Millington* (1966) 241 CA2d 520 50 CR 592.
- **The expert's specific expertise**. A prestigious attorney with no real experience in the purchase or sale of residential property can have less expertise than a sole practitioner real estate broker with 20 years of experience in buying and selling single-family residences in the community where the property in question is located. An expert who is a "professional" expert witness may be viewed as a hired gun who will simply testify as to whatever his lawyer wants him to or an ivory tower idealist with no real practical experience. The occasional, unpolished expert, however, may be so awkward in his testimony as to affect his credibility.
- **Whether the expert is a attorney or a broker**. If one side has as its expert witness a real estate broker and the other side has an attorney, the jury may believe that the attorney is much less biased toward the real estate industry, and by virtue of more extensive education and being a member of the legal profession, may warrant greater respect and believability. When qualifying a real estate broker as an expert witness, focus should be placed on the broker's experience in order to diminish the perceived edge that the attorney expert's "professional status" may project in the minds of the jury. The jury may also see the broker as having a vested interest in protecting a colleague, or acting as a jealous competitor. Therefore, it is important that the broker's testimony be inherently more believable than the attorney's expert testimony when rendering their opinion.

In selecting an expert witness, counsel should consider whom the other side has selected or is likely to select. If plaintiff retains a real estate broker whose credentials are not extraordinary, then defense counsel may find that selecting another real estate broker with equal or better credentials is sufficient to shift credibility to his or her client's favor. For example, a broker who is or has been a president of the California Association of Realtors® has more credibility than a broker who has merely been a president of a local board, who in turn has more credibility than a broker who has never held that position. In this regard, attorneys attempt to ensure that their expert has the more impressive credentials.

WARNING: A lawyer selecting an expert should, if possible, obtain references and speak with someone who has actually seen the expert in deposition or at trial and can help the lawyer evaluate the expert's credibility and ability to perform. An expert with impeccable credentials can be a disaster if perceived as arrogant or condescending.

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§13.9 7. Expense

Expense must be considered in the selection of the expert. Everyone wants to retain the best expert possible, but as a practical matter the expert selected is usually the best expert the client can afford. The choice of the expert has to be tempered by the size of the dispute and the client's ability to pay. However, the budgetary issue is a slippery slope that can lead to the selection of an expert who is affordable but significantly less qualified. To the extent that expense is a factor in the selection of the expert, counsel must ensure that the client understands the risks of using a less expensive but less qualified expert and the effect it may have upon the ultimate disposition of the case. See also discussion in §§12.8-12.9.

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§13.10 B. Ethics Issues of Attorneys Acting as Experts

Just as legal counsel has ethical concerns and issues that must be considered and dealt with, an expert also has ethical issues that must be considered. An expert who is an attorney is still subject to many of the ethics restrictions applicable to lawyers, even though as an expert he or she is technically not acting in the capacity of a lawyer. No hard and fast rules exist to govern an attorney expert's ethical duties toward his or her clients. While many professional associations provide guidelines for their members who serve as expert witnesses, no common set of rules exists to guide an attorney expert's conduct prior to and at the time of designation. Lawyers, of course, must adhere to the California Rules of Professional Conduct. Although a literal reading of the rules does not create ethical obligations for an attorney expert witness, attorney experts should comply with the rules as both an agent of the hiring lawyer and as a member of the State Bar.

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§13.11 1. Trial Counsel Bears Responsibility for Expert

Attorneys are professionally responsible for supervising the work of employees who act for the lawyer, the rendering of the lawyer's professional services, and ensuring that such employees comply with the rules of professional conduct applicable to the lawyer. *Vaughn v State Bar* (1972) 6 C3d 847, 857, 100 CR 713; Cal Rules of Prof Cond 3-110. An attorney who is hired to testify as an expert witness acts as an agent for trial counsel in the rendering of counsel's professional services, and thus the duties imposed by ethical rules are indirectly applicable to the attorney expert under agency theory. Accordingly, before the time of designation, the attorney expert should become sufficiently familiar with the facts of the case to render a meaningful opinion. Further, the attorney expert should decline accepting designations as an expert if not able to truthfully testify.

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§13.12 2. Court-Imposed Professional Standard of Care

Once the attorney expert has been designated, many courts impose a professional standard of care on the expert and have even held expert witnesses liable for a violation of that standard. See *Lambert v Carneghi* (2008) 158 CA4th 1120, 1141, 70 CR3d 626 (litigation privilege does not preclude client from suing expert witness employed by client). See also Richards & Walter, *When Are Expert Witnesses Liable for Their Malpractice?* 19 IEEE Eng'g in Medicine and Biology 107 (March/April 2000). The Pennsylvania Supreme Court has even expanded the liability of expert witnesses to include negligence in the preparation of testimony. *LMMD of Michigan, Inc. v Jackson-Cross Co.* (Pa 1999) 740 A2d 186.

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§13.13 3. Conflict-of-Interest Attorney Experts and Prior Clients

Expert witnesses, in particular attorneys who are expert witnesses, are subject to conflict-of-interest rules. Provisions of the California Rules of Professional Conduct governing conflicts of interest require that the expert attorney not do anything that will "injuriously affect his former client in any matter in which he formerly represented him nor may he at any time use against his former client knowledge or information acquired by virtue of a previous relationship." *Galbraith v State Bar* (1933) 218 C 329, 333, 23P2d 291. See Cal Rules of Prof Cond 3-310.

Although most counsel would decline to hire an attorney expert who previously provided legal representation to the opposing party, it is important to note that the fact of the earlier representation does not in itself create a conflict of interest meriting disqualification. *Santa Teresa Citizen Action Group v City of San Jose* (2003) 114 CA4th 689, 711, 7 CR3d 868. Instead, an attorney expert must evaluate whether former fiduciary duties as counsel to one of the parties precludes subsequently testifying as an expert witness. California courts employ the "substantial relationship" test to determine whether an expert should be disqualified from testifying in a matter. *Brand v 20th Century Ins. Co./21st Century Ins. Co.* (2004) 124 CA4th 594, 602, 21 CR3d 380. Courts consider the time spent by the lawyer on the matter, the type of work performed, and the lawyer's possible exposure to the formulation of the policy or strategy of the opposing party. *Huston v Imperial Credit Commercial Mortgage Inv. Corp.* (CD Cal 2001) 179 F Supp 2d 1157, 1167. Under this test, the disqualification of the attorney expert depends on the similarities between the legal issues involved in the former representation and the current matter. Courts also ask for the confidential information material to the current dispute that would normally have been imparted to the lawyer by virtue of the nature of the former representation. Courts presume that a confidential relationship existed if an attorney expert had contact with the opposing party. The burden is then on the attorney expert to overcome this conclusive presumption by producing evidence that there was no opportunity for confidential information to be divulged. *City Nat'l Bank v Adams* (2002) 96 CA4th 315, 324, 117 CR2d 125. Other factors bearing on the presumption of disclosure include evidence that the attorney considered the previous relationship to be confidential. *Wang Labs, Inc. v Toshiba Corp.* (ED Va 1991) 762 F Supp 1246, 1248. In the absence of a screening wall, however, the lack of other available experts with specialized knowledge of an issue in the case may prevent the court from granting an order to preclude the expert from testifying. See *EEOC v Locals 14 and 15 Int'l Union of Operating Eng'rs* (SD NY 1981) 24 Fair Empl Prac Cas (BNA) 1821. See also *Western Digital Corp. v Superior Court* (1998) 60 CA4th 1471, 1488, 71 CR2d 179 (discussion of necessity of screening).

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§13.14 C. Use of the Expert as a Consultant

When an expert is retained as a consultant purely to assist and advise counsel and not to be called as a witness at trial, the expert's reports, opinions, and knowledge are at least conditionally protected. *Brokopp v Ford Motor Co.* (1977) 71 CA3d 841, 857, 139 CR 888. However, experts are often used both as pretrial consultants and as experts at trial. Trial counsel who has never handled a case involving a broker standard of care issue may find an experienced expert witness invaluable in helping to understand the strengths and weaknesses of the case. The expert, especially if an attorney, can help trial counsel evaluate the case to determine whether it should be settled or litigated.

The extent to which an attorney serves as an expert and is a consultant in a case depends on the attorney's expertise. If an attorney expert acts as a consultant, however, there is a risk that the expert may effectively become co-counsel; trial counsel and the attorney expert must exercise care to avoid crossing ethical boundaries, as this would undermine the expert's impartiality and taint the expert's testimony. See ABA Formal Opinion 97-407 (1997). Care should be taken to ensure that the expert is used as a consultant only on those issues affecting the standard of care and evaluation of the strengths and weaknesses of the case. The expert should always act as a disinterested third party expert who has no financial stake in the outcome (see also discussion in §12.9).

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II. DISCOVERY AND TRIAL

§13.15 A. Disclosure of Expert's Work Product

Until designated as an expert witness in the case, communications between counsel and the expert witness are privileged, whether the expert is a broker or an attorney. *San Diego Prof. Ass'n v Superior Court* (1962) 58 C2d 194, 199, 23 CR 384. If the expert is also acting as a consultant (see §13.14), counsel must remember that communications with the expert are protected only until the expert is designated as a witness. Once designated as a witness, opposing counsel can seek disclosure of the expert's reports (CCP §2034.210(c)), but may be required to make a showing of good cause. *Shadow Traffic Network v Superior Court* (1994) 24 CA4th 1067, 1079, 29 CR2d 693. After designation, all communications, documents, and correspondence become subject to discovery. *Williamson v Superior Court* (1978) 21 C3d 829, 835, 148 CR 39.

PRACTICE TIP: Counsel should be wary of the expert who is overly helpful in evaluating the case and wants to help by pointing out not only strengths but also weaknesses. Experts should be cautioned not to make notes or comments on the materials they are reviewing. A note on a deposition that says "this really hurts us" or "she missed following up on this" or similar comments will be seen by the other side. However, the "work product doctrine" provides absolute protection to the portions of the expert's or consultant's report that embrace counsel's impressions and conclusions. See *Shadow Traffic Network v Superior Court, supra*. See also *Kizer v Sulnick* (1988) 202 CA3d 431, 248 CR 712. Too avoid "oversharing," many experts prepare only a final report, with no drafts.

For further information regarding the disclosure of expert reports, see California Expert Witness Guide §§10.12-10.14 (2d ed Cal CEB 1991).

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§13.16 1. Use of Discovery Limits

After designation of experts, CCP §2034.250 provides that either party can move for a protective order to limit the scope of discovery under certain circumstances. Of relevance in broker standard of care cases is CCP §2034.250(b)(5)-(6), which allows the court to issue an order combining some or all of the parties into "sides" on the basis of their identity of interest in the case and to force the sides to reduce the list of experts designated by that side.

Thus, for example, in an action in which counsel is defending a broker against both the buyer and seller or in which there are multiple cross-complaints which go beyond indemnity claims (both of which are common occurrences), it may be appropriate to invoke CCP §2034.250(b)(5) if counsel is faced with multiple experts opining that the broker fell below the standard of care in the same transaction. If there is a reasonable identity of interest among the claimants, the court can limit the number of experts used against the broker, or perhaps limit their testimony to issues specific to the sponsoring party's participation in the transaction. This limitation is especially important in a jury trial, as the sheer number of experts can influence a juror, even though instructed otherwise. Similarly, some counsel seek to intimidate opposing parties by designating an overabundance of experts, whom they may or may not use, but the other side nevertheless is faced with the expense of attorney deposition time and expert fees.

Before a motion for a protective order may be filed, the Civil Discovery Act (CCP §§2016.010-2036.050) requires an informal attempt to resolve the dispute. Commonly, this is referred to as the "meet and confer" requirement, though the Act does not require an in-person meeting. A meet and confer declaration must state facts showing a "reasonable and good faith attempt" to informally resolve the dispute without formal court intervention. CCP §2016.040. The informal attempt to resolve the dispute may be made "in person, by telephone, or by letter" to the opposing party's attorney or to the opposing party, if unrepresented. CCP §2023.010(i). Counsel should be mindful of the time that has elapsed during the meet and confer process because the motion for protective order must be filed "promptly." CCP §2034.250(a).

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Source: Real Property/California Real Estate Brokers: Law and Litigation/13 Standard of Care Experts/§13.17 2. Designation Narrative

§13.17 2. Designation Narrative

The Civil Discovery Act (CCP §§2016.010-02036.050) provides that when parties exchange information concerning their expert witnesses, the disclosure must include a "brief narrative of the general substance of the testimony that the expert is expected to give." CCP §2034.260(c)(2). Counsel should pay particular attention to the scope of the intended expert testimony as framed in both his or her own narrative as well as those received from the other parties to the action. The disclosure should be broadly drawn; thus, narratives often state that the broker expert is expected to testify "on the standard of care and practice of other real estate licensees in similar fact situations" or some similar statement. However, it is still true that an expert must be able to testify on a standard in the given community, be it a geographical community or an area of specialization. Some experts may also be qualified to opine on valuation standards, damages, or mitigation; therefore, counsel should be careful about responding automatically with a generic scope disclosure and should consider whether the narrative should be more narrowly drawn based on issues in a given case.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/13 Standard of Care Experts/§13.18 B. Deposing the Expert

§13.18 B. Deposing the Expert

It is most common for experts to be deposed as a form of discovery. The examiner, therefore, is usually on the opposing side from the expert being deposed. On rare occasions, however, counsel may depose his or her own expert for the purpose of using the deposition testimony at trial in place of having the expert testify. See CCP §2025.620(d).

The expert deposition serves several purposes. First, it is to discover the expert's opinions and the basis of those opinions. However, it also allows opposing counsel to evaluate the credentials of the expert and determine whether there is a basis to challenge the expert, or more likely, a basis to attack the credibility of the expert's credentials if admitted as an expert. Because the credibility of the expert is quite often critical, the deposition gives counsel an opportunity to determine how the expert will come across as a witness before the jury: to evaluate the expert's relative persuasiveness and believability. Is the expert at ease or tense, arrogant or congenial? Most important of all, is the expert believable?

For further discussion of expert depositions, see California Expert Witness Guide, chap 11 (2d ed Cal CEB 1991).

When deposing a designated expert, counsel should include in the deposition notice a request that the expert bring his or her complete file to assist in ascertaining certain basic criteria:

- What has the expert reviewed in forming conclusions and opinions, and is there anything more he or she needs to do before testifying at trial?
- Has the expert written up any opinions, notes, or charts which counsel should have copies of?
- What are the opinions being offered and the foundational facts (or assumptions) relied on in reaching such opinions?

In contrast with usual deposition taking, it would be entirely proper to ask an expert an open-ended question, such as "What opinions have you been asked to give in this case?" A good expert should be able to state a list, from which counsel can then review each opinion. An expert will be limited in what he or she can opine on at trial by the scope of his or her deposition opinions. Thus, the sponsoring party must insist on deposition preparation with an expert so that both are in agreement with the need for, and type of, opinions to be offered.

PRACTICE TIP: Every deposition of an expert should include asking the expert if he or she has given all of his or her opinion. This question will lay the basis for an evidentiary objection at trial should the expert attempt to offer an opinion not previously disclosed. See, *e.g.*, *Kennemur v State of Cal.* (1982) 133 CA3d 907, 184 CR 393.

Deposition is not generally an opportunity to challenge the expert. Expert depositions are customarily quite short. The expert's qualifications are usually provided via a resume attached to opposing counsel's witness designation. Nevertheless, experienced counsel may use judgment on whether to challenge an expert at deposition, especially if the expert appears unprepared, is inexperienced, or seems cavalier in his or her conclusions.

It is sometimes appropriate to contact other experienced trial attorneys and ask if they have encountered a given expert before and obtain their evaluation of his or her performance and credibility as a witness. Some attorneys even maintain copies of prior expert depositions, which counsel could review, especially if the expert testified on the "other" side before, *e.g.,* for plaintiff as opposed to defense, or vice versa. Consistency of opinion is important within the framework of distinguishing facts.

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§13.19 C. Eliciting or Attacking Expert Testimony at Deposition or Trial

At trial, counsel who has retained the expert will want to demonstrate the expert's knowledge to the jury. Counsel quite often misses an opportunity to attack the credibility of an expert witness merely because the witness is qualified as an expert. Because credibility is a question of the relative credentials of each side's expert, however, there is an opportunity for counsel to show that the other side's expert is less experienced or qualified.

In broker standard of care cases, counsel should always obtain a copy of the National Association of Realtors® (NAR) Code of Ethics for the year in which the transaction occurred. See §1.7, App A of this book. The vast majority of practicing brokers are members of NAR, as are most expert witnesses. Experts are also generally members, and often officers, of a state or local real estate association, as discussed in §§1.6-1.10. The NAR Code of Ethics includes standards of practice that the membership is expected to adhere to, and which can have a very significant impact on the expert's opinions. These include expectations in dealing with the public, with clients, and with other brokers. Often these standards are quite specific. An expert who is not familiar with the Code of Ethics is vulnerable and should not be used. The Code of Ethics is the first place to start in preparing cross-examination of an opposing broker standard of care expert.

PRACTICE TIP: Counsel should ascertain the license status of the designated expert before deposing an expert who claims to be a California licensee. Current information is available online at the Department of Real Estate (DRE) website listed in the Directory. A full certified history can be ordered from the DRE for $20 with a form available on the website. Counsel may find that a disclosed expert has been disciplined by the DRE; though rare, this finding could prove devastating to the expert's impact on the case.

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§13.20 1. Voir Dire of the Expert

Counsel usually begins direct examination of an expert at trial by asking the expert questions that demonstrate that the expert is qualified to give an opinion on the particular issue involved. It is common for opposing counsel to then cross-examine (usually referred to as "voir dire") the expert on his or her qualifications, before counsel presenting the expert begins direct examination on the facts of the case. After voir diring the expert, opposing counsel either accepts the expert as qualified or objects that the witness is unqualified to state an expert opinion.

Counsel should alert the court in advance, if possible, that he or she may wish to voir dire an expert when the expert is called to testify, because it interrupts the full examination of the expert by the expert's proponent. Voir dire should be used sparingly, but it is a very effective tool if there is reason to doubt that the expert should be considered qualified.

It is better to get the court to disallow the expert *before* the expert's opinions are given. Voir dire gives counsel the opportunity to alert the trier of fact to weaknesses in the expert's qualifications. For example, in a case involving a commercial transaction, it may be appropriate to challenge a proffered expert who has only done residential brokerage. Even if the court still allows the testimony, it sets the stage for doubt. In a bench trial, the court will almost always admit the testimony but will state that it will take into account any deficiencies in assessing the weight to be given the expert's testimony. In a jury trial, the judge must take such challenges more seriously since the jury may not be as effective in balancing an expert's opinions; a proper challenge alerts the jury to listen to the expert's opinions with a some healthy skepticism.

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§13.21 2. Cross-Examination

Cross-examination can also be an effective tool to convince the jury that the expert's standards were either unreasonably high or unreasonably low. Counsel should, whenever possible, try to turn an expert's strengths into weaknesses. A professional expert who has done nothing but testify as an expert witness for 5 years must be carefully examined on real life experience. Academics testifying as experts are extremely vulnerable on issues of practical experience versus ivory tower idealism. The senior partner of a large firm who is a preeminent authority on a specific subspecialty of real estate law can have that stature turned against him by showing that his opinions reflect an unreasonably high standard of "competence." Real estate brokers who have done nothing but testify as expert witnesses for the past 10 years are vulnerable as having lost touch with current developments.

PRACTICE TIP: A seldom-asked question in deposition (and if useful, repeated on cross-examination) is why the expert witness chose to become an expert witness? Why did the real estate broker or the lawyer decide to become an expert witness? The fact that a real estate broker may have begun his career as an expert witness following the bankruptcy of his real estate brokerage firm, or that an attorney has added a real estate expert witness consulting practice to augment her declining legal practice, real estate brokerage practice, or real estate instructor practice can expose him or her to an accusation of being a jack of all trades and master of none. Care should be taken, however, in utilizing this approach not to demean or insult the expert witness, since the jury might take exception.

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§13.22 3. Framing the Question

A question asked of the expert regarding a broker's conduct may be framed specifically or hypothetically. One approach is to have the expert review substantially all of the pleadings and depositions in the case that are specifically related to the standard of care issues and to ask the expert to give an opinion as to whether the defendant's conduct fell below the standard of care. This approach is obviously time-consuming for the expert and thus very expensive. It also exposes the expert to attack on cross-examination because the opposing lawyer can ask questions from literally hundreds of pages of documents to trip up the expert. The expert may lose credibility with the jury if he or she does not remember or mistakes what was said on any particular page of any of the voluminous documents.

Alternatively, trial counsel may limit the expert's review of case material and instead frame the expert's opinion in the form of a hypothetical question. When hypothetical questions are used, the expert is asked to assume the correctness of facts and other matters that have been testified to by other witnesses, and to express the opinion he or she has reached based on those assumptions. *Rosenberg v Goldstein* (1966) 247 CA2d 25, 30, 55 CR 306. This severely limits the opponent's ability to cross-examine, since any material not contained within the assumed facts cannot be used. However, it runs the risk of the jury failing to agree with one or more of the facts assumed and then disregarding the testimony, since the jury instructions will say that "in determining the weight to give to the expert's opinion that is based on the assumed facts you should consider whether the assumed facts are true." It may also appear to the jury that counsel is attempting to shape the expert's opinion by keeping him or her blind to portions of the case. See generally CACI 220.

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§13.23 4. Framing the Opinion

Real estate expert witnesses sometimes have a tendency to misperceive their role as being that of an advocate rather than an expert. Care should be taken in framing the expert's opinion to avoid testimony as to an opinion of the law rather than just the standard of care. For example, whether a broker's duty to disclose was violated is a matter of law. The expert cannot testify on this topic. However, the custom and practice of what constitutes meeting that duty is something the expert can testify about. The line between law and custom is constantly changing as new appellate decisions further refine the distinction. See, *e.g., Blickman Turkus, LP v MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 76 CR3d 325 (no duty to disclose tenant's deteriorating financial health after lease signing); *Michel v Moore & Assocs.* (2007) 156 CA4th 756, 763, 67 CR3d 797 (discussing whether listing salesperson could be imputed with knowledge of another salesperson in same office); *Manderville v PCG&S Group, Inc.* (2007) 146 CA4th 1486, 55 CR3d 59 (rejecting exculpatory clause in standardized broker purchase agreement). What may be an issue of custom and practice when the expert is retained may have become an established law by the time the case gets to trial. Counsel should constantly be alert to new appellate decisions that may affect pending litigation and whether their expert's testimony was made moot by a new statute or appellate ruling. See discussion in §§12.28, 13.1. For further discussion on eliciting expert testimony, see California Expert Witness Guide §§13.7-13.20 (2d ed Cal CEB 1991).

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Appendix A

Code of Ethics and Standards of Practice of the National Association of Realtors®



Code of Ethics and Standards of Practice of the NATIONAL ASSOCIATION OF REALTORS®

Effective January 1, 2009

Where the word REALTORS® is used in this Code and Preamble, it shall be deemed to include REALTOR-ASSOCIATE®s.

While the Code of Ethics establishes obligations that may be higher than those mandated by law, in any instance where the Code of Ethics and the law conflict, the obligations of the law must take precedence.

Preamble

Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization. REALTORS® should recognize that the interests of the nation and its citizens require the highest and best use of the land and the widest distribution of land ownership. They require the creation of adequate housing, the building of functioning cities, the development of productive industries and farms, and the preservation of a healthful environment.

Such interests impose obligations beyond those of ordinary commerce. They impose grave social responsibility and a patriotic duty to which REALTORS® should dedicate themselves, and for which they should be diligent in preparing themselves. REALTORS®, therefore, are zealous to maintain and improve the standards of their calling and share with their fellow REALTORS® a common responsibility for its integrity and honor.

In recognition and appreciation of their obligations to clients, customers, the public, and each other, REALTORS® continuously strive to become and remain informed on issues affecting real estate and, as knowledgeable professionals, they willingly share the fruit of their experience and study with others. They identify and take steps, through enforcement of this Code of Ethics and by assisting appropriate regulatory bodies, to eliminate practices which may damage the public or which might discredit or bring dishonor to the real estate profession. REALTORS® having direct personal knowledge of conduct that may violate the Code of Ethics involving misappropriation of client or customer funds or property, willful discrimination, or fraud resulting in substantial economic harm, bring such matters to the attention of the appropriate Board or Association of REALTORS®. *(Amended 1/00)*

Realizing that cooperation with other real estate professionals promotes the best interests of those who utilize their services, REALTORS® urge exclusive representation of clients; do not attempt to gain any unfair advantage over their competitors; and they refrain from making unsolicited comments about other practitioners. In instances where their opinion is sought, or where REALTORS® believe that comment is necessary, their opinion is offered in an objective, professional manner, uninfluenced by any personal motivation or potential advantage or gain.

