

Buying From Clients: BEWARE

It goes without saying that the great recession in the real estate market has resulted in properties being listed for sale for extraordinary lengths of time. It would appear that one consequence of this situation is that REALTORS® are buying properties from their clients more than ever before. Due to the existence of a fiduciary relationship between the buyer, REALTOR®-buyer, and the seller, there is a heightened danger that such a transaction can blow up in the face of the REALTOR®.

As all REALTORS® are aware, the existence of a fiduciary relationship requires a listing REALTOR® to discharge certain duties to the seller, including complete loyalty and disclosure of all material facts. If a REALTOR® buys the property of a client, and a dispute arises after the sale, the burden will be on the REALTOR® to prove that the transaction was completely fair to the client. As might be guessed, it is extremely difficult to prove that any transaction is “completely fair.”

The following hypothetical will demonstrate how REALTORS® can fall into a difficult situation as a result of a purchase from a client.

Assume that REALTOR® Brown has listed elderly Mrs. Jones’ property at 123 Elm Street for over a year. There has been very little activity on the property, as Mrs. Jones’ home is in severe need of an update both inside and outside. Unfortunately, Mrs. Jones is rapidly reaching the point where she can no longer take care of herself and will need to move to an assisted living facility.

REALTOR® Brown has done his homework and, based on comparables he has gathered, is comfortable that Mrs. Jones’ house is correctly priced at \$40,000. REALTOR® Brown is sympathetic with the plight of Mrs. Jones and sees the possibility for a win-win situation. He is willing to pay Mrs. Jones the \$40,000 list price for her home. Further, REALTOR® Brown has done his due diligence and is confident that under applicable local ordinances, the house at 123 Elm Street can be converted into a two-unit rental after a capital expenditure of \$20,000 for improvements.

REALTOR® Brown proceeds forward and purchases the home from Mrs. Jones for \$40,000. Mrs. Jones moves into the assisted living facility and REALTOR® Brown proceeds forward with the conversion of the house into two rental units. His investment appears to be a good one as he rents both units within a very short period of time.

Mrs. Jones has two adult grandchildren. One of the grandchildren lives in New York City and the other lives in San Francisco. Well after the

fact, the two grandchildren become aware that Mrs. Jones sold her home to REALTOR® Brown for \$40,000. Based on the cost of living in New York City and San Francisco, the grandchildren are convinced that no habitable home could be fairly purchased for \$40,000. The grandchildren are therefore certain that REALTOR® Brown has taken advantage of their grandmother and breached his fiduciary duties to her by paying her far less than the home was worth.

The grandchildren convince Mrs. Jones to file a lawsuit against REALTOR® Brown alleging a breach of fiduciary duty. In support of Mrs. Jones’ breach of fiduciary duty claim, the grandchildren obtain an appraisal of 123 Elm Street based on the capitalized income approach from the rental stream from the two units. This appraisal concludes that the fair market value of 123 Elm Street is \$100,000.

REALTOR® Brown has a tall mountain to climb if he is to prevail in this lawsuit. He will likely point out that Mrs. Jones was not in the position to, convert 123 Elm Street into a two-unit rental. He can also point out, if it is the case, that Mrs. Jones did not have the capital necessary to undertake the renovation necessary to make 123 Elm Street a two-unit rental. Finally, REALTOR® Brown can argue that Mrs. Jones had no experience as a landlord and simply did not have the capability to complete the conversion to two rental units.

In defending the litigation, REALTOR® Brown is faced with two major obstacles. First, he has no proof other than his own comparables that \$40,000 was a fair price for the purchase of the home from his principal, Mrs. Jones. Second, he has nothing to prove that he made full disclosure to Mrs. Jones about the potential economic benefits of converting 123 Elm Street into two rental units. Even if Mrs. Jones could not have realistically converted her home into two rental units, a claim will be made that REALTOR® Brown’s duty of complete disclosure required him to provide her with this information.

In order to better protect himself in this situation, REALTOR® Brown should have included a contingency in his purchase agreement with Mrs. Jones that 123 Elm Street would appraise for \$40,000 or less. The contingency should have also provided that if the appraisal was greater than \$40,000, then the purchase price would be the amount of the appraisal or, alternatively, REALTOR® Brown would have the option of



terminating the purchase agreement. The purchase agreement should have provided that the appraiser would be selected by Mrs. Jones. If Mrs. Jones had no notion how to go about obtaining a residential appraisal, then REALTOR® Brown should have directed her to a REALTOR® (not from his firm or from his family) who could recommend one or more appraisers. Ideally, the appraisal would be paid for by REALTOR® Brown.

If REALTOR® Brown did not want to pay the cost of an appraisal, he should have at least had Mrs. Jones obtain a broker price opinion from another REALTOR® (again, not from REALTOR® Brown's firm or family) with respect to the value of 123 Elm Street.

“If a REALTOR® buys the property of a client, and a dispute arises after the sale, the burden will be on the REALTOR® to prove that the transaction was completely fair to the client.”

REALTOR® Brown's situation is made more difficult by the fact that REALTOR® Brown purchased 123 Elm Street in order to make improvements which would produce a rental stream off of two rental units. Again, in order to protect himself, REALTOR® Brown should have obtained written acknowledgement from Mrs. Jones that the property had the potential of being converted into two rental units which could substantially increase the value of the property. This acknowledgment could be set forth in the

purchase agreement or in a separate document.

Armed with an appraisal and an acknowledgment from Mrs. Jones as to the potential commercial use for 123 Elm Street, REALTOR® Brown would be in a better position to demonstrate to Mrs. Jones' grandchildren that he had not taken advantage of their grandmother or, alternatively, if he was sued, to demonstrate to the court that he had acted fairly towards his elderly client. Without such an appraisal and acknowledgement, REALTOR® Brown may be in for expensive litigation that he could very well lose.

It should be noted that some REALTORS® are involved in the purchase of their client's property through a limited liability company, e.g., REALTOR® Brown and three other people would buy the property as “Acme, LLC.” The fact that REALTOR® Brown indirectly purchased Mrs. Jones' house through a corporate entity in which he has an interest does not protect him. In this situation, in addition to the appraisal and acknowledgement of the rental opportunity, REALTOR® Brown would also need to provide evidence that he had disclosed his interest as a member of the limited liability company.

Consider the following twist to this hypothetical. Assume that REALTOR® Brown's sister is moving back to the area and wishes to purchase 123 Elm Street. REALTOR® Brown dutifully advises Mrs. Jones that the prospective buyer is his sister, but that he will only be representing Mrs. Jones and can faithfully discharge his fiduciary duties to her. While a written acknowledgment from Mrs. Jones that REALTOR® Brown has disclosed the status of the purchase as being his sister may be of some help, if there is later a claim of breach of fiduciary duty, in most instances this will be an indefensible situation. REALTOR® Brown will likely be unable to convince a judge or a jury that he acted solely in the interest of Mrs. Jones if his sister bought the property.

Obviously, this article is not aimed at providing advice to real estate licensees who wish to take advantage of their principals in purchasing property from them. Instead, it is aimed at protecting REALTORS® who believe they are acting in the best interest of their clients in purchasing the property and wish to avoid the situation where “no good deed goes unpunished.” **MAR**

Michigan REALTORS® can stay informed of legal issues with updates through our Legal Lines.