



REPORT OF
THE
STATE AUDITOR

Department of Regulatory Agencies
Division of Real Estate

Performance Audit
October 2004

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This report contains the results of a performance audit of the Colorado Division of Real Estate. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, recommendations, and the responses of the Division of Real Estate and the Real Estate Commission.

A handwritten signature in cursive script that reads "Joanne Hill".

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JOANNE HILL, CPA
State Auditor

**Department of Regulatory Agencies
Division of Real Estate
Performance Audit
October 2004**

Authority, Purpose, and Scope

This performance audit was conducted under the authority of Section 2-3-103, C.R.S., which authorizes the Office of the State Auditor to conduct performance audits of all departments, institutions, and agencies of state government. The audit work was conducted from April through September 2004 in accordance with generally accepted government auditing standards. During this audit we evaluated the efficiency and effectiveness of the Division of Real Estate's licensing, monitoring, and enforcement activities. We acknowledge the assistance and cooperation extended by the management and staff at the Division of Real Estate, the Department of Regulatory Agencies, and the members of the Real Estate Commission.

Background

The Division of Real Estate (Division) is organizationally located within the Department of Regulatory Agencies. The Division's mission is "to protect the public from incompetent and dishonest real estate practitioners through effective education, licensing, and enforcement of Colorado laws." To this end, the Division regulates real estate professionals, including real estate brokers and subdivision developers. The Real Estate Commission (Commission) oversees Division activities and provides policy direction through its rule-making authority. The Division is entirely cash-funded from license and registration fees, and during Fiscal Year 2004 its expenditures totaled about \$3.8 million. The Division's 37 full-time equivalent (FTE) positions perform various functions, including licensing real estate professionals in accordance with applicable requirements, investigating complaints against licensees, auditing escrow and trust accounts maintained by licensees, and referring cases to the Commission for disciplinary action. As of June 30, 2004, there were approximately 36,500 actively licensed real estate brokers and approximately 180 registered subdivision developers in the State.

Summary of Audit Findings

Licensing

Through various licensing requirements, the State seeks competence and integrity on the part of real estate practitioners. During our audit we identified several weaknesses in the Division's licensing activities as follows:

For further information on this report, contact the Office of the State Auditor at 303.869.2800.

SUMMARY

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- **Criminal background checks.** In Fiscal Years 2003 and 2004 the Division did not submit fingerprints to the CBI and the FBI for approximately 425 (10 percent) and 430 (9 percent) real estate broker license applicants, respectively, as required by statutes. In addition, according to CBI data, approximately 3 percent and 5 percent of the fingerprint cards received in Fiscal Years 2003 and 2004, respectively, were unreadable and only a name search was performed. The Division issues real estate broker licenses before the results of the criminal background checks are known.
- **Commission licensing decisions.** The Commission lacks sufficient criteria to license individuals with criminal backgrounds consistently. Our review of 30 applications from individuals with criminal histories found that individuals with real estate–related crimes, such as theft, forgery, and fraud, did not appear any more or less likely to be issued a real estate broker license than individuals with non-real estate–related crimes, such as drug charges or assault. The Commission does not adequately document the relevant decision criteria and rationale used when denying or issuing licenses to individuals with criminal backgrounds.
- **Subdivision developer background checks.** The Division does not conduct sufficient criminal history review of subdivision developer applicants. Our review of Colorado criminal court records for a sample of 29 subdivision developers identified 2 developers with a possible match to individuals with felony convictions including theft, burglary, and forgery. We also identified three developers in our sample with prior misdemeanor convictions.
- **Independent errors and omissions insurance policies.** At the time of our audit, approximately 1,275 (3 percent) actively licensed real estate brokers maintained errors and omissions insurance coverage through an insurer independent from the state-contracted group insurance plan. For a sample of 25 brokers, we identified 2 brokers with policies that did not appear to comply with a Commission rule that independent insurers be authorized and licensed by the Division of Insurance to write policies of errors and omissions insurance in the State. We also identified two brokers with active licenses whose independent errors and omissions insurance policies had expired.

Monitoring and Enforcement

Statutes direct the Commission to investigate all written complaints filed against real estate brokers and grant the Commission authority to take disciplinary action against licensees. We identified weaknesses related to effective complaint management and enforcement practices as follows:

- **Complaint management system.** The Division lacks a comprehensive, integrated complaint management system that provides accurate, easily accessible information on complaints against licensees from receipt through disposition. Complaint data are

inconsistently maintained in 14 separate complaint logs. Additionally, the Division's electronic complaint database contains errors and inconsistencies.

- **Complaint prioritization and timeliness.** Complaints are not prioritized or investigated timely in accordance with Division standards. Of a sample of 15 open complaints, 2 complaints were assigned priority levels inconsistent with the seriousness of the complaint. In addition to our sample, we identified two complaints that had not been assigned a high priority level consistent with criteria reported by Division staff. Priority levels are not updated as the complaint investigation progresses and the highest priority level is rarely used. About 21 percent of open complaints remained open longer than established time frames.
- **Dismissed complaints.** Division staff dismiss complaints that should be referred to the Commission for review. Of a sample of 10 dismissed complaints, we identified one broker who allegedly used escrow funds to repay a gambling debt and a second broker who had a history of complaints alleging violations of rental service agreements. These complaints were dismissed by Division staff without referral to the Commission.
- **Enforcement actions.** The Commission does not sufficiently exercise its enforcement authority. Our review of 49 disciplinary cases found that brokers committing similar infractions received significantly different disciplinary actions. Further, the Commission substantially reduced the discipline for four brokers through counteroffers without providing adequate justification and documentation for these reductions.
- **Compliance monitoring.** The Division does not sufficiently monitor brokers to ensure they comply with the terms set forth in their disciplinary actions. Of a sample of 30 disciplinary actions reviewed, we identified 2 brokers (7 percent) whose licenses were not suspended in accordance with the terms set forth by the Commission. In addition, six brokers (20 percent) did not provide proof of restitution payments or completion of education requirements, and four brokers (13 percent) met compliance only after Division staff either accepted substitutions or extended due dates.

Policy Issues

In addition to weaknesses identified in the Division's licensing, monitoring, and enforcement efforts, we found the Division could do more to serve the consumers of the State. Specifically:

- **Orientation toward public consumers.** The Division needs to focus more of its attention and resources to ensure it is the first point of contact for real estate-related consumer issues. The Division does not coordinate complaint handling and referrals with other entities, use a standard complaint form, or effectively publicize disciplinary actions against brokers.

SUMMARY

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- **Consumer protection.** The Commission and the Division need to critically assess and reevaluate errors and omissions insurance requirements and the Real Estate Recovery Fund—two mechanisms intended to protect consumers. First, factors such as high insurance premiums and few contract bidders could make contracting for a group errors and omissions insurance plan at a reasonable premium increasingly difficult in the future. We also question whether a state-contracted group policy is the optimal arrangement for the State. Second, statutes impose a number of requirements and restrictions that may discourage individuals with legitimate losses from filing a claim against the Real Estate Recovery Fund. Moreover, statutory provisions related to the Recovery Fund’s financing do not work to prevent the buildup of an excessive fund balance.

Our recommendations and the responses of the Division of Real Estate and the Real Estate Commission can be found in the Recommendation Locator.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	17	Seek statutory change to require real estate broker license applicants to submit fingerprint cards and payment for the required criminal background check directly to the Colorado Bureau of Investigation. Require applicants to have a completed criminal background check prior to applying for a license, or withhold issue of broker licenses until the results of the criminal background check are known.	Division of Real Estate	Agree	March 2005
2	21	Assess the need for additional statutory guidance and establish written decision criteria and guidelines for the review of license applications from individuals with criminal histories. Assess and implement appropriate standards for documenting factors relevant to licensing outcomes.	Real Estate Commission	Agree	July 2005
3	25	Seek statutory authority to require a fingerprint-based criminal history record check of subdivision developer applicants, capture sufficient identifying information on the subdivision developer application, and correct problems identified with electronic subdivision developer records.	Division of Real Estate	Agree	August 2005
4	29	Repeal rule prohibiting determination of whether independent errors and omissions insurance policies comply with Commission requirements.	Real Estate Commission	Partially Agree	March 2005
5	29	Establish formal procedures to ensure that independent errors and omissions insurance policies maintained by real estate brokers comply with Commission rules and state statutes. Improve electronic licensing system functionality to identify and inactivate licenses of brokers whose insurance has expired.	Division of Real Estate	Agree	August 2005

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
6	33	Improve the collection of errors and omissions insurance claims data and analyze these data on a regular basis to identify patterns of activity among real estate brokers and real estate firms that should warrant additional monitoring and investigation.	Division of Real Estate	Agree	March 2005
7	37	Develop written policies and procedures for logging, maintaining, and reporting on complaint information, improve electronic system controls and edits, review tracking logs on a regular basis, and integrate manual logs into a comprehensive electronic system.	Division of Real Estate	Agree	August 2005
8	41	Reassess the current complaint priority system, adopt written policies and procedures for assigning and evaluating priority levels, and review complaint investigations for timeliness.	Division of Real Estate	Agree	January 2005
9	43	Develop formal criteria for dismissing complaints or referring complaints to the Commission.	Division of Real Estate	Agree	March 2005
10	46	Develop written criteria and guidelines for use in determining disciplinary actions against real estate brokers, assess and implement appropriate standards for documenting factors relevant to disciplinary actions, and make information regarding disciplinary actions more widely available and easily accessible to the public.	Real Estate Commission	Agree	August 2005
11	50	Develop and implement policies and procedures outlining the compliance monitoring process, develop a more comprehensive compliance tracking log, report on compliance statistics, and regularly pursue additional sanctions when the terms of disciplinary actions are not met.	Division of Real Estate	Agree	August 2005

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
12	51	Promulgate rules or seek statutory change to require the referral of criminal or potentially criminal acts to the Attorney General's Office or local district attorneys, as appropriate.	Real Estate Commission and Division of Real Estate	Agree	October 2005
13	54	Ensure that escrow and trust account shortages identified through financial audits are replaced and that disciplinary action is taken when appropriate.	Division of Real Estate	Agree	Ongoing
14	57	Develop more formal processes for referring and sharing information on real estate-related complaints among consumer protection agencies, better publicize disciplinary actions taken against licensees, develop a standard complaint form, explore other ways to solicit feedback and input from the public.	Division of Real Estate	Agree	August 2005
15	61	Critically assess and evaluate the errors and omissions insurance requirement for licensed real estate brokers and whether a state-contracted group policy is the optimal arrangement for the State.	Real Estate Commission and Division of Real Estate	Agree	January 2005
16	64	Critically assess the Real Estate Recovery Fund and evaluate available policy alternatives. Furnish a report on these policy alternatives to the General Assembly by July 1, 2005.	Real Estate Commission and Division of Real Estate	Agree	January 2005

Division of Real Estate

Overview

Background

The Division of Real Estate (Division) is organizationally located within the Colorado Department of Regulatory Agencies (Department). The mission of the Department is to “serve the public through responsible regulation and the vigorous and fair enforcement of Colorado law, while promoting economic and business competitiveness.” Within this overall framework, the Division’s specific mission is “to protect the public from incompetent and dishonest real estate practitioners through effective education, licensing and enforcement...” To this end, the Division regulates real estate professionals, including real estate brokers, subdivision developers, and real estate appraisers as follows:

- **Real Estate Brokers** - Persons or firms who, for compensation, are involved in the listing, negotiation, sale, exchange, purchase, rental, or lease of real property. Pursuant to House Bill 96-1107 which took effect on January 1, 1997, Colorado became the first state in the nation to eliminate the real estate salesperson license. Prior to the passage of House Bill 96-1107, Colorado granted real estate salesperson and broker licenses. When this law took effect, individuals licensed as real estate salespersons were required to obtain real estate broker licenses to continue operating in the State. As of June 30, 2004, there were approximately 47,000 real estate brokers in the State. Of this total, almost 36,500 (78 percent) had active real estate broker licenses in that they had met and were actively maintaining all of the requirements of licensure.
- **Subdivision Developers** - Any person who participates as owner, promoter, or agent in the promotion, sale, or lease of a subdivision. Statutes define “subdivision” as real property divided into 20 or more interests solely intended for residential use, including timeshares, conversions of existing structures into a common interest community (e.g., loft or condominium conversions), and groups of proprietary leases in a cooperative housing corporation. As of June 30, 2004, there were approximately 180 subdivision developers registered with the Division.
- **Real Estate Appraisers** - