

## A RISK MANAGEMENT NEWSLETTER FOR REAL ESTATE PROFESSIONALS FROM TRAVELERS BOND & FINANCIAL PRODUCTS

This edition deals with two situations in which real estate agents may find themselves and ways to decrease the potential for a claim to be pursued against them. The first article involves a hot topic at this time, the subprime situation and its potential to involve real estate agents. This article was written by Attorney George N. ("Trey") Wilson, a partner in the Dallas, Texas office of Thompson, Coe, Cousins & Irons. Mr. Wilson became licensed to practice law in Texas in 1997, after receiving his Juris Doctor from the University of Texas School of Law. He has successfully represented numerous real estate agents and brokers across North, Central and East Texas in cases involving the DTPA, as well as commercial and residential cases involving construction defects and contract disputes. His trial experience include cases in both state and federal courts.

The second article discusses foreclosed properties being sold "as is" and the potential for claims being pursued against real estate agents. This article was written by Attorney Craig L. Dowis, a partner in the Dallas, Texas office of Thompson, Coe, Cousins & Irons. Mr. Dowis became licensed to practice law in Texas in 2000, after receiving his Juris Doctor from the University of Texas School of Law. He focuses on the defense of real estate agents and brokers throughout the state and offers in-house seminars on disclosure issues faced by real estate agents and their clients. He is licensed to practice in both state and federal court.

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### **THE SUBPRIME WEB AND REAL ESTATE AGENTS: WILL REALTORS GET CAUGHT?**

**BY GEORGE N. WILSON, III (TREY)**

Here is the scenario. Jill is a buyer's agent. She represents first-time homebuyer Jack. Jill has a buyer representation agreement and the agreement contains language like "will use best efforts to assist Client in acquiring property" and "will assist Client in negotiating the acquisition of property." Jack gives a copy of his pre-approval letter to Jill. Everything looks good. During the course of the transaction, though, Jill discovers that Jack's mortgage broker has set him up with a 2/28 ARM (adjustable rate mortgage) loan – the first 2 years of the loan are fixed; but after those 2 years, the loan will reset at a higher rate that will increase Jack's monthly payments, perhaps significantly.

What should Jill do? Legally, what is she required to do?

As many of you are no doubt aware, the subprime mortgage industry has drawn considerable attention over the past several months, especially in light of the bankruptcy filed by New Century Financial, at the time the second largest subprime lender in the United States, and the recent explosion in home foreclosures. Consider these numbers: During the first quarter of 2006, there were roughly 323,000 reported foreclosures. In the first quarter of 2008? Approximately 650,000. Just how many of these foreclosures involve subprime loans? Based on numbers we have seen for the third quarter of 2007, subprime ARM loans accounted for only around 7% of mortgages in the U.S., yet those loans represented 43% of the foreclosures started.

As with any market crisis, assessing blame becomes a paramount task for certain groups, including the group who will likely try to cast the widest net – plaintiff's attorneys. So the question becomes, what is the potential exposure for real estate agents? What are the potential landmines?

Briefly, subprime loans refer to mortgages offered to buyers who cannot qualify for conventional loans – generally, the buyer will have a credit score of 620 or lower. The subprime loan that has drawn perhaps the most attention is the 2/28 ARM mentioned above. The idea behind the 2/28 ARM is to offer fixed-rate payments for 2 years, even at

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rates lower than conventional loans, but after those 2 years, the loan resets at a higher rate. Often, the 2/28 ARM was offered with the carrot of refinancing before the expiration of the first 2 years as the buyer could use that time to improve his credit. That improvement process would be aided by the rise in home prices, which would increase the buyer's equity. As home prices dropped, however, the hope of improved credit through increased equity dwindled. Coupled with general residential market downturn, 2/28 ARMs often included prepayment penalties that diminished the chances for refinancing. Buyers stuck with 2/28 ARMs then saw their monthly payments increase, and when they could not meet their new payments – foreclosure.



To date, we have found no reported cases where a real estate agent has been sued in connection with a subprime loan. Before realtors breathe a sigh of relief, though, consider these Internet articles:

- The CNNMoney.com article “The Subprime Blame Game”<sup>1</sup> identifies real estate agents as culprits along with mortgage brokers, appraisers, Wall Street, lenders, and regulators. According to the article, in an effort to increase commission dollars, agents encourage consumers to buy much more house than they can afford and show them how to do so through the use of “exotic mortgage products.”
- The Knowledge@Wharton article, “The Subprime Blame Game: Where Were the Realtors?”<sup>2</sup> – In this article, the President of the National Fair Housing Alliance, Shanna Smith, says that realtors have yet to receive their fair share of the blame for the subprime mess – “I think the greed factor works with agents as well as loan originators.” The idea expressed in this article is essentially the same as the CNNMoney.com article: “Nudging buyers toward subprime loans, or keeping mum about the risks, means more sales go through. Also, the low teaser rate on a subprime loan allows the buyer to borrow more, helping to boost sales prices and commissions.”

We can certainly imagine the allegations that might be made against real estate agents, especially buyer's agents, in connection with subprime loans, i.e., you kept quiet about the risks of a 2/28 ARM because you wanted the deal to close, and/or you pushed your buyer into a 2/28 ARM so they could buy a more expensive house, thereby increasing your commission. But, are realtors responsible for a buyer's decision to accept a subprime loan?

From our perspective, the most likely causes of action applicable to real estate agents and the subprime situation are negligence and breach of fiduciary duty. Negligence is typically defined as the breach of a standard of care. For a real estate agent, this would comprise failing to do that which a reasonably prudent agent would have done under the same or similar circumstances. Breach of fiduciary duty involves the agent's obligations to her clients as a fiduciary. These obligations include, generally, the duties of fidelity, integrity, and

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competency. Specifically, an agent's duties to his client may be defined in an agreement, like the buyer representation agreement noted in our example above. In many cases, the agent's fiduciary obligations define what a reasonably prudent agent would do, so we can consider negligence and breach of fiduciary duty together.

Let's go back to our example. Jill's buyer representation agreement talks about using "best efforts" and assisting her buyer in negotiating the purchase of his property. Further, Jill, like most agents, works in a state that has statutes and rules that govern the conduct of real estate agents. These rules, specifically the ethics rules, may provide that agents shall be "scrupulous and meticulous in performing the agent's functions," shall be "informed on national, state, and local issues and developments in the real estate industry," and shall "exercise judgment and skill in the performance of the work."

With these standards in mind, what should Jill do when she discovers that her buyer, Jack, has a 2/28 ARM? Since she must use her "best efforts" to assist her client, is she obligated to explain to him the potential pitfalls associated with 2/28 ARM loans?

If we look at other parts of a residential transaction, we may gain some insight about how to answer our subprime question. In the home inspection process, real estate agents are not inspectors, so generally speaking, they are not charged with inspecting a property to discover adverse conditions. The Code of Ethics and Standards of Practice promulgated by the National Association of Realtors specifically states that realtors are not obligated to discover latent defects at a property. If agents are not responsible for inspecting properties, when do they become vulnerable in situations where a consumer discovers a latent defect after the closing? Based on our experience in Texas, three situations come to mind:

1. When the agent makes a representation about the property that turns out to be untrue;
2. When the agent is aware of material information about a property but withholds that information; and
3. When the agent immerses herself in the inspection process by either making representations about a property such that the client develops an expectation about what services the agent is providing or the agent refers her client to a particular inspector who misses something.

We feel that the third situation is perhaps most analogous to the subprime question. Just as realtors are not inspectors, realtors are not mortgage brokers (it is worth noting in this respect that the Code of Ethics and Standards of Practice mentioned above does not impose upon a realtor "the obligation of expertise in other professional or technical disciplines"). Oftentimes, the only information that a realtor receives about her client's finances is the pre-approval letter. Additionally, subprime loans, including the much-maligned 2/28 ARM loan, are not inherently evil. These loans often give consumers who would otherwise be shut out from home ownership the opportunity to become homeowners. As such, the mere fact that a client elects to accept a subprime adjustable rate mortgage is not in and of itself a sign of nefarious activity. Getting back to our scenario, our buyer's agent, Jill, who finds out that her client, Jack, has elected to finance his home with a 2/28 ARM loan should not find herself subject to liability if Jack finds himself in financial distress two years later.

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Like the inspection process, though, the more an agent interjects herself into the financing process, the more she may subject herself and her broker to potential liability exposure. For instance, an agent should be watchful of the following:

- First and foremost, suggesting a subprime adjustable rate loan without explaining the risks associated with the loan. Once a realtor steps into the world of mortgage terms and rates with her client, you can expect that the client will allege that he trusted his agent to give him sound advice about financing.
- Sending a client to a particular mortgage broker, especially if the broker is in-house. Plaintiff attorneys love to play the sweetheart deal/conspiracy angle with juries.
- Showing properties to a client that are outside of his stated price range, especially if the client's financing changes from a conventional loan to a subprime loan as the home prices increase.

All agents should understand that when a homebuyer becomes a plaintiff in a lawsuit, the homebuyer becomes a naïve, wide-eyed creature who places all his trust in his real estate agent to shepherd him through the dark forest known as the home sale. Knowing that this is the tactic often employed, agents should understand that the more they become involved in functions outside of "normal realtor-type functions," whether that is home inspections, title work, or financing, they potentially broaden the scope of what it means to use their best efforts to assist their clients, and an agent can find herself transformed into an inspector, title examiner, mortgage broker, etc., in the ensuing lawsuit.

As attorneys, we always hesitate to give business advice because the world of litigation often bears only a passing resemblance to the real world. While you see transactions through the prism of customer service and what sets you apart from other realtors, we are usually looking backwards after someone has become very upset, feels violated and wronged, and wants their pound of flesh. Therefore, take our words with a grain of salt. That being said, given that the subprime crisis is in its relative infancy (many 2006 2/28 ARMs are scheduled to reset this year), be wary of involving yourself in client financing, especially if the financing involves a subprime loan. If lawsuits result from this mess, we can expect that plaintiffs will seek damages in an amount that puts them back into the same position they were in before they closed on their house, i.e., they may ask for the recovery of all closing costs, all payments made, and recovery related to their damaged credit. Also, we can expect that sympathies will generally rest with the borrowers as the media paints an ugly picture of predatory and irresponsible subprime lending.

To go back to the title of this article, it is too early to say what the fall-out may be for realtors from the subprime situation. Can realtors get caught in the subprime web? Certainly. Unfortunately, many of you may already know that you can be sued for anything. Will realtors get caught? The more that realtors involve themselves in the loan process, the greater the chance of getting stuck in a subprime web. And given the national, and really international, impact of the subprime crisis, once you are stuck, we expect that getting out will not be easy.

<sup>1</sup> Les Christie, *The Subprime Blame Game*, CNNMoney.com, April 13, 2007.

<sup>2</sup> *The Subprime Blame Game: Where Were the Realtors?* Knowledge@Wharton, October 17, 2007.

## FORECLOSURE PROPERTIES AND THE “AS IS” CLAUSE

BY CRAIG L. DOWIS

With the increase in subprime foreclosures, we expect that many agents will become involved with the sale of foreclosed properties. As you may know, foreclosure properties are typically sold “as is.” Generally speaking, a valid “as is” agreement prevents a buyer from holding a seller liable if the property sold turns out to be worth less than the price paid because of a latent defect. This of course begs the question, what constitutes a valid “as-is” agreement?<sup>1</sup>

Although the enforceability requirements for “as is” clauses may differ from state to state, several important considerations should be kept in mind when your seller (mortgage holder or otherwise) sells a property “as is.” One state’s supreme court has held:

Where the “as is” clause is an important part of the basis of the bargain, not an incidental or “boiler-plate” provision, and is entered into by parties of relatively equal bargaining position, a buyer’s affirmation and agreement that he is not relying on representations by the seller should be given effect. *Prudential Ins. Co. of America v. Jefferson Assocs., Ltd.*, 896 S.W.2d 156, 162 (Tex. 1995).

In other words, it is probably not enough to rely solely on boiler-plate “as is” language found in a sales contract – language like “Buyer accepts the Property in its present condition.” If there is a “Special Provisions” section in the contract, consider inserting “as is” language approved by your broker in addition to any “present condition” language that may be found in the contract. The purpose behind this is to convey that the “as is” provision is a specifically negotiated term of the contract, so specificity is encouraged. For instance, one example we have encountered is a seller attempting to convey a property “as is” to an individual buyer. Despite the fact that the buyer was one person, the seller had the buyer sign a form that stated, “**we**, the undersigned, **Purchasers** of the referenced property...” Needless to say, it did not take the buyer’s attorney long to point out to the court that this was boiler-plate language, given that the contract was with an individual purchaser rather than purchasers.

When evaluating the relative bargaining position of the buyer and seller, courts also look at whether the buyer had an opportunity to inspect the property. Although a listing agent cannot force a buyer to obtain a home inspection, the listing agent should make it clear that the property is available for inspection during the option period. For example, the listing agent could include language in the “Special Provisions” section of the contract such as, “buyer is welcome to have the property inspected during the option period,” or the listing agent could send similar language to the buyer’s agent in an e-mail. If the buyer obtains an



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inspection, it will serve as further evidence that the buyer and seller are of relatively equal bargaining position and the buyer is not relying on the seller's representations about the property. If the buyer chooses not to obtain an inspection, the listing agent may then argue that the seller did not impede the buyer's ability to inspect the property.

Finally, in our experience, the most common way a buyer negates the effect of an "as is" provision is by arguing that he was fraudulently induced into purchasing the property. For example, if a buyer sues an agent in an "as is" transaction, the buyer may argue that he had the property inspected and although the inspection report noted that the property had foundation issues, the agent dismissed the problems as cosmetic or nothing to worry about. Now we all know that this statement would be a cardinal sin paramount to asking for a lawsuit, but regardless of the validity of the alleged misrepresentation, it is often enough to create an issue about the enforceability of an "as is" agreement.

To summarize for those of you who may choose to brave the foreclosure waters, "as is" agreements are far from a sure thing. If you plan to rely on them: be specific; if you are the listing agent, make your properties available for inspection; if you are the buyer's agent, encourage your clients in writing to get an inspection; and avoid making any representations about material aspects of the home, like the foundation, the roof, drainage, mold, and termites. Again, though, as we indicated in the preceding article, do not let lawyers run your business – just keep these nuggets somewhere in your desk. If you use them, they may help you if your rainy day should ever come.

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<sup>1</sup> In addition to the validity question, it is worth considering what protection an "as is" agreement affords a realtor. In most cases, a realtor is not considered a party to the sales contract. Consequently, a buyer who becomes a plaintiff in a lawsuit may argue that the realtor is not entitled to rely on a term in the contract, i.e., the "as is" clause, to escape liability. We have seen cases, though, where courts have extended the protection of "as is" language to the listing agent. Unless the buyer's agent is specifically identified as part of an "as is" agreement, there may be a question whether the buyer's agent can rely on the agreement.



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