

# UNIT 9:

## ***RISK MANAGEMENT***

**Unit Nine Learning Objectives:** When the student has completed this unit he or she will be able to:

- Identify numerous ways to capitalize on risk reduction via the adoption of key risk management strategies
- Summarize significant areas of risk encountered by licensees in the ordinary discharge of their brokerage activities

### **RISK MANAGEMENT STRATEGIES**

Risk is the chance of losing something. Its two dimensions are the probability of occurrence and the extent of exposure to monetary or non-monetary consequences. Since most risks are related to judgments and decisions, the real estate licensee, who makes numerous complex decisions every day, faces a high degree of risk potential.

Risk management is a structured approach to dealing with the uncertainties and consequences of risk. In real estate practice, the aim is to reduce risk to an acceptable level through anticipation and planning.

Well-established strategies for managing risk are:

- Avoidance (elimination)
- Reduction (mitigation, sharing)
- Transference (outsourcing, insuring)

#### **Avoidance**

Avoidance includes refraining from an activity that carries risk. Complete avoidance of risk in real estate practice is almost impossible. A broker, for instance, may believe that hiring only experienced affiliates eliminates the risk that affiliates will commit license law violations. However, even experienced practitioners may not know the law, and, sometimes, people break the law deliberately. The risk may be reduced, but it remains. Perhaps a better example is bragging about a neighborhood and how the homes in it are virtually assured to enjoy a very high degree of appreciation. That form of exaggeration creates an unnecessary risk that the licensee will be sued when such appreciation doesn't happen. The lesson is to avoid indefensible claims using the avoidance strategy.

#### **Reduction**

Employing the reduction strategy involves taking steps to reduce the probability or the severity of a potential loss. A familiar example is a sprinkler system that dispenses water to reduce the risk of fire.

In real estate practice, one risk reduction tactic is to share responsibility for making a decision. The agent provides the consumer with expertise, and perhaps some advice, but lets the consumer decide

how much to offer. In this way, the agent gets some relief from the risks inherent in the buyer's decision to purchase.

### **Transference**

Transference means passing the risk to another party, by contract or other means. An insurance policy is the common example. In the real estate business, transference is typically and most successfully accomplished by means of an errors and omissions (E&O) insurance policy, either on the individuals in a firm or on the firm itself. Another form of transference is recommending licensed specialists to provide advice rather than offering one's own opinion. This strategy commonly comes into play when disclosing the condition of a property. Beyond the superficialities of what the eye can see, there are numerous issues that a professional inspector might unveil. Using licensed inspectors transfers the risk of a licensee's liability in representing property condition to the professional inspector.

## **RISK MANAGEMENT TACTICAL PROCEDURES**

Experience shows that the most common strategies for risk management in real estate practice are reduction and transference. To effect these strategies, the licensee can adopt effective, practical tactics or actions in actual practice. These include:

- education
- disclosure
- documentation
- insurance

### **Education**

Education is the first line of defense against risk. When agents are familiar with the forms provided by the office, how and when to complete them and where to send them, the likelihood of errors is reduced. Likewise, agents need to be able to identify and understand common contract elements, complete contract forms developed by attorneys, and refrain from offering legal opinions.

In Florida, brokers have a legal obligation to provide supervision of affiliated licensees, which also implies compliance training. In addition, licensees must satisfy legal requirements for continuing education, while those who care about personal excellence will seek further education and training to enhance their professional skills.

### **Disclosure**

Licensees have the duty to ensure that all parties have the information they are entitled to via required disclosures. Proper disclosure in turn reduces the risk that clients and customers will accuse a licensee of misleading or inducing them to make a decision with incomplete information.

Disclosure may be made in writing or verbally and may or may not require written acknowledgment from the receiving party. Required disclosures include those that clarify:

- agency relationships
- property condition

- duties and obligations of licensees
- whether a licensee has a personal interest in a transaction
- material facts that affect the decision-making of the client

## Documentation

Documentation provides evidence of compliance with laws and regulations. It proves what clients and customers and licensees said and did in a transaction. Some documentation is required by law.

The components of a thoroughly documented paper trail include:

- standard Realtor® or broker-approved forms
- communication records
- transaction records
- contracts
- trust records
- promulgated transaction addenda

**Policy and procedures manual.** A written and uniformly enforced company policy manual lets everyone in the firm know what to expect before problems arise. The policy manual should cover the company's rules in such areas as floor duty privileges, assignment of relocation properties to agents, referrals between agents within the company, and requirements for continuing education, sales meeting participation, and property tours.

Company procedures in the P&P manual should spell out how to handle every aspect of the company's business that agents and brokers need to know—from handling consumers' funds and documents, conducting consumer transactions, dealing with MLS-related matters, and placing signage, to all procedures prescribed by state or federal law, especially license, banking and fair housing laws. Whenever changes are made to the P&P manual, each agent should sign the revised manual as evidence that the agent has examined it.

**Standard forms.** Standard forms save time and protect against the unauthorized practice of law. Since they are most often prepared by lawyers familiar with the market area, they can address contingencies that are common in the area in a manner that reflects the real estate laws of the state. On the other hand, a licensee often needs to adapt a standardized form for a client by assisting with filling in blanks, modifying terms, and attaching addenda. The licensee must always remain aware of the limitations the state has placed on performing such activities without a law license.

**Transaction records.** State laws require licensees to document transactions. Firms are required to keep written records of all real estate transactions for a specific time period after closing or termination. Document retention is inherently a primary risk management tactic in addition to being mandated by FREC.

## Insurance

Many forms of insurance are available for property owners and managers. Some of these types are also used to manage certain risks of brokers and licensees.

**General Liability.** General liability insurance provides coverage for risks incurred by a property owner when the public or a licensee enters the owned property (public liability). The insurer pays the covered claim and legal fees, costs, and expenses, including medical expenses, resulting from owner negligence or other causes. This type of insurance does not cover professional liability, for which an Errors & Omissions policy is necessary.

**Errors and Omissions.** Professional liability is of two general types:

- Unprofessional conduct – a claim that one has failed to carry out fiduciary duties and provide an acceptable standard of care
- Breach of contract – a claim that one has failed to perform services under the terms of a contract in a timely manner

The primary method for transferring the professional liability risks of brokers, managers, and licensees is Errors & Omissions (E&O) insurance. A standard E&O policy provides coverage for “damages resulting from any negligent act, error or omission arising out of Professional Services.”

A standard policy does NOT cover:

- violations of law
- fraudulent, dishonest, criminal or malicious acts
- mishandling of escrow moneys, earnest money deposits, or security deposits
- antitrust violations
- sexual harassment
- Fair Housing violations
- agent-owned properties
- environmental violations
- failure to detect or disclose environmental conditions, including mold
- acts committed prior to licensure or after termination of active status
- activities as an appraiser if licensing other than a real estate license is required

E&O insurance, in short, covers “mistakes” but not crimes. It is an outstanding risk management tactic – but it has very tangible limitations.

## **RISK MANAGEMENT IN PRACTICE**

### **Agency**

The risks involved in agency relationships generally will occur in one of two areas:

- the requirement to inform and disclose
- the requirement to carry out an agency duty.

In Florida agency relationships are in writing and must be disclosed to all parties to a transaction. State law may spell out agency duties, or the duties may be a part of general agency law. In states that do not use agency, there is still the obligation to explain and disclose the nature of the relationship.

Disclosure requirements. A licensee may be acting in a transaction as facilitator, agent, subagent, designated agent, single agent, dual agent, non-agent or in some capacity. Regardless of status, the licensee must follow state disclosure requirements. These are, typically, to:

- disclose status verbally to other licensees on initial contact
- disclose status verbally to buyer and seller before providing real estate services
- confirm the disclosure in writing before signing a listing agreement or presenting a purchase offer (to an unrepresented seller) or before preparing a purchase offer (to an unrepresented buyer)
- get a signed receipt indicating the written disclosure has been made

Carrying out the duties of agency also require disclosures of :

- personal interest the agent has in a transaction (such as owner or buyer)
- personal benefit the agent will derive from a service referral
- required property and market information
- information about customers a client is entitled to have

The key to good risk management practice in brokerage relationships is to “put everything on the table” at the earliest opportunity. This applies to disclosing the nature of the relationship to the prospective client and to subsequent customers.

### **Conflicts of interest**

Conflicts of interest arise when an agent forgets to put the best interests of a client ahead of those of everyone else. This can happen in situations involving undisclosed dual agencies, broker-owned listings, licensees buying for their own account, vendor referrals, and property management subcontracting of services, among many others. Even ordinary, everyday transactions carry a built-in risk of conflict of interest. Consider the fact that a licensee usually receives no compensation for a failed transaction. Therefore, it is in the licensee’s interest to see the transaction completed, even if it may not be in the client’s best interest. A negative result from a home inspection or other test has the potential to cause a buyer to back out of a contract. A licensee who has forgotten whose best interest should be primary might be tempted to recommend inspectors who will overlook problems in exchange for receiving referrals. Licensees must always disclose any self-interest they have in a transaction, and always remember their duties to clients and consumers.

### **Property disclosures**

Property condition. Florida requires the seller of a residential property to deliver to the buyer a written disclosure or disclaimer about the property’s condition, including any material defects the owner knows about. The disclosure is required before any purchase contract is accepted. The licensee should always obtain the parties’ signatures acknowledging receipt of these disclosures.

Generally the licensee has no further duty to disclose property condition after properly informing parties of their rights and obligations. However, the licensee may still be subject to legal action for

- deliberately distorting the facts (intentional misrepresentation)
- cheating any party (fraud)

- concealing or failing to disclose adverse facts which the licensee knew about or should have known about (intentional or unintentional misrepresentation)

### **Comparative Market Analysis (CMA).**

In preparing a Comparative Market Analysis, licensees should guard against using the terms “appraisal” and “value,” which are reserved for the use of certified appraisers. Misuse of these terms could lead to a charge of misrepresenting oneself as an appraiser. In discussing listed properties with clients or customers, real estate licensees should be careful to use guarded terms such as “recommended listing price,” “recommended purchase price,” and “recommended listing price range.”

Agents should make every effort to help the sellers find a reasonable listing price based on the current market. If the CMA leads the seller to list at a price that is too high, the seller may blame the agent when the transaction fails because of an appraisal that comes in below the selling price. To minimize this risk, it is best to be conservative in the CMA and retain documentation that the seller went above the recommended price in spite of the agent’s advice.

### **Estimate of Closing Costs**

In preparing an estimate of closing costs for a seller or buyer, there is the risk of forgetting something, leading to an unpleasant surprise when the consumer suddenly faces unexpected costs or conditions. Licensees should use their broker’s form, if there is one, and make it clear to the consumer that it is only an estimate of likely costs, not a statement of actual costs. In some states, brokers and agents do not prepare closing cost estimates, leaving that task to the lender.

### **Advertising**

State and federal laws regulate advertising, including the federal Fair Housing laws as they pertain to discriminatory advertising and providing of services. Advertising includes electronic communication, social media/networking, and internet marketing. Usage must be consistent with company image and legal requirements. The license laws of most states list illegal advertising actions subject to discipline such as:

- making any substantial and intentional misrepresentation
- making any promise that might cause a person to enter into a contract or agreement when the promise is one the licensee cannot or will not abide by
- making continued and blatant misrepresentations or false promises through affiliate brokers, other persons, or any advertising medium
- making misleading or untruthful statements in any advertising, including using the term “Realtor” when not authorized to do so and using any other trade name, insignia or membership in a real estate organization when the licensee is not a member.

**Authorizations and Permissions.** Licensees should stay within the bounds of the authority granted by the agency agreement or must not do anything requiring permission without first getting that permission in writing. For instance, permission should be obtained before doing any of the following unless the listing agreement specifically grants the authority:

- post a sign on the property

- remove other signs
- show the property
- hand out the property condition disclosure
- distribute marketing materials
- use a multiple listing service
- cooperate with other licensees
- divide the commission or negotiate a commission split
- share final sales data with the MLS
- place a lock box on the property

### **Scope of expertise**

Real estate licensees are not, by nature, financial consultants, accountants, appraisers, soil scientists, well-diggers, lawyers, decorators, contractors, builders, plumbers, carpenters, inspectors, , and a number of other kinds of expert. However, in today's competitive environment, consumers often demand much more from a licensee than the traditional basic services. An agent who fails to live up to prevailing standards may be held liable for negligence, fraud, or violation of state real estate license laws and regulations. At the same time, agents must be particularly careful about the temptation to misrepresent themselves as experts and offer inappropriate expert advice.

Disclaiming one's expertise and referring parties to specialized professionals are always the best risk control procedures. This practice avoids being accused of misrepresentation from a consumer who claims to have been harmed by reliance on the licensee's non-existent expertise. The exact nature of the licensee's services to be provided should be stated as clearly as possible in the listing agreement.

### **Contracting process**

According to the Statute of Frauds, all contracts for real estate must be in writing to be enforceable. Contracts that contain incorrect information or are inadequately prepared can pose a serious liability for a licensee. To avoid such a situation, it is imperative for the contract to reflect the terms that the parties have agreed upon in the most accurate and honest manner.

Common risks and errors in the contracting process include:

- using an illegal form

A licensee may be punished for using any real estate listing agreement form, sales contract form, or offer to purchase form that lacks a definite termination date.

- failing to state inclusions and exclusions

The parties should identify as included in or excluded from the transfer any ambiguous items. Unwritten agreements between the parties are a source of later dispute and trouble.

- failing to track the progress of contingency satisfaction

The time period for completing contingencies such as inspections is specific and limited. Failure to meet or waive a condition may terminate the contract. A "time is of the essence" clause in the standard agreement makes the time period for contingencies critical.

- mistakes in entering data in a form

All data should be checked and verified: dates, times, amounts, warranties, descriptions, names, representations, promises, procedures, authority, etc. One way to reduce risk in the contracting process is to use a checklist that covers all the contract items.

### **Rules and regulations**

Florida real estate laws and regulations attempt to cover every principal threat to the public safety when involved in real estate brokerage. Violations of these strictures represents a direct threat to the legal and financial status of licensee. The following prohibitions should be carefully observed in implementing one's risk management strategies:

- obtaining a license under false pretenses
- committing a "prohibited act"
- neglecting to present every written offer as required
- neglecting to deliver signed copies of accepted offers to transaction parties as required
- failing to make sure that all required terms and conditions are present in a contract to purchase
- handling earnest money and other escrow funds improperly
- acting without a license when a license is required
- demanding a referral fee without reasonable cause
- entering into a net listing
- trying to induce another licensee's client to end or change an existing agency contract
- paying a commission to an unlicensed individual or company
- receiving an illegal referral fee, rebate or kickback
- practicing with an expired license

### **Referring service providers**

There are several risks attending the recommendation of vendors and service providers to a consumer. First, the consumer may not be satisfied with the performance of the recommended party and blame the licensee. Second, in cases where a recommended provider performs illegal acts, there may be legal consequences for the licensee. Third, if a licensee has a business relationship with a recommended vendor or provider and neglects to disclose the fact, there are legal consequences.

The major risk management technique in referring service providers is to shift the responsibility for choosing a vendor to the consumer. This can be done

- by refusing to recommend vendors at all
- by presenting a broad range of choices and allowing the consumer to select; or
- by presenting a short list of thoroughly vetted vendors and allowing the consumer to make the decision

In addition, licensees should include the disclaimer that, to the best of the licensee's knowledge, the vendors on the list are competent and honest, but that the consumer is responsible for investigating and making his or her own judgment before hiring or buying.