The term REALTOR® has come to connote competency, fairness, and high integrity resulting from adherence to a lofty ideal of moral conduct in business relations. No inducement of profit and no instruction from clients ever can justify departure from this ideal.

In the interpretation of this obligation, REALTORS® can take no safer guide than that which has been handed down through the centuries, embodied in the Golden Rule, "Whatsoever ye would that others should do to you, do ye even so to them."
Accepting this standard as their own, REALTORS® pledge to observe its spirit in all of their activities whether conducted personally, through associates or others, or via technological means, and to conduct their business in accordance with the tenets set forth below. *(Amended 1/07)*

Duties to Clients and Customers

Article 1

When representing a buyer, seller, landlord, tenant, or other client as an agent, REALTORS® pledge themselves to protect and promote the interests of their client. This obligation to the client is primary, but it does not relieve REALTORS® of their obligation to treat all parties honestly. When serving a buyer, seller, landlord, tenant or other party in a non-agency capacity, REALTORS® remain obligated to treat all parties honestly. *(Amended 1/01)*

- **Standard of Practice 1-1**
  REALTORS®, when acting as principals in a real estate transaction, remain obligated by the duties imposed by the Code of Ethics. *(Amended 1/93)*

- **Standard of Practice 1-2**
  The duties imposed by the Code of Ethics encompass all real estate-related activities and transactions whether conducted in person, electronically, or through any other means.

  The duties the Code of Ethics imposes are applicable whether REALTORS® are acting as agents or in legally recognized non-agency capacities except that any duty imposed exclusively on agents by law or regulation shall not be imposed by this Code of Ethics on REALTORS® acting in non-agency capacities.

  As used in this Code of Ethics, "client" means the person(s) or entity(ies) with whom a REALTOR® or a REALTOR®'s firm has an agency or legally recognized non-agency relationship; "customer" means a party to a real estate transaction who receives information, services, or benefits but has no contractual relationship with the

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REALTOR® or the REALTOR®'s firm; "prospect" means a purchaser, seller, tenant, or landlord who is not subject to a representation relationship with the REALTOR® or REALTOR®'s firm; "agent" means a real estate licensee (including brokers and sales associates) acting in an agency relationship as defined by state law or regulation; and "broker" means a real estate licensee (including brokers and sales associates) acting as an agent or in a legally recognized non-agency capacity. *(Adopted 1/95, Amended 1/07)*

• Standard of Practice 1-3
REALTORS®, in attempting to secure a listing, shall not deliberately mislead the owner as to market value.

• Standard of Practice 1-4
REALTORS®, when seeking to become a buyer/tenant representative, shall not mislead buyers or tenants as to savings or other benefits that might be realized through use of the REALTOR®'s services. *(Amended 1/93)*

• Standard of Practice 1-5
REALTORS® may represent the seller/landlord and buyer/tenant in the same transaction only after full disclosure to and with informed consent of both parties. *(Adopted 1/93)*

• Standard of Practice 1-6
REALTORS® shall submit offers and counter-offers objectively and as quickly as possible. *(Adopted 1/93, Amended 1/95)*

• Standard of Practice 1-7
When acting as listing brokers, REALTORS® shall continue to submit to the seller/landlord all offers and counter-offers until closing or execution of a lease unless the seller/landlord has waived this obligation in writing. REALTORS® shall not be obligated to continue to market the property after an offer has been accepted by the seller/landlord. REALTORS® shall recommend that sellers/landlords obtain the advice of legal counsel prior to acceptance of a subsequent offer except where the acceptance is contingent on the termination of the pre-existing purchase contract or lease. *(Amended 1/93)*

• Standard of Practice 1-8
REALTORS®, acting as agents or brokers of buyers/tenants, shall submit to buyers/tenants all offers and counter-offers until acceptance but have no obligation to continue to show properties to their clients after an offer has been accepted unless otherwise agreed in writing. REALTORS®, acting as agents or brokers of buyers/tenants, shall recommend that buyers/tenants obtain the advice of legal counsel if there is a question as to whether a pre-existing contract has been terminated. *(Adopted 1/93, Amended 1/99)*

• Standard of Practice 1-9
The obligation of REALTORS® to preserve confidential information (as defined by state law) provided by their clients in the course of any agency relationship or non-agency relationship recognized by law continues after termination of agency relationships or any non-agency relationships recognized by law. REALTORS® shall not knowingly, during or following the termination of professional relationships with their clients:

1) reveal confidential information of clients; or
2) use confidential information of clients to the disadvantage of clients; or
3) use confidential information of clients for the REALTOR®'s advantage or the advantage of third parties unless:
   a) clients consent after full disclosure; or
   b) REALTORS® are required by court order; or
   c) it is the intention of a client to commit a crime and the information is necessary to prevent the crime; or
   d) it is necessary to defend a REALTOR® or the REALTOR®'s employees or associates against an accusation of wrongful conduct.

Information concerning latent material defects is not considered confidential information under this Code of Ethics. *(Adopted 1/93, Amended 1/01)*

• Standard of Practice 1-10
REALTORS® shall, consistent with the terms and conditions of their real estate licensure and their property management agreement, competently manage the property of clients with due regard for the rights, safety and health of tenants and others lawfully on the premises. *(Adopted 1/95, Amended 1/00)*

• Standard of Practice 1-11
REALTORS® who are employed to maintain or manage a client's property shall exercise due diligence and make reasonable efforts to protect it against reasonably foreseeable contingencies and losses. *(Adopted 1/95)*

• Standard of Practice 1-12
When entering into listing contracts, REALTORS® must advise sellers/landlords of:

1) the REALTOR®'s company policies regarding cooperation and the amount(s) of any compensation that will be offered to subagents, buyer/tenant agents, and/or brokers acting in legally recognized non-agency capacities;
2) the fact that buyer/tenant agents or brokers, even if compensated by listing brokers, or by sellers/landlords may represent the interests of buyers/tenants; and
3) any potential for listing brokers to act as disclosed dual agents, e.g., buyer/tenant agents. *(Adopted 1/93, Renumbered 1/98, Amended 1/03)*

• Standard of Practice 1-13
When entering into buyer/tenant agreements, REALTORS® must advise potential clients of:

1) the REALTOR®'s company policies regarding cooperation;
2) the amount of compensation to be paid by the client;
3) the potential for additional or offsetting compensation from other brokers, from the seller or landlord, or from other parties;
4) any potential for the buyer/tenant representative to act as a disclosed dual agent, e.g., listing broker, subagent, landlord's agent, etc., and
5) the possibility that sellers or sellers' representatives may not treat the existence, terms, or conditions of offers as confidential unless confidentiality is required by law, regulation, or by any confidentiality agreement between the parties. *(Adopted 1/93, Renumbered 1/98, Amended 1/06)*

• Standard of Practice 1-14
Fees for preparing appraisals or other valuations shall not be contingent upon the amount of the appraisal or valuation. *(Adopted 1/02)*

• Standard of Practice 1-15
REALTORS®, in response to inquiries from buyers or cooperating brokers shall, with the sellers' approval, disclose the existence of offers on the property. Where disclosure is authorized,

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REALTORS® shall also disclose, if asked, whether offers were obtained by the listing licensee, another licensee in the listing firm, or by a cooperating broker. *(Adopted 1/03, Amended 1/09)*

Article 2

REALTORS® shall avoid exaggeration, misrepresentation, or concealment of pertinent facts relating to the property or the transaction. REALTORS® shall not, however, be obligated to discover latent defects in the property, to advise on matters outside the scope of their real estate license, or to disclose facts which are confidential under the scope of agency or non-agency relationships as defined by state law. *(Amended 1/00)*

• Standard of Practice 2-1
REALTORS® shall only be obligated to discover and disclose adverse factors reasonably apparent to someone with expertise in those areas required by their real estate licensing authority. Article 2 does not impose upon the REALTOR® the obligation of expertise in other professional or technical disciplines. *(Amended 1/96)*

• Standard of Practice 2-2
(Renumbered as Standard of Practice 1-12 1/98)

• Standard of Practice 2-3
(Renumbered as Standard of Practice 1-13 1/98)

• Standard of Practice 2-4
REALTORS® shall not be parties to the naming of a false consideration in any document, unless it be the naming of an obviously nominal consideration.

• Standard of Practice 2-5
Factors defined as "non-material" by law or regulation or which are expressly referenced in law or regulation as not being subject to disclosure are considered not "pertinent" for purposes of Article 2. *(Adopted 1/93)*

Article 3

REALTORS® shall cooperate with other brokers except when cooperation is not in the client's best interest. The obligation to cooperate does not include the obligation to share commissions, fees, or to otherwise compensate another broker. *(Amended 1/95)*

• Standard of Practice 3-1
REALTORS®, acting as exclusive agents or brokers of sellers/landlords, establish the terms and conditions of offers to cooperate. Unless expressly indicated in offers to cooperate, cooperating brokers may not assume that the offer of cooperation includes an offer of compensation. Terms of compensation, if any, shall be ascertained by cooperating brokers before beginning efforts to accept the offer of cooperation. *(Amended 1/99)*

• Standard of Practice 3-2
REALTORS® shall, with respect to offers of compensation to another REALTOR®, timely communicate any change of compensation for cooperative services to the other REALTOR® prior to the time such REALTOR® produces an offer to purchase/lease the property. *(Amended 1/94)*

• Standard of Practice 3-3
Standard of Practice 3-2 does not preclude the listing broker and cooperating broker from entering into an agreement to change cooperative compensation. *(Adopted 1/94)*

• Standard of Practice 3-4
REALTORS®, acting as listing brokers, have an affirmative obligation to disclose the existence of dual or variable rate commission arrangements (i.e., listings where one amount of commission is payable if the listing broker's firm is the procuring cause of sale/lease and a different amount of commission is payable if the sale/lease results through the efforts of the seller/landlord or a cooperating broker). The listing broker shall, as soon as practical, disclose the existence of such arrangements to potential cooperating brokers and shall, in response to inquiries from cooperating brokers, disclose the differential that would result in a cooperative transaction or in a sale/lease that results through the efforts of the seller/landlord. If the cooperating broker is a buyer/tenant representative, the buyer/ tenant representative must disclose such information to their client before the client makes an offer to purchase or lease. *(Amended 1/02)*

• Standard of Practice 3-5
It is the obligation of subagents to promptly disclose all pertinent facts to the principal's agent prior to as well as after a purchase or lease agreement is executed. *(Amended 1/93)*

• Standard of Practice 3-6
REALTORS® shall disclose the existence of accepted offers, including offers with unresolved contingencies, to any broker seeking cooperation. *(Adopted 5/86, Amended 1/04)*

• Standard of Practice 3-7
When seeking information from another REALTOR® concerning property under a management or listing agreement, REALTORS® shall disclose their REALTOR® status and whether their interest is personal or on behalf of a client and, if on behalf of a client, their representational status. *(Amended 1/95)*

• Standard of Practice 3-8
REALTORS® shall not misrepresent the availability of access to show or inspect a listed property. *(Amended 11/87)*

Article 4

REALTORS® shall not acquire an interest in or buy or present offers from themselves, any member of their immediate families, their firms or any member thereof, or any entities in which they have any ownership interest, any real property without making their true position known to the owner or the owner's agent or broker. In selling property they own, or in which they have any interest, REALTORS® shall reveal their ownership or interest in writing to the purchaser or the purchaser's representative. *(Amended 1/00)*

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• Standard of Practice 4-1

For the protection of all parties, the disclosures required by Article 4 shall be in writing and provided by REALTORS® prior to the signing of any contract. *(Adopted 2/86)*

Article 5

REALTORS® shall not undertake to provide professional services concerning a property or its value where they have a present or contemplated interest unless such interest is specifically disclosed to all affected parties.

Article 6

REALTORS® shall not accept any commission, rebate, or profit on expenditures made for their client, without the client's knowledge and consent.

When recommending real estate products or services (e.g., homeowner's insurance, warranty programs, mortgage financing, title insurance, etc.), REALTORS® shall disclose to the client or customer to whom the recommendation is made any financial benefits or fees, other than real estate referral fees, the REALTOR® or REALTOR®'s firm may receive as a direct result of such recommendation. (Amended 1/99)

• Standard of Practice 6-1

REALTORS® shall not recommend or suggest to a client or a customer the use of services of another organization or business entity in which they have a direct interest without disclosing such interest at the time of the recommendation or suggestion. *(Amended 5/88)*

Article 7

In a transaction, REALTORS® shall not accept compensation from more than one party, even if permitted by law, without disclosure to all parties and the informed consent of the REALTOR®'s client or clients. *(Amended 1/93)*

Article 8

REALTORS® shall keep in a special account in an appropriate financial institution, separated from their own funds, monies coming into their possession in trust for other persons, such as escrows, trust funds, clients' monies, and other like items.

Article 9

REALTORS®, for the protection of all parties, shall assure whenever possible that all agreements related to real estate transactions including, but not limited to, listing and representation agreements, purchase contracts, and leases are in writing in clear and understandable language expressing the specific terms, conditions, obligations and commitments of the parties. A copy of each agreement shall be furnished to each party to such agreements upon their signing or initialing. *(Amended 1/04)*

• Standard of Practice 9-1

For the protection of all parties, REALTORS® shall use reasonable care to ensure that documents pertaining to the purchase, sale, or lease of real estate are kept current through the use of written extensions or amendments. *(Amended 1/93)*

• Standard of Practice 9-2

When assisting or enabling a client or customer in establishing a contractual relationship (e.g., listing and representation agreements, purchase agreements, leases, etc.) electronically, REALTORS® shall make reasonable efforts to explain the nature and disclose the specific terms of the contractual relationship being established prior to it being agreed to by a contracting party. *(Adopted 1/07)*

Duties to the Public

Article 10

REALTORS® shall not deny equal professional services to any person for reasons of race, color, religion, sex, handicap, familial status, or national origin. REALTORS® shall not be parties to any plan or agreement to discriminate against a person or persons on the basis of race, color, religion, sex, handicap, familial status, or national origin. *(Amended 1/90)*

REALTORS®, in their real estate employment practices, shall not discriminate against any person or persons on the basis of race, color, religion, sex, handicap, familial status, or national origin. *(Amended 1/00)*

• Standard of Practice 10-1

When involved in the sale or lease of a residence, REALTORS® shall not volunteer information regarding the racial, religious or ethnic composition of any neighborhood nor shall they engage in any activity which may result in panic selling, however, REALTORS® may provide other demographic information. *(Adopted 1/94, Amended 1/06)*

• Standard of Practice 10-2

When not involved in the sale or lease of a residence, REALTORS® may provide demographic information related to a property, transaction or professional assignment to a party if such demographic information is (a) deemed by the REALTOR® to be needed to assist with or complete, in a manner consistent with Article 10, a real estate transaction or professional assignment and (b) is obtained or derived from a recognized, reliable, independent, and impartial source. The source of such information and any additions, deletions, modifications, interpretations, or other changes shall be disclosed in reasonable detail. *(Adopted 1/05, Renumbered 1/06)*

• Standard of Practice 10-3

REALTORS® shall not print, display or circulate any statement or advertisement with respect to selling or renting of a property that indicates any preference, limitations or discrimination based on race, color, religion, sex, handicap, familial status, or national origin. *(Adopted 1/94, Renumbered 1/05 and 1/06)*

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• Standard of Practice 10-4
As used in Article 10 "real estate employment practices" relates to employees and independent contractors providing real estate-related services and the administrative and clerical staff directly supporting those individuals. *(Adopted 1/00, Renumbered 1/05 and 1/06)*

Article 11

The services which REALTORS® provide to their clients and customers shall conform to the standards of practice and competence which are reasonably expected in the specific real estate disciplines in which they engage; specifically, residential real estate brokerage, real property management, commercial and industrial real estate brokerage, real estate appraisal, real estate counseling, real estate syndication, real estate auction, and international real estate.

REALTORS® shall not undertake to provide specialized professional services concerning a type of property or service that is outside their field of competence unless they engage the assistance of one who is competent on such types of property or service, or unless the facts are fully disclosed to the client. Any persons engaged to provide such assistance shall be so identified to the client and their contribution to the assignment should be set forth. *(Amended 1/95)*

• Standard of Practice 11-1
When REALTORS® prepare opinions of real property value or price, other than in pursuit of a listing or to assist a potential purchaser in formulating a purchase offer, such opinions shall include the following:
1) identification of the subject property
2) date prepared
3) defined value or price
4) limiting conditions, including statements of purpose(s) and intended user(s)
5) any present or contemplated interest, including the possibility of representing the seller/landlord or buyers/tenants
6) basis for the opinion, including applicable market data
7) if the opinion is not an appraisal, a statement to that effect *(Amended 1/01)*

• Standard of Practice 11-2
The obligations of the Code of Ethics in respect of real estate disciplines other than appraisal shall be interpreted and applied in accordance with the standards of competence and practice which clients and the public reasonably require to protect their rights and interests considering the complexity of the transaction, the availability of expert assistance, and, where the REALTOR® is an agent or subagent, the obligations of a fiduciary. *(Adopted 1/95)*

• Standard of Practice 11-3
When REALTORS® provide consultive services to clients which involve advice or counsel for a fee (not a commission), such advice shall be rendered in an objective manner and the fee shall not be contingent on the substance of the advice or counsel given. If brokerage or transaction services are to be provided in addition to consultive services, a separate compensation may be paid with prior agreement between the client and REALTOR®. *(Adopted 1/96)*

• Standard of Practice 11-4
The competency required by Article 11 relates to services contracted for between REALTORS® and their clients or customers; the duties expressly imposed by the Code of Ethics; and the duties imposed by law or regulation. *(Adopted 1/02)*

Article 12

REALTORS® shall be honest and truthful in their real estate communications and shall present a true picture in their advertising, marketing, and other representations. REALTORS® shall ensure that their status as real estate professionals is readily apparent in their advertising, marketing, and other representations, and that the recipients of all real estate communications are, or have been, notified that those communications are from a real estate professional. *(Amended 1/08)*

• Standard of Practice 12-1
REALTORS® may use the term "free" and similar terms in their advertising and in other representations provided that all terms governing availability of the offered product or service are clearly disclosed at the same time. *(Amended 1/97)*

• Standard of Practice 12-2
REALTORS® may represent their services as "free" or without cost even if they expect to receive compensation from a source other than their client provided that the potential for the REALTOR® to obtain a benefit from a third party is clearly disclosed at the same time. *(Amended 1/97)*

• Standard of Practice 12-3
The offering of premiums, prizes, merchandise discounts or other inducements to list, sell, purchase, or lease is not, in itself, unethical even if receipt of the benefit is contingent on listing, selling, purchasing, or leasing through the REALTOR® making the offer. However, REALTORS® must exercise care and candor in any such advertising or other public or private representations so that any party interested in receiving or otherwise benefiting from the REALTOR®'s offer will have clear, thorough, advance understanding of all the terms and conditions of the offer. The offering of any inducements to do business is subject to the limitations and restrictions of state law and the ethical obligations established by any applicable Standard of Practice. *(Amended 1/95)*

• Standard of Practice 12-4
REALTORS® shall not offer for sale/lease or advertise property without authority. When acting as listing brokers or as subagents, REALTORS® shall not quote a price different from that agreed upon with the seller/landlord. *(Amended 1/93)*

• Standard of Practice 12-5
REALTORS® shall not advertise nor permit any person employed by or affiliated with them to advertise listed property in any medium (e.g., electronically, print, radio, television, etc.) without disclosing the name of that REALTOR®'s firm in a reasonable and readily apparent manner. *(Adopted 11/86, Amended 1/07)*

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• **Standard of Practice 12-6**
REALTORS®, when advertising unlisted real property for sale/lease in which they have an ownership interest, shall disclose their status as both owners/landlords and as REALTORS® or real estate licensees. *(Amended 1/93)*

• **Standard of Practice 12-7**
Only REALTORS® who participated in the transaction as the listing broker or cooperating broker (selling broker) may claim to have "sold" the property. Prior to closing, a cooperating broker may post a "sold" sign only with the consent of the listing broker. *(Amended 1/96)*

• **Standard of Practice 12-8**
The obligation to present a true picture in representations to the public includes information presented, provided, or displayed on REALTORS®' websites. REALTORS® shall use reasonable efforts to ensure that information on their websites is current. When it becomes apparent that information on a REALTOR®'s website is no longer current or accurate, REALTORS® shall promptly take corrective action. *(Adopted 1/07)*

• **Standard of Practice 12-9**
REALTOR® firm websites shall disclose the firm's name and state(s) of licensure in a reasonable and readily apparent manner.

Websites of REALTORS® and non-member licensees affiliated with a REALTOR® firm shall disclose the firm's name and that REALTOR®'s or non-member licensee's state(s) of licensure in a reasonable and readily apparent manner. *(Adopted 1/07)*

• **Standard of Practice 12-10**
REALTORS®' obligation to present a true picture in their advertising and representations to the public includes the URLs and domain names they use, and prohibits REALTORS® from:
1) engaging in deceptive or unauthorized framing of real estate brokerage websites;
2) manipulating (e.g., presenting content developed by others) listing content in any way that produces a deceptive or misleading result; or
3) deceptively using metatags, keywords or other devices/ methods to direct, drive, or divert Internet traffic, or to otherwise mislead consumers. *(Adopted 1/07)*

• **Standard of Practice 12-11**
REALTORS® intending to share or sell consumer information gathered via the Internet shall disclose that possibility in a reasonable and readily apparent manner. *(Adopted 1/07)*

• **Standard of Practice 12-12**
REALTORS® shall not:
1) use URLs or domain names that present less than a true picture, or
2) register URLs or domain names which, if used, would present less than a true picture. *(Adopted 1/08)*

• **Standard of Practice 12-13**
The obligation to present a true picture in advertising, marketing, and representations allows REALTORS® to use and display only professional designations, certifications, and other credentials to which they are legitimately entitled. *(Adopted 1/08)*

Article 13
REALTORS® shall not engage in activities that constitute the unauthorized practice of law and shall recommend that legal counsel be obtained when the interest of any party to the transaction requires it.

Article 14
If charged with unethical practice or asked to present evidence or to cooperate in any other way, in any professional standards proceeding or investigation, REALTORS® shall place all pertinent facts before the proper tribunals of the Member Board or affiliated institute, society, or council in which membership is held and shall take no action to disrupt or obstruct such processes. *(Amended 1/99)*

• **Standard of Practice 14-1**
REALTORS® shall not be subject to disciplinary proceedings in more than one Board of REALTORS® or affiliated institute, society, or council in which they hold membership with respect to alleged violations of the Code of Ethics relating to the same transaction or event. *(Amended 1/95)*

• **Standard of Practice 14-2**
REALTORS® shall not make any unauthorized disclosure or dissemination of the allegations, findings, or decision developed in connection with an ethics hearing or appeal or in connection with an arbitration hearing or procedural review. *(Amended 1/92)*

• **Standard of Practice 14-3**
REALTORS® shall not obstruct the Board's investigative or professional standards proceedings by instituting or threatening to institute actions for libel, slander, or defamation against any party to a professional standards proceeding or their witnesses based on the filing of an arbitration request, an ethics complaint, or testimony given before any tribunal. *(Adopted 11/87, Amended 1/99)*

• **Standard of Practice 14-4**
REALTORS® shall not intentionally impede the Board's investigative or disciplinary proceedings by filing multiple ethics complaints based on the same event or transaction. *(Adopted 11/88)*

Duties to REALTORS®

Article 15
REALTORS® shall not knowingly or recklessly make false or misleading statements about competitors, their businesses, or their business practices. *(Amended 1/92)*

• **Standard of Practice 15-1**
REALTORS® shall not knowingly or recklessly file false or unfounded ethics complaints. *(Adopted 1/00)*

• **Standard of Practice 15-2**
The obligation to refrain from making false or misleading statements about competitors' businesses and competitors' business practices includes the duty to not knowingly or recklessly repeat, retransmit, or republish false or misleading statements made by others. This duty applies whether false or misleading statements are repeated in person, in writing, by technological means (e.g., the Internet), or by any other means. *(Adopted 1/07)*

Article 16

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REALTORS® shall not engage in any practice or take any action inconsistent with exclusive representation or exclusive brokerage relationship agreements that other REALTORS® have with clients. *(Amended 1/04)*

• Standard of Practice 16-1

Article 16 is not intended to prohibit aggressive or innovative business practices which are otherwise ethical and does not prohibit disagreements with other REALTORS® involving commission, fees, compensation or other forms of payment or expenses. *(Adopted 1/93, Amended 1/95)*

• Standard of Practice 16-2

Article 16 does not preclude REALTORS® from making general announcements to prospects describing their services and the terms of their availability even though some recipients may have entered into agency agreements or other exclusive relationships with another REALTOR®. A general telephone canvass, general mailing or distribution addressed to all prospects in a given geographical area or in a given profession, business, club, or organization, or other classification or group is deemed "general" for purposes of this standard. *(Amended 1/04)*

Article 16 is intended to recognize as unethical two basic types of solicitations:

First, telephone or personal solicitations of property owners who have been identified by a real estate sign, multiple listing compilation, or other information service as having exclusively listed their property with another REALTOR®; and

Second, mail or other forms of written solicitations of prospects whose properties are exclusively listed with another REALTOR® when such solicitations are not part of a general mailing but are directed specifically to property owners identified through compilations of current listings, "for sale" or "for rent" signs, or other sources of information required by Article 3 and Multiple Listing Service rules to be made available to other REALTORS® under offers of subagency or cooperation. *(Amended 1/04)*

• Standard of Practice 16-3

Article 16 does not preclude REALTORS® from contacting the client of another broker for the purpose of offering to provide, or entering into a contract to provide, a different type of real estate service unrelated to the type of service currently being provided (e.g., property management as opposed to brokerage) or from offering the same type of service for property not subject to other brokers' exclusive agreements. However, information received through a Multiple Listing Service or any other offer of cooperation may not be used to target clients of other REALTORS® to whom such offers to provide services may be made. *(Amended 1/04)*

• Standard of Practice 16-4

REALTORS® shall not solicit a listing which is currently listed exclusively with another broker. However, if the listing broker, when asked by the REALTOR®, refuses to disclose the expiration date and nature of such listing; i.e., an exclusive right to sell, an exclusive agency, open listing, or other form of contractual agreement between the listing broker and the client, the REALTOR® may contact the owner to secure such information and may discuss the terms upon which the REALTOR® might take a future listing or, alternatively, may take a listing to become effective upon expiration of any existing exclusive listing. *(Amended 1/94)*

• Standard of Practice 16-5

REALTORS® shall not solicit buyer/tenant agreements from buyers/tenants who are subject to exclusive buyer/tenant agreements. However, if asked by a REALTOR®, the broker refuses to disclose the expiration date of the exclusive buyer/tenant agreement, the REALTOR® may contact the buyer/tenant to secure such information and may discuss the terms upon which the REALTOR® might enter into a future buyer/tenant agreement or, alternatively, may enter into a buyer/tenant agreement to become effective upon the expiration of any existing exclusive buyer/tenant agreement. *(Adopted 1/94, Amended 1/98)*

• Standard of Practice 16-6

When REALTORS® are contacted by the client of another REALTOR® regarding the creation of an exclusive relationship to provide the same type of service, and REALTORS® have not directly or indirectly initiated such discussions, they may discuss the terms upon which they might enter into a future agreement or, alternatively, may enter into an agreement which becomes effective upon expiration of any existing exclusive agreement. *(Amended 1/98)*

• Standard of Practice 16-7

The fact that a prospect has retained a REALTOR® as an exclusive representative or exclusive broker in one or more past transactions does not preclude other REALTORS® from seeking such prospect's future business. *(Amended 1/04)*

• Standard of Practice 16-8

The fact that an exclusive agreement has been entered into with a REALTOR® shall not preclude or inhibit any other REALTOR® from entering into a similar agreement after the expiration of the prior agreement. *(Amended 1/98)*

• Standard of Practice 16-9

REALTORS®, prior to entering into a representation agreement, have an affirmative obligation to make reasonable efforts to determine whether the prospect is subject to a current, valid exclusive agreement to provide the same type of real estate service. *(Amended 1/04)*

• Standard of Practice 16-10

REALTORS®, acting as buyer or tenant representatives or brokers, shall disclose that relationship to the seller/landlord's representative or broker at first contact and shall provide written confirmation of that disclosure to the seller/landlord's representative or broker not later than execution of a purchase agreement or lease. *(Amended 1/04)*

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• **Standard of Practice 16-11**
On unlisted property, REALTORS® acting as buyer/tenant representatives or brokers shall disclose that relationship to the seller/landlord at first contact for that buyer/tenant and shall provide written confirmation of such disclosure to the seller/landlord not later than execution of any purchase or lease agreement. *(Amended 1/04)*

REALTORS® shall make any request for anticipated compensation from the seller/landlord at first contact. *(Amended 1/98)*

• **Standard of Practice 16-12**
REALTORS®, acting as representatives or brokers of sellers/ landlords or as subagents of listing brokers, shall disclose that relationship to buyers/tenants as soon as practicable and shall provide written confirmation of such disclosure to buyers/tenants not later than execution of any purchase or lease agreement. *(Amended 1/04)*

• **Standard of Practice 16-13**
All dealings concerning property exclusively listed, or with buyer/tenants who are subject to an exclusive agreement shall be carried on with the client's representative or broker, and not with the client, except with the consent of the client's representative or broker or except where such dealings are initiated by the client.

Before providing substantive services (such as writing a purchase offer or presenting a CMA) to prospects, REALTORS® shall ask prospects whether they are a party to any exclusive representation agreement. REALTORS® shall not knowingly provide substantive services concerning a prospective transaction to prospects who are parties to exclusive representation agreements, except with the consent of the prospects' exclusive representatives or at the direction of prospects. *(Adopted 1/93, Amended 1/04)*

• **Standard of Practice 16-14**
REALTORS® are free to enter into contractual relationships or to negotiate with sellers/landlords, buyers/tenants or others who are not subject to an exclusive agreement but shall not knowingly obligate them to pay more than one commission except with their informed consent. *(Amended 1/98)*

• **Standard of Practice 16-15**
In cooperative transactions REALTORS® shall compensate cooperating REALTORS® (principal brokers) and shall not compensate nor offer to compensate, directly or indirectly, any of the sales licensees employed by or affiliated with other REALTORS® without the prior express knowledge and consent of the cooperating broker.

• **Standard of Practice 16-16**
REALTORS®, acting as subagents or buyer/tenant representatives or brokers, shall not use the terms of an offer to purchase/lease to attempt to modify the listing broker's offer of compensation to subagents or buyer/tenant representatives or brokers nor make the submission of an executed offer to purchase/lease contingent on the listing broker's agreement to modify the offer of compensation. *(Amended 1/04)*

• **Standard of Practice 16-17**
REALTORS®, acting as subagents or as buyer/tenant representatives or brokers, shall not attempt to extend a listing broker's offer of cooperation and/or compensation to other brokers without the consent of the listing broker. *(Amended 1/04)*

• **Standard of Practice 16-18**
REALTORS® shall not use information obtained from listing brokers through offers to cooperate made through multiple listing services or through other offers of cooperation to refer listing brokers' clients to other brokers or to create buyer/tenant relationships with listing brokers' clients, unless such use is authorized by listing brokers. *(Amended 1/02)*

• **Standard of Practice 16-19**
Signs giving notice of property for sale, rent, lease, or exchange shall not be placed on property without consent of the seller/landlord. *(Amended 1/93)*

• **Standard of Practice 16-20**
REALTORS®, prior to or after terminating their relationship with their current firm, shall not induce clients of their current firm to cancel exclusive contractual agreements between the client and that firm. This does not preclude REALTORS® (principals) from establishing agreements with their associated licensees governing assignability of exclusive agreements. *(Adopted 1/98)*

Article 17

In the event of contractual disputes or specific non-contractual disputes as defined in Standard of Practice 17-4 between REALTORS® (principals) associated with different firms, arising out of their relationship as REALTORS®, the REALTORS® shall submit the dispute to arbitration in accordance with the regulations of their Board or Boards rather than litigate the matter.

In the event clients of REALTORS® wish to arbitrate contractual disputes arising out of real estate transactions, REALTORS® shall arbitrate those disputes in accordance with the regulations of their Board, provided the clients agree to be bound by the decision.

The obligation to participate in arbitration contemplated by this Article includes the obligation of REALTORS® (principals) to cause their firms to arbitrate and be bound by any award. *(Amended 1/01)*

• **Standard of Practice 17-1**
The filing of litigation and refusal to withdraw from it by REALTORS® in an arbitrable matter constitutes a refusal to arbitrate. *(Adopted 2/86)*

• **Standard of Practice 17-2**
Article 17 does not require REALTORS® to arbitrate in those circumstances when all parties to the dispute advise the Board in writing that they choose not to arbitrate before the Board. *(Amended 1/93)*

• **Standard of Practice 17-3**
REALTORS®, when acting solely as principals in a real estate transaction, are not obligated to arbitrate disputes with other REALTORS® absent a specific written agreement to the contrary. *(Adopted 1/96)*

• **Standard of Practice 17-4**
Specific non-contractual disputes that are subject to arbitration pursuant to Article 17 are:

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1) Where a listing broker has compensated a cooperating broker and another cooperating broker subsequently claims to be the procuring cause of the sale or lease. In such cases the complainant may name the first cooperating broker as respondent and arbitration may proceed without the listing broker being named as a respondent. When arbitration occurs between two (or more) cooperating brokers and where the listing broker is not a party, the amount in dispute and the amount of any potential resulting award is limited to the amount paid to the respondent by the listing broker and any amount credited or paid to a party to the transaction at the direction of the respondent. Alternatively, if the complaint is brought against the listing broker, the listing broker may name the first cooperating broker as a third-party respondent. In either instance the decision of the hearing panel as to procuring cause shall be conclusive with respect to all current or subsequent claims of the parties for compensation arising out of the underlying cooperative transaction. *(Adopted 1/97, Amended 1/07)*

2) Where a buyer or tenant representative is compensated by the seller or landlord, and not by the listing broker, and the listing broker, as a result, reduces the commission owed by the seller or landlord and, subsequent to such actions, another cooperating broker claims to be the procuring cause of sale or lease. In such cases the complainant may name the first cooperating broker as respondent and arbitration may proceed without the listing broker being named as a respondent. When arbitration occurs between two (or more) cooperating brokers and where the listing broker is not a party, the amount in dispute and the amount of any potential resulting award is limited to the amount paid to the respondent by the seller or landlord and any amount credited or paid to a party to the transaction at the direction of the respondent. Alternatively, if the complaint is brought against the listing broker, the listing broker may name the first cooperating broker as a third-party respondent. In either instance the decision of the hearing panel as to procuring cause shall be conclusive with respect to all current or subsequent claims of the parties for compensation arising out of the underlying cooperative transaction. *(Adopted 1/97, Amended 1/07)*

3) Where a buyer or tenant representative is compensated by the buyer or tenant and, as a result, the listing broker reduces the commission owed by the seller or landlord and, subsequent to such actions, another cooperating broker claims to be the procuring cause of sale or lease. In such cases the complainant may name the first cooperating broker as respondent and arbitration may proceed without the listing broker being named as a respondent. Alternatively, if the complaint is brought against the listing broker, the listing broker may name the first cooperating broker as a third-party respondent. In either instance the decision of the hearing panel as to procuring cause shall be conclusive with respect to all current or subsequent claims of the parties for compensation arising out of the underlying cooperative transaction. *(Adopted 1/97)*

4) Where two or more listing brokers claim entitlement to compensation pursuant to open listings with a seller or landlord who agrees to participate in arbitration (or who requests arbitration) and who agrees to be bound by the decision. In cases where one of the listing brokers has been compensated by the seller or landlord, the other listing broker, as complainant, may name the first listing broker as respondent and arbitration may proceed between the brokers. *(Adopted 1/97)*

5) Where a buyer or tenant representative is compensated by the seller or landlord, and not by the listing broker, and the listing broker, as a result, reduces the commission owed by the seller or landlord and, subsequent to such actions, claims to be the procuring cause of sale or lease. In such cases arbitration shall be between the listing broker and the buyer or tenant representative and the amount in dispute is limited to the amount of the reduction of commission to which the listing broker agreed. *(Adopted 1/05)*

• **Standard of Practice 17-5**

The obligation to arbitrate established in Article 17 includes disputes between REALTORS® (principals) in different states in instances where, absent an established inter-association arbitration agreement, the REALTOR® (principal) requesting arbitration agrees to submit to the jurisdiction of, travel to, participate in, and be bound by any resulting award rendered in arbitration conducted by the respondent(s) REALTOR®'s association, in instances where the respondent(s) REALTOR®'s association determines that an arbitrable issue exists. *(Adopted 1/07)*

The* Code of Ethics *was adopted in 1913. Amended at the Annual Convention in 1924, 1928, 1950, 1951, 1952, 1955, 1956, 1961, 1962, 1974, 1982, 1986, 1987, 1989, 1990, 1991, 1992, 1993, 1994, 1995, 1996, 1997, 1998, 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007 and 2008.

Explanatory Notes

The reader should be aware of the following policies which have been approved by the Board of Directors of the National Association:

In filing a charge of an alleged violation of the Code of Ethics by a REALTOR®, the charge must read as an alleged violation of one or more Articles of the Code. Standards of Practice may be cited in support of the charge.

The Standards of Practice serve to clarify the ethical obligations imposed by the various Articles and supplement, and do not substitute for, the Case Interpretations in Interpretations of the Code of Ethics.

Modifications to existing Standards of Practice and additional new Standards of Practice are approved from time to time. Readers are cautioned to ensure that the most recent publications are utilized.

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Appendix B

Broker Checklist: Do's and Don'ts

Todd J. Wenzel

This checklist contains items beyond the normal scope of the attorney's duty, but may be shared with broker clients to provide insight into avoiding disputes with principals.

Do's for Brokers

- Put your client's interest ahead of yours.
- Perform with diligence in your client's interest.
- Keep organized and clean copies of each transaction or transaction-in-progress in separate, readily accessible files.
- Present all offers to your listing clients and all viable listings to your buyer or tenant clients.
- Provide competent advice about the transaction, within personal knowledge.
- Sit down with listing clients to discuss their disclosures.
- Get disclosures in listing client's handwriting.
- Refer clients to counsel or other experts if advice requested is beyond the broker's knowledge.
- Consider verifying disclosures about building through public records.
- Properly account for all fees and compensation earned on each transaction.

Don'ts for Brokers

- Practice law.
- Give advice on tax implications, unless qualified.
- Speculate about property conditions as disclosed.
- Mislead your client or parties on other end of transaction.
- Encourage listing clients to be vague on disclosures.
- Endeavor to acquire secret profits from transactions you are involved in.
- Act as dual agent without full disclosures to and consent from both sides.
- Agree to work with a dishonest client or a client suggesting anything illegal related to a transaction.

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Appendix C

Listing Agreement Checklist

When reviewing a listing agreement prepared by the broker, counsel for the property owner should pay particular attention to the following provisions:

- The amount of the commission, usually expressed as a percentage of the sales price. By law, all commissions are negotiable. Bus & P C §10147.5.
- The term of the listing agreement. A 3- or 6-month term is common. If the term is too short, the broker may not be sufficiently motivated to market the property. If the term is too long, it may be difficult to switch to another broker if the first broker is not putting forth sufficient effort.
- Does the agreement specifically list what constitutes "due diligence" by the broker and the specific tasks the broker will perform? Industry forms rarely include such provisions.
- The language concerning when the commission is earned (as opposed to the time when payment is due). From the owner's standpoint, the commission should not be earned until the sale has closed, unless closing was prevented by the owner's breach of the sale agreement. Listing agreements frequently provide that the commission is earned when the broker produces a "ready, willing, and able" buyer or tenant. Under such a provision, the owner may be liable for the commission once an unconditional contract is accepted, even if the buyer or tenant later refuses to complete the transaction (although the broker may have difficulty proving that a defaulting party was, in fact, "ready, willing, and able"). See §7.20. Some listing agreements may contain ambiguous language concerning when the commission is earned. For example, some may state that the commission is earned when the property is "sold."
- Is the broker expected to cooperate with other brokers, and, if so, how is the commission to be shared?
- If a residential transaction, will the listing be submitted to the multiple listing service (see §§1.11-1.14)? Sellers usually wish to get the broadest possible exposure of the property as quickly as possible.
- The price and terms of sale or lease. Even though these terms in a listing agreement do not obligate the owner to sell to a buyer or lease to a tenant whose offer meets the terms, the broker may have earned a commission when he or she procures an offer that meets the specified terms.

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Source: Real Property/California Real Estate Brokers: Law and Litigation/Appendix D Procuring Cause Guidelines of the California Association of Realtors

Appendix D

Procuring Cause Guidelines of the California Association of Realtors®



CALIFORNIA ASSOCIATION OF REALTORS®

Legal Brief

Procuring Cause Guidelines

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The following was approved by the C.A.R. Board of Directors, on October 20, 2001, for distribution to local Associations of REALTORS® and their members. These Procuring Cause Guidelines are intended to assist arbitration panelists in deciding which of multiple brokers is the procuring cause of a given transaction. Use of the Guidelines by any particular local association is strictly voluntary.

I. Introduction

The offer of compensation from a listing broker to a cooperating/selling broker almost always has its source in the MLS rules. The California Model MLS rules provide that "In filing a property with the MLS, the broker participant makes a blanket unilateral contractual offer of compensation to the other MLS broker participants for their services in selling the property..." Rule 7.12. "This broker participant's contractual offer (with or without sub agency) is accepted by the participant/selling broker by procuring a buyer which ultimately results in the creation of a sales or lease contract. ..." Rule 7.13. Therefore, the listing broker's contractual offer is accepted by the cooperating broker "procuring" the buyer. The term, "procuring cause" has taken on a life of its own, however, and many lists and memos have been developed to try to predict the outcome of a given dispute. There are a few key concepts that serve as a baseline, however.

- Procuring Cause is a factors test that *doesn't necessarily have one triggering event* that will give a sure result.
- N.A.R. Policy prohibits local associations from adopting a rule that "predetermines" outcomes in commission disputes.
- While a number of definitions of "procuring cause" exist, NAR defines procuring cause as the uninterrupted series of causal events, which results in the successful transaction.

The purpose of these Guidelines is to provide a framework with specific illustrations and guidance so that brokers can train their agents in a manner to minimize disputes and so that panelists hearing those disputes can be more consistent with similar fact patterns.

II. Burden of Proof

The broker who files the arbitration complaint carries the burden of proof to demonstrate, by a preponderance of the evidence, why he or she is the procuring cause of the transaction and is, thus, entitled to the commission (because

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only brokers can offer and accept compensation under the MLS Rules, the term "broker" will be used throughout this paper to refer to both brokers and their agent salespeople in the proper context). Generally, the broker filing the complaint is the one who does not have the commission. Therefore, in most situations, the broker who does not have the commission in-pocket will have to prove that he or she is entitled to it. In the case in which the complainant did write the contract, however, and arbitration is needed to release funds from escrow, he or she, as the complainant, would have the burden of proof to show why he or she is entitled to the commission.

A number of relevant factors, including the behavior of the involved brokers and the reason the buyer left the first broker, would be used by the panel to decide who gets the commission.

III. Factors Chart

The Factors Chart is a compilation of "facts" that are considered by an arbitration panel to help determine whether the broker closing the transaction is, indeed, entitled to the commission as the procuring cause of the transaction. The factors chart contains factors gathered from many sources that have been used by arbitration panelists for years. It includes factors from NAR materials, CAR materials and case law, as well as general recurring patterns in transactions. The chart should *NOT* be used as a numerical system to give points to one side or the other. In given circumstances, *some factors will not be present; others should be given more weight.* Accordingly, the chart should serve as a guide to raise and consider relevant issues. For purposes of the chart, Intro Broker is the one who did not ultimately write the contract, and Closing Broker is the one who wrote the contract that was ultimately accepted and performed services through escrow to close the transaction. The chart is divided as follows:

A. **Connection to the Transaction.** Factors 1-7 include the relationship of both brokers to the buyer in this particular transaction. Since a broker must be the procuring cause as it relates to the property and transaction in question, this series of factors focuses on the involvement of the broker.

B. **Buyer's Choice.** Factors 8-10 focus on why the buyer left the Intro Broker. Relevant factors here are examined to determine if the reason was so justified as to defeat the Intro Broker's procuring cause claim.

C. **Broker Conduct.** Factors 11-18 focus on the conduct of the Closing Broker. Did the Closing Broker conduct him or herself in such a way that could have prevented the problem? Did the Closing Broker engage in inappropriate conduct that contributed to the "break" in the chain of events started by the Intro Broker that otherwise would not have occurred?

D. **Other.** Factors 19-24 deal with contractual and other miscellaneous issues that are relevant to the ultimate decision.

The factors refer to three buyer representation contracts:

C.A.R. Form BBE Buyer Broker Agreement -Exclusive (Right to Represent) or other form used by brokers for the same purpose are similar to exclusive right to sell listings except that they describe the property needs of a buyer and give the broker the authority to locate property for the buyer. These contracts provide for payment even if the broker does not locate the property ultimately purchased.

C.A.R. Form BBNE Buyer Broker Agreement - Non Exclusive (Right to Represent) or other form used by brokers for the same purpose define the agency relationship and provide for payment to the broker only if the broker introduces the successful buyer to the seller and the transaction is closed.

C.A.R. Form BBNN Buyer Broker Agreement (Non-Exclusive/Not for Compensation) or other form used by brokers for the same purpose define the agency relationship only and do not provide for any commission rights.

THIS CHART IS NOT A CHECKLIST. FACTORS ARE NOT ADDITIVE -- SOME ARE ENTITLED TO MORE WEIGHT THAN OTHERS.

	Favors Intro Broker	Favors Closing Broker	Comments
Connection to the Transaction			
1. Buyer is first introduced to the property by Intro Broker.	X		
2. Closing Broker never showed the property.	X		
3. Intro Broker wrote and presented an offer on the property on behalf of the buyer but the transaction was not consummated.	X		
4. Closing Broker wrote and presented an offer on the property on behalf of the buyer that was substantially similar to an offer written by Intro Broker within a short period of time.	X		If the two offers are not close in substance or time, this would move to neutral.
5. A significant amount of time elapsed between the time Intro Broker last showed a property and Closing Broker wrote an offer on the same property.		X	
6. Intro Broker provided significant information about the specific property, its neighborhood, value of the property, financing and other issues over a period of time.	X		Although the amount of time spent is not the test, a great amount of activity on this specific property could mean Intro Broker significantly contributed to the buyer's interest in the property.
7. Closing Broker wrote and negotiated the offer and performed all the services during escrow.		X	Consideration should be given to how Closing Broker entered the transaction.
Buyer's Choice			
8. Intro Broker does not keep in touch with buyer after a period of time.		X	Consideration should be given as to whether the broker attempted to make contact but the buyer would not respond.
9. Intro Broker is the listing broker. As a result of Intro Broker providing agency disclosure, the buyer elects to have separate representation.		X	
10. Buyer is dissatisfied with Intro Broker due to the broker's professional abilities or conduct. Examples could include misrepresentations or failure to disclose, lack of knowledge with an area or type of property, being non- responsive to the client/buyer by failing to be timely or return calls, disclosures of conflicts of interest, self-dealing or negotiating skills.		X	



Broker Conduct			
11. Closing Broker asked about buyer's relationship with another broker early in the process and determined there was no existing contractual or exclusive relationship between Intro Broker and the buyer.		X	
12. Closing Broker asked about buyer's relationship with other brokers late in the process.	X		Brokers have an affirmative duty to inquire about existing relationships.
13. Closing Broker instructed a buyer to go to open houses, or made appointments for the buyer, or was aware that the buyer would be going to open houses, and instructed the buyer to inform open house brokers of the buyer's relationship with Closing Broker.		X	
14. Intro Broker was aware that the buyer would be going to open houses, and told the buyer to inform other brokers of the buyer's relationship with Intro Broker.	X		
15. Closing Broker instructed the buyer to go and shop with other brokers in the area and return to Closing Broker once the buyer is ready to make an offer on the property	X		
16. Closing Broker does not belong to the MLS in which the property is listed, or any MLS in a reciprocal arrangement with the MLS, and has not made independent arrangements with the listing broker for a commission.	X		This assumes that Intro Broker does have such an offer through the MLS. However, if the commission has been paid, it might be assumed that the listing broker somehow agreed to compensate Closing Broker.
17. Closing Broker is the listing broker.			Neutral. Although the listing broker will get compensation for the listing side, this should not independently determine the outcome without reference to the other factors.
18. Closing Broker is the listing broker and offered financial incentive to the buyer if the buyer came directly to him, after the listing broker knew of the involvement of the other broker.	X		
Other			
19. Intro Broker has a Buyer Broker Agreement - Exclusive (Right to Represent) (such as C.A.R. Form BBE or other form used for the same purpose) that contains a description of property, which includes the subject property and is dated before Closing Broker meets with the buyer.	X		There is a contractual right between Intro Broker and the *buyer*. Even though it establishes a close connection between Intro Broker and the buyer, the conduct of Closing Broker, and his or her behavior in determining the existence of the contract, will have more weight than the contract itself in a dispute between the *brokers*.
20. Intro Broker has a Buyer Broker Agreement - Non Exclusive (Right to Represent) (C.A.R. Form BBNE or other form used for the same purpose) that predates the involvement of Closing Broker.	X		There is a contractual right between Intro Broker and the *buyer*, if the broker introduced the buyer to a specific property and worked on the buyer's behalf. Even though it establishes a close connection between Intro Broker and the buyer, the conduct of Closing Broker, and his or her behavior in determining the existence of the contract, will have more weight

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			than the contract itself in a dispute between the *brokers*.
21. Intro Broker has a Buyer Broker Agreement (Non-Exclusive/Not for Compensation) (C.A.R. Form BBNN or other form used for the same purpose).	X		This contract does not establish a commission right between the buyer and the broker but does help determine the timeframe of the agency relationship.
22. Closing Broker has a Buyer Broker Agreement - Exclusive (Right to Represent) (C.A.R. Form BBE or other form used for the same purpose).		X	Same as #19, except that this factor may be overcome, in a dispute between *brokers*, if the Closing Broker's behavior was inappropriate in obtaining the contract. There may be a contractual right to be compensated by the buyer.
23. Closing Broker has a Buyer Broker Agreement - Non Exclusive (Right to Represent) (C.A.R. Form BBNE or other form used for the same purpose).		X	Same as #22 except that the contractual claim against the buyer would be different because the contract is not exclusive.
24. Closing Broker has a Buyer Broker Agreement (Non-Exclusive/Not for Compensation) (C.A.R. Form BBNN or other form used for the same purpose).			Neutral. Although this demonstrates a commitment to Closing Broker, so does writing up the contract with her.
25. Intro Broker failed to give an Agency Disclosure Statement.		X	Any agent who has more than a casual relationship with a buyer should present the buyer with an Agency Disclosure Statement.

IV. Preventive Tips for Practitioners

1. Always ask a prospective buyer whether he or she is working with another broker.

2. If you find out that a prospective buyer is working with another broker, explore whether the first broker has an exclusive contractual agreement.

3. If you discover your client has been working with another broker on the same transaction, try to ascertain the reason why the client left the first broker and if appropriate, make immediate contact with the broker and try to resolve the issue. Failing to address it early on may result in you working through a difficult escrow, closing the transaction and not getting paid.

4. Give agency disclosures (C.A.R. Form AD) early in the transaction.

5. Use buyer representation agreements (with or without the brokers compensation element). This will help memorialize the relationship and help prompt the discussion about other relationships. If the contract includes a buyer's commission obligation to the broker, it will also create an incentive for the buyer to come to you and terminate the contract prior to going to another broker.

6. Never send your buyer client to other brokers with instructions to come back when the buyer is ready to write the offer.

7. Try to accompany your clients to open houses, but if you can't, give your clients your cards and instruct them to tell the agent sitting the open house that they are already working with you and present them your card. By not accompanying them, you take the risk that this explanation may not occur.

8. Stay in close contact with your client and be responsive during the transaction.

9. If you are conducting an open house, keep a registry of all prospective buyers including a note of whether there was a broker with the buyer. Also, keep a record that the agent sitting the open house asked the buyer if they were working with an agent.

10. If you have a listing where the property is being shown by brokers when you are not present, leave a sign-in sheet with buyers' names and brokers' names similar to those at a new home development. Include dates and times in the registry. This creates a record of who was shown the property and with which broker.

V. Fact Patterns

The following fact patterns are NOT to be construed as definitive outcomes for similar real-life situations. In truth, very few real-life fact patterns would exactly match the ones below, because real-life cases would have nuances and facts that are not and can not be addressed in this paper. All of the facts of a particular case must be considered by a panel to determine procuring cause. The fact situations here are merely a guide for panelists, to demonstrate how the factors are used to determine which broker is the procuring cause.

"Intro Broker" refers to the one who did not ultimately write the offer.

"Closing Broker" refers to the one who wrote the offer that was ultimately accepted and performed services through escrow to close the transaction. Closing Broker also received the commission.

"Exclusive Buyer's Agency Contract" refers to any contract that creates an exclusive agency between the buyer and the agent, such as the Buyer Broker Agreement -Exclusive (Right to Represent) (C.A.R. Form BBE) or other form used by brokers for the same purpose. The contract does not have to grant a commission to be exclusive.

FACT SITUATION 1 -- WRITTEN AGREEMENT

FACT SITUATION 1A

Buyer is working with several agents and is shown the property by Intro Broker, but has no written agreement with him or her. Three days later Buyer is shown the same property by Closing Broker, who, after ascertaining that Buyer has no prior buyer's agreement, writes a successful offer and receives the commission.

In the absence of other material facts favoring Intro Broker, the factors favor Closing Broker as the procuring cause. Showing the property first is only one factor. According to the fact pattern, Intro Broker did not write an offer and, since Buyer was working with several agents, may not have spent a significant amount of time with Buyer. Further, the absence of any agency agreement with Intro Broker is a factor that weighs against him. Given the fact that Closing Broker inquired about a prior buyers agreement, a panel would likely conclude that Intro Broker has not carried the burden of proof, and that Closing Broker is the procuring cause and entitled to the commission.

FACT SITUATION 1B

Same as 1A, and in addition, Intro Broker had Buyer sign a Buyer Broker Agreement (Non-Exclusive/Not for Compensation) (C.A.R. Form BBNN or other form used for the same purpose).

This case differs from 1A, in that Intro broker now has an agreement that weighs in his favor. The signed buyer's representation agreement, by itself, however, does not resolve the issue. A panel would need to inquire whether Closing Broker asked Buyer about an agreement with another agent or engaged in other conduct that might create additional factors in Intro Broker's favor. Assuming, however, that there are no additional factors in Intro Broker's favor, a panel could find that Closing Broker is the procuring cause.

FACT SITUATION 1C

Intro Broker had Buyer sign an exclusive buyer's agency contract. Intro Broker showed some properties to Buyer, but not the one that Buyer ultimately purchased. Closing Broker asked Buyer before showing any property to Buyer whether Buyer had signed any buyer's agency contracts or forms other than the agency disclosure form. Buyer replied, "Yes, I signed an exclusive buyer's agency contract, but don't worry about it, show me some property." Closing Broker then obtained Intro Broker's agreement from Buyer and reviewed it. Closing Broker discussed the situation with Buyer: Closing Broker told Buyer the importance of the written agency agreement with Intro Broker and that Buyer was exposed to paying a commission to Intro Broker. Buyer nonetheless insisted on proceeding with Closing Broker and said, "I'll take care of Intro Broker, don't worry." Closing Broker showed Buyer properties. Buyer liked one of the homes shown by the Closing Broker and asked Closing Broker to write an offer. So Closing Broker wrote the offer, which was accepted.

Intro Broker files an arbitration for the commission, claiming Closing Broker interfered with his contract with Buyer. If the panel's inquiry reveals that Closing Broker did everything necessary to protect both Intro Broker and Buyer, and there are no additional facts showing that Closing Broker lured Buyer away from Intro Broker or otherwise engaged in behavior that would create factors favoring Intro Broker, the panel would probably find that Closing Broker is the procuring cause. Their ultimate conclusion depends on how the panel weights the various factors. It appears that Buyer may be the culprit here, and if Intro Broker loses the procuring cause question with Closing Broker, Intro Broker still has a contract right to bring an action against Buyer for a commission.

FACT SITUATION 1D

Same facts as 1C, but also the property purchased was one that Intro Broker had previously shown Buyer.

This scenario is much more difficult because the factors are more evenly divided between the brokers. The outcome here, however, depends not on the number of factors in a broker's favor, but, instead, on how much weight the panel gives each factor. Having shown the same house helps Intro Broker. Depending on that factor's weight with the panel, it may well be sufficient to carry the burden of proof for Intro Broker.

FACT SITUATION 1E

Same facts as 1A, but Intro Broker has a Buyer Broker Agreement -Exclusive (Right to Represent) (C.A.R. Form BBE or other form used for the same purpose) with Buyer. Also, Closing Broker fails to ask Buyer if any agency form or buyer broker agreement had been signed with a prior broker, and Buyer doesn't volunteer the information.

In California today, a buyer's broker should always inquire if Buyer has signed any agreement with a prior agent, and if the answer is "yes," find out what that agreement is. In this case, the conduct of Closing Broker, and his failure to determine the existence of a contract, could tip the procuring cause decision in favor of Intro Broker.

FACT SITUATION 2 – OPEN HOUSES

FACT SITUATION 2A

Buyer has been shown property by Intro Broker, but Intro Broker has no agency agreement with Buyer. Buyer goes alone to Closing Broker's open house, which was previously shown by Intro Broker. Buyer asks Closing Broker to write an offer for Buyer. Closing Broker successfully does so, without inquiring about any prior agency relationship with other agents.

In the absence of other material facts favoring Intro Broker, it appears that the factors favor Closing Broker as the procuring cause. Showing the property first is only one factor. According to the fact pattern, Intro Broker did not write an offer. Further, the absence of any agency agreement with Intro Broker is a factor that weighs against him. Given the facts in this scenario, a panel could conclude that Closing Broker is the procuring cause and entitled to the commission.

FACT SITUATION 2B

Same facts as 2A, but Closing Broker does inquire if Buyer has been working with another agent, and Buyer says" yes," but never mentions that she has seen the house before. Closing Broker determines that Buyer signed C.A.R.'s Buyer Broker Agreement (Non-Exclusive/Not for Compensation) (C.A.R. Form BBNN) with Intro Broker. Buyer asks Closing Broker to write an offer on the property, and Closing Broker successfully does so.

Closing Broker has determined that there is no exclusive agency with Intro Broker and does not know Buyer has seen the property before. Absent other material facts favoring Intro Broker, Closing Broker probably prevails. Of course, the ultimate outcome depends on any other factors present and the weight given to them by the panel.

Note, a question here is whether Closing Broker should have asked Buyer if she had seen the property before. While Closing Broker's knowledge that Buyer had seen the property with Intro Broker is a factor in favor of Intro Broker, the panel will have to decide if it outweighs the other factors in favor of Closing Broker. In the limited facts of this scenario, it probably would not. Closing Broker has determined that Buyer had no exclusive agency with Intro Broker, and showing the property first is only one factor to consider.

FACT SITUATION 2C

Buyer has worked only with Intro Broker and has signed an Buyer Broker Agreement -Exclusive (Right to Represent) (C.A.R. Form BBE or other form used for the same purpose) with Intro Broker. Buyer goes alone to Closing Broker's open house, which Buyer had previously seen with Intro Broker. Closing Broker never inquires if Buyer has a prior agency relationship with another agent. Buyer makes an offer on the same property through Closing Broker.

A buyer's broker should always inquire if Buyer has signed any agreement with a prior agent, and if the answer is "yes," find out what that agreement is. While the fact that Closing Broker closed the deal is a factor in his favor, the conduct of Closing Broker, and his behavior in determining the existence of the contract, particularly since Intro Broker had shown the same property, could tip the procuring cause decision in favor of Intro Broker.

FACT SITUATION 2D

Same as 2C, but Closing Broker inquires and Buyer tells Closing Broker that he/she has not signed any exclusive agency agreement.

Intro Broker files an arbitration for the commission, claiming Closing Broker interfered with his contract with Buyer. If

the panel's inquiry reveals that Closing Broker did everything necessary to protect both Intro Broker and Buyer, and there are no additional material facts favoring Intro Broker, the panel would probably find that Closing Broker is the procuring cause. It appears that Buyer has lied intentionally to Closing Broker, which could favor Closing Broker. If Intro Broker loses the procuring cause question with Closing Broker, Intro Broker still has the right to bring an action against Buyer for a commission.

FACT SITUATION 3 -- CLOSING BROKER INDUCES BUYER TO LEAVE INTRO BROKER

FACT SITUATION 3A

Buyer is working with Intro Broker and is very interested in a house shown by Intro Broker. Buyer discusses the home with a friend, Closing Broker, who happens to be licensed. Closing Broker says he can get Buyer a better deal, by rebating 1% of his commission to Buyer. Closing Broker shows the property again, and then writes the offer. Closing Broker has no written agency agreement with Buyer.

Absent other material facts favoring Closing Broker, it appears that Intro Broker is entitled to the commission. Closing Broker intentionally interfered with Intro Broker's agency relationship, which is a heavy factor in favor of Intro Broker. Such intentional interference probably overcomes any factors in favor of Closing Broker, and carries the burden of proof for Intro Broker. Whether Closing Broker shows the property again is not a material fact in and of itself.

FACT SITUATION 3B

Buyer has been working with Intro Broker, who has shown numerous houses over a period of several weeks. However, Buyer is dissatisfied with Intro Broker's efforts, and feels it is Intro Broker's fault he hasn't found a property to purchase. While looking at open houses, Buyer meets Closing Broker. Closing Broker inquires of Buyer whether Buyer is working with any other agents. Buyer says yes, and also says, "but I'm not really happy with Intro Broker," and goes on to state why. Buyer is uncertain whether Buyer can in good conscience abandon Intro Broker, but Closing Broker convinces Buyer that it's OK. Closing Broker shows Buyer several homes, but none are appealing, so Buyer asks to see a home previously shown by Intro Broker. Closing Broker successfully writes an offer on that home for Buyer.

Intro Broker has no exclusive agency agreement. However, the reason for Buyer's dissatisfaction with Intro Broker is a material fact in this case, particularly, since it appears Closing Broker may have taken advantage of the situation to sway Buyer's opinion against Intro Broker. If there are no additional material facts favoring Closing Broker, the panel could find that Intro Broker is the procuring cause.

FACT SITUATION 3C

Same facts as 3B, but there is a Buyer Broker Agreement - Exclusive (Right to Represent) (C.A.R. Form BBE or other form used for the same purpose) with Intro Broker. When Buyer expresses dissatisfaction with Intro Broker's efforts, Closing Broker cautioned Buyer that Buyer may have pre-existing contractual obligations to Intro Broker.

While Intro Broker had an exclusive buyer's agency agreement, Closing Broker made the proper inquiry and counseled Buyer as to Buyer's obligations under the agreement. If the panel's inquiry reveals that Closing Broker did everything necessary to protect both Intro Broker and Buyer, and there are no additional material facts favoring Intro Broker, the panel would probably find that Closing Broker is the procuring cause. If Intro Broker loses the question of procuring cause to Closing Broker, he or she still may have a contractual right to compensation from Buyer.

FACT SITUATION 4 -- INTRO BROKER'S PRIOR OFFER FAILED

FACT SITUATION 4A

Intro Broker has written an offer for Buyer, but it failed and all negotiations on the property were terminated, because Buyer thought the seller's counteroffer was too high. A few days later, Buyer consults with Closing Broker, who convinces Buyer that the seller was not asking too much in light of current market conditions. Closing Broker rewrites the same offer, and when seller counters at a price Closing Broker believes is good, Closing Broker convinces Buyer it is a fair price and successfully writes a counteroffer.

Intro Broker has no exclusive agency agreement. However, showing the property and writing an offer first is a factor here. If the panel's inquiry reveals that Closing Broker wrote substantially the same offer as Intro Broker, and there are no additional facts favoring Closing Broker, the panel would likely find that Intro Broker is the procuring cause.

FACT SITUATION 4B

Same as 4A and, in addition, Intro Broker had an Buyer Broker Agreement -Exclusive (Right to Represent) (C.A.R. Form BBE or other form used for the same purpose) with Buyer, which had not expired at the time of Closing Broker's writing the offer for Buyer. Buyer did not volunteer that he had an agency agreement with Intro Broker, and Closing Broker did not ask.

Intro Broker did have an exclusive buyer's agency agreement, and Closing Broker failed to make the proper inquiry. In addition, Intro Broker's prior offer on the property is a factor in his or her favor. If there are no additional material facts favoring Closing Broker, the panel could find that Intro Broker is the procuring cause. If Intro Broker loses the question of procuring cause to Closing Broker, he or she still may have a contractual right to compensation from Buyer.

VI. Frequently Asked Questions

Q ***1. Does the arbitration always result in an "all or nothing" award or may arbitrators split the award between the two disputing brokers?***

A In most cases, sound analysis will lead arbitrators to conclude that only one broker was the procuring cause, and that broker should get the entire commission. Further, arbitrators should not avoid the "all or nothing" decision, just because it is a hard one to make. Nonetheless, after all factors have been weighed, under some fact patterns, arbitrators may decide to split the commission.

Q ***2. Must a listing broker be named as a party to an arbitration complaint when he or she has contractually offered the commission to other brokers through the MLS?***

A Although the listing broker offered the compensation, generally, only the disputing cooperating brokers are necessary parties to the arbitration. A listing broker can be named, however, and it is up to the complainant to determine the proper parties to the complaint.

Q ***3. Must the respective responsible brokers for the agents in a commission dispute be named in the arbitration complaint?***

A California Code of Ethics and Arbitration Manual require that the responsible broker be named as a complainant to an arbitration complaint. There is no similar requirement for the respondent, but it is advisable to have the responsible brokers on both sides of the dispute.

Q ***4. Does a broker with a Buyer Broker Agreement - Exclusive (Right to Represent) (C.A.R. Form BBE or other form used for the same purpose) with the buyer need to go through arbitration?***

A Yes. There are factors, which taken together, can outweigh the exclusive buyer broker contract.

Q ***5. Are these guidelines a "predetermination of entitlement" to a commission, which is prohibited under NAR policy?***

A No. The guidelines are merely factors to be considered in light of the specific facts of the case.

Q ***6. Where can additional information regarding the topics discussed in this memorandum be obtained?***

A This memorandum is one of the many Legal Briefs, Legal Q&As, and other free legal publications made available to REALTORS® by C.A.R. These publications are available at many local Associations/Boards of REALTORS®, and are automatically distributed to subscribers of PreventionExpress™, C.A.R.'s suite of products and services designed to help REALTORS® stay abreast of legal developments affecting the real estate industry. For information on PreventionExpress™, contact Real Estate Business Services, Inc., a C.A.R. subsidiary, at 213.739.8227. In addition, many C.A.R. publications are available through C.A.R.'s website at http://www.car.org or CARFAX, C.A.R.'s fax-on-demand system. To access CARFAX, call 213.739.8329 and request the CARFAX catalogue.

For free recorded messages on more than 200 real estate-related topics, C.A.R. members can call C.A.R.'s Automated Legal Information System, or ALIS®, 24 hours a day. To access ALIS®, simply call 213.739.8205 from a touch-tone phone and follow the prompts.

Readers who require specific advice should review their facts with an attorney. C.A.R. members requiring legal assistance may contact C.A.R.'s Member Legal Hotline at 213.739.8282, Monday through Friday, 9:00 A.M. to 6:00 P.M. C.A.R. members who are broker-owners, office

managers, Designated REALTORS® or PreventionExpress™ subscribers may contact the Member Legal Hotline at 213.739.8350 to receive expedited service. Members may also fax or e-mail their questions to the Member Legal Hotline at 213.480.7724 or legal_hotline@car.org. Written correspondence should be addressed to:

California Association of REALTORS®
Member Legal Services
525 South Virgil Avenue
Los Angeles, California 90020

Local associations requiring assistance with these Guidelines may contact the Corporate Legal Department at 213.739.8279. Written correspondence should be addressed to:

California Association of REALTORS®
Corporate Legal Department
525 South Virgil Avenue
Los Angeles, California 90020

The information contained herein is believed accurate as of November 26, 2002. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney.

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§§1.6, 7.26, 8.3

- The website for the National Association of Realtors® (NAR) is http://www.realtor.org.
- A list of local associations in all 50 states is available on the NAR website at the following URL: http://www.realtor.org/leadrshp.nsf/webassoc?OpenView&Start=1&Count=30&Expand=5#5.
- Information about the registered mark "Realtor®" is available on the NAR website on the "ABOUT REALTORS®" page, at the following URL: http://www.realtor.org/realtororg.nsf/pages/AboutREALTORS.
- Information about the principles established by the National Association of Realtors® (NAR) Code of Ethics can be found on the "ABOUT REALTORS®" page on the NAR website, at the following URL: http://www.realtor.org/realtororg.nsf/pages/AboutREALTORS.
- The NAR Code of Ethics is available online at http://www.realtor.org/MemPolWeb.nsf/pages/COde.

§§1.8, 1.11, 2.39, 2.46, 2.50, 2.64, 3.8, 3.14, 7.3, 7.14, 7.27, 7.30, 7.33, 7.34, 7.41, 8.3, 8.42

- The website for the California Association of Realtors® (CAR) is http://www.car.org.
- The CAR mission statement is available at http://www.car.org/aboutus/mission.
- The CAR California Code of Ethics and Arbitration Manual is available at http://www.car.org/media/pdf/107547.

The California Model MLS Rules are available on the CAR website at the following URL: http://www.car.org/legal/mls/ca-model-mls-rules.

- Information about the state-wide MLS, CALMLS, is available on the CAR website at the following URL: http://www.car.org/cal-statewide-mls.

§§1.9, 2.20, 7.8, 7.28

- The website for the AIR Commercial Real Estate Association is http://www.airea.com.
- The website for the International Council of Shopping Centers is http://www.ICSC.org.
- The website for the Building Owners and Managers Association is http://www.Boma.org.

§1.13

- The website for LoopNet is http://www.loopnet.com.
- The website for the CoStar Group is http://www.costar.com.

§2.58

Richard Goodman's 2008 article, "Short Sales and Deeds in Lieu After the Mortgage Forgiveness Debt Relief Act of 2007," is available online at the following URL: http://www.the1031attorney.com. Click on the "My Publications" link.

§2.64

The IRS online article entitled "The Mortgage Forgiveness Debt Relief Act and Debt Cancellation" is available at the following URL: http://www.irs.gov/individuals/article/0,,id=179414,00.html.

§§4.20, 8.1-8.2, 8.48, 9.1, 9.3, 9.13, 9.19, 9.24, 9.37, 13.19

- The website for the California Department of Real Estate (DRE) is http://www.dre.ca.gov.
- Information about the DRE Reference Book is available at http://www.dre.ca.gov/pub_referencebk.html.
- The DRE publication *Guidelines for Unlicensed Assistants* is available at http://www.dre.ca.gov/pdf_docs/guide_unlic_asst.pdf.
- The DRE publication *Instructions to License Applicants* is available at http://www.dre.ca.gov/pdf_docs/re4.pdf.

- The website for the DRE Real Estate Recovery Fund is http://www.dre.ca.gov/cons_recovery_acct.html
- Forms for the DRE Real Estate Recovery Account are available at http://www.dre.ca.gov/frm_recovery.html.

§8.6

- The website for the U.S. Department of Housing and Urban Development (HUD) is http://www.hud.gov.
- The HUD memorandum *Guidance Regarding Advertisements Under §804(c) of the Fair Housing Act* is available at http://www.hud.gov/offices/fheo/disabilities/sect804achtenberg.pdf.

§8.9

The Federal Trade Commission (FTC) website is http://www.ftc.gov.

§8.24

- The website for the California Department of Corporations is http://www.corp.ca.gov.

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The website for the California Employment Development Department is http://www.edd.ca.gov.

§12.22

The Judicial Council website is http://www.courtinfo.ca.gov/.

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