

Day-to-day transactions getting tougher

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The more things change, the more they stay the same. At least that seems to be true in the world of real estate litigation.

Turmoil in real estate markets has brought new legal challenges to brokers, including a greater likelihood of disputes surrounding property condition disclosures and commission payments. Yet agency—a broad topic that includes dual agency, buyer representation, and fiduciary duty dilemmas, among other things—continues to be an area of high risk, according to the 2011 National Association of Realtors® Legal Scan, a biennial study that's based on interviews with real estate commissioners and brokers, a review of cases, and a close analysis of recently enacted state statutes. The report seeks to identify current and emerging legal issues and risks.

"The day-to-day reality is that every transaction is tougher today than five years ago," says David Howell, executive vice president and chief information officer at McEanearney Associates Inc. in McLean, Va. "You have to be at the top of your game more than ever to avoid disputes."

Good Ol' Agency Still Causing Trouble

With the exception of property condition disclosure, Legal Scan respondents ranked agency issues in their top three legal issues more than any other topic.

"When it comes to dual and buyer agency, disclosure is a concept that sales associates are continually lax in dealing with," says Ron Hardgrove, director of real estate for the Illinois Department of Financial and Professional Regulation, Division of Professional Regulation in Springfield. "Sales associates have trouble saying, 'This is who I am and what I do, and it's a value to you.'"

Practitioners are supposed to disclose agency relationships at their first substantive contact with customers. But consumers complain that they were never told about dual agency or about agency relationships in general, Hardgrove says. "Salespeople fumble that, but not necessarily with intent to deceive," he says.

Sylvia Golden Norris, a real estate lawyer in Sarasota, and SAR's attorney, says her clients also struggle with agency. "A large part of my practice is handling agency representation cases for big insurance carriers," Norris says. "When we discuss the claims we're seeing, agency is always high up there, and breach of fiduciary duty comes into play."

She says that she doesn't think some licensees understand what a fiduciary duty is and perhaps

are unclear about the breadth of responsibility owed to clients.

"Know your obligations; remember whom you represent, what you're allowed to do, and what you're not allowed to do; and put it all in writing so everybody's clear," she says.

Agency issues can overlap with distressed sale issues. Some sales associates don't understand they're fiduciaries of lenders when they're representing lenders in REO sales. They owe lenders the duties they owe individual buyers or sellers. They must communicate, put things in writing, and keep on top of disclosures required of lenders.

The Law of Distress

A hefty 68 percent of Legal Scan respondents ranked property condition disclosure among their top three current legal issues. The most significant development in this area is the emergence of disputes arising from distressed sales.

"The typical scenario is that right before or after a closing, something gets discovered that the buyers felt should have been disclosed," says Bill Wright, broker-owner at the seven-office RE/MAX Executive Realty in Franklin, Mass. "All our [distressed] sales are as-is with no warranties, but there still needs to be full disclosure of any known material defects."

In Massachusetts, sellers aren't required to complete property condition disclosure forms, and some sellers, on the advice of their attorney, refuse to do so, Wright says. Nonetheless, his company now requires sellers to complete the form before his company will list their home on the market.

"Listings are hard to come by, without a doubt," Wright says. "But when I've had to make a phone call to the seller, I've always been successful in getting that disclosure form. If someone refuses to fill one out, I see red flags."

Distressed property disputes aren't limited to property condition issues, says Dax Watson, a real estate lawyer at Mack, Drucker & Watson in Phoenix. "What we're



Sylvia Golden Norris

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seeing—and my guess is it's the trend going forward—is a large number of complaints arising out of how sales associates handle distressed properties.”

Watson says he's seen two common types of problems arising from short sales, resulting in lawsuits:

1. Frustrated sellers. “The listing agent negotiates with the bank but isn't successful at getting the sale closed, and that becomes the sales associate's fault,” Watson says. “Sometimes it's because the associate wasn't paying attention to the foreclosure sale date or other deadlines. But, even if they do nothing wrong, if they don't finalize the transaction, sales-

people are going to get blamed.”

2. Giving legal or tax advice. Never advise sellers on issues outside of your expertise. “Short sale sellers will ask, ‘Is the bank or Uncle Sam going to come after me because this sale isn't going to cover my mortgage?’” Watson says. “If salespeople answer that question, that's a violation of their license. And if they get it wrong, that's bad. We see a lot of litigation related to that.”

Watson remains concerned about future legal challenges arising from short sales. “People are in a position of stress, and even if we see a successful closing, they may come back and say, ‘You should have gotten me a better deal,’” he says. “I do worry about that.”

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Inc. of Gainesville, Fla. Beery also carefully reviews covenant clauses on retail properties. “You need to know how many other tenants will vacate if one major tenant leaves,” he says.

Risk Three: Inflation

Even if rents do rise, net operating income faces another major challenge: inflation. “Too often, investors overlook the risk of capital expenditures and how inflation can drive up expenses,” says Riggs.

“We haven't seen any real inflation in a decade, and if it comes, I'm not sure those 2 percent per year increases built into most office leases will be enough to cover rising expenses,” says William O'Brien, SIOR, president of M.C. O'Brien Inc. in Brooklyn, N.Y. Lease clauses that tied operating increases to the Consumer Price Index were once commonplace, but today's owners seldom have such protections, he says.

Multifamily rents have been rising in most markets and are up 3.8 percent in the second quarter of 2011 compared with the same period in 2010, according to Carrollton, Texas-based MPF Research, but higher inflation could quickly erode profits, warns Baca. He's advising his clients who intend to hold properties for 10 years or more to make all upgrades and repairs now, while cash flow can support the cost.

Wild Card Risk: Fear Itself

Perhaps the hardest risk to evaluate and control in commercial real estate is the fear of taking risk.

“The greatest concern today for many investors is preserving capital, even though risk-adjusted return is probably a lot higher than it was before the credit crisis,” Riggs explains. “Buyers are concerned that history will repeat itself,” so they're doing a lot more research and worst-case scenario analysis. That slows down deal velocity, says Beery.

Some buyers and owners are also fearful that there won't be a viable market when they want to sell in five to eight years and move on to their next investment.

“When investors don't see an exit strategy, they get skittish,” says Baca. Fears have lessened in the last year, however, he

adds. Price increases are beginning to trickle down from Class A assets to lesser properties and second-tier markets. In July, research company CoStar reported that its Commercial Repeat Sales Index was showing comparable price increases in both investment-grade and general commercial real estate for the prior three months.

Commercial brokers have to walk a fine line between painting a realistic picture of market risk and adding to fears that may kill a deal, Wiegmann says. One option: Demonstrate to investors that the return on the investment reflects any added risk that's present today.

Why Risk Predictions Can Go Wrong

If the financial crisis has taught investors anything, it's that even really smart people don't see every risk coming. A big part of the problem is that most investors—even sophisticated professionals—base their projections for future risk on what happened in the past, says Liang Peng, assistant professor with the Leeds School of Business at the University of Colorado at Boulder. “They don't assume the correlation between risk and return can change over time,” he says.

Another difficulty, says Norman Miller, director of the Burnham-Moores Center for Real Estate at the University of San Diego, is that investors often spend their time focusing on less critical variables like cap rates and hold periods, but overlook key—but difficult to predict—risk factors that can have a much greater impact. For example, he says, “if I'd told you in 2006 that the CMBS market would be almost nonexistent in 2009, you'd have thought I was crazy.”

Analyzing critical factors such as vacancy rates, absorption, rent growth, refinance rates, and expenses helps create a clearer picture of risk, says Miller. So, too, can finding indicators of potential macro risk that affect real estate. In a soon-to-be published article, “Risk and Return of Commercial Real Estate: A Property Level Analysis,” Peng uses data from the National Council of Real Estate Investment Fiduciaries to determine which variables are indicators of commercial real estate risk. His findings: Commercial real estate risk is positively correlated with GDP growth and the change in the credit spread. Negative correlations occur with inflation, stock market volatility, and the change in the credit spread over 10-year Treasuries.