



Regulatory Corner - January 2018

Lessons offered by two recent disciplinary cases

Once again, complaints filed with the North Carolina Real Estate Commission involving property managers provide an opportunity to learn from the mistakes of others. Both of the matters discussed below were handled by the Commission's Regulatory Affairs Division in 2017.

How often should property managers inspect the properties they manage?

Property managers who have studied the Real Estate Manual published by the Real Estate Commission know that the Commission considers the maintenance and protection of clients' property to be one of the principal functions of property managers. The Manual suggests that the property management agreement "should address the agent's duty to inspect the property".

In reality, many property management agreements are silent on the subject of inspections. The NC REALTORS® Exclusive Property Management Agreement (Standard Form 401) sets forth the duties of property managers in more general terms. Paragraph 6 of Form 401 states that Agents shall "manage the Property to the best of Agent's ability", and devote such time and attention to that endeavor as may be necessary. Paragraph 6(f) of Form 401 states that property managers "shall... make arrangements on Owner's behalf for any repairs which, in agent's opinion, "may be necessary to preserve, maintain and protect the Property."

While these provisions may imply a duty to inspect the managed property, there is certainly no guidance on when, or how often, those inspections should take place. A recent case, that has not been reported, sheds some light on what the Commission considers adequate.

In 2017, an owner filed a complaint with the Commission alleging that her property manager had failed to manage her property properly. The property management firm responded to the complaint, and described the inspection schedule it had followed. The firm argued that it had complied with its contractual duties under Form 401, and had conducted inspections "at appropriate intervals based on the conditions it observed, the regular rent payments it received, and the lack of tenant complaints."

After considering the firm's response, the Commission agreed that discipline was not warranted. However, its closing letter contained some helpful guidance. First, the Commission

suggested that an inspection would be appropriate whenever a lease was to be renewed. In the Commission's words: "Having updated information regarding the condition of the property would have been material to (the owner's) decision whether to renew the lease... (The agent) should have inspected the exterior and interior of the subject property before asking (the owner) whether she wanted to renew the lease."

The Commission also cautioned the property manager to "exercise greater care in the future to inspect rental properties on a regular basis (i.e. prior to the renewal of a lease and any time anyone expresses a concern about the condition of a rental property or conduct by a tenant). Its closing letter noted that, while the Commission does not have a rule specifying the frequency of such inspections, it expects brokers "to be diligent in monitoring the conditions of rental properties and to take swift action to resolve problems when they arise."

The take-away is that firms should establish a "regular" inspection schedule for each property they manage. At a minimum, each property should be inspected before any lease renewal. If circumstances warrant it, a more frequent schedule should be adopted. Factors to consider are the conditions observed at prior inspections, and the number and seriousness of tenant complaints.

How to reduce the risk of employee embezzlement?

Another recent case highlights the very serious consequences that can result if a broker-in-charge fails to properly supervise an employee charged with maintaining the firm's financial records. The case, which will be reported in the February 2018 *Real Estate Bulletin*, involves a property management firm in Charlotte.

According to the Consent Orders signed by the firm and its broker-in-charge, the firm's broker-in-charge failed to review the firm's trust account records each month. As a result, an unlicensed bookkeeper was able to embezzle over \$200,000 from the firm's trust accounts. The Consent Orders state that the broker-in-charge notified the North Carolina State Bureau of Investigation of the embezzlement, and began replacing the missing funds. Perhaps because of these actions, the Commission allowed the firm to stay in business (but on probation for three years). However, the broker-in-charge had his license suspended for six months, and was then placed on probation for an additional 30 months.

To reduce the risk of employee embezzlement, brokers-in-charge need to pay close and consistent attention to the trust account records that are maintained in their office. It is the broker-in-charge who has the ultimate responsibility for ensuring the safe-keeping of trust account funds. If a broker-in-charge sees one of the following "red flags", he or she should immediately investigate further:

- NSF notices on checks drawn on a trust account
- Canceled checks missing from bank statements
- Excessive voided checks
- Checks written to bookkeeper
- Checks written to an unknown vendor

- Missing trust account records
- Large transfers of funds between trust accounts

In some cases, embezzlement occurs despite the best efforts of the broker-in-charge. In that context, one issue that arises is whether the broker-in-charge and the firm should “self-report” the embezzlement to the Commission. The Commission has offered the following guidance on that subject in the materials for its 2015-2016 Broker-in-Charge Update Course:

The Commission is usually more lenient with brokers who make an “honest mistake” while trying to comply with the Commission’s rules than with brokers who disregard the Commission’s rules. The Commission also tends to be more lenient with brokers who report embezzlement within their firms than if we discover the theft through an investigation or spot audit.

The Commission’s course materials conclude with a warning that the truth always has a way of coming out, and that it’s usually just a matter of time.

The question of whether to self-report is a difficult one. Before making a decision on that question, you may want to confer with your own attorney.

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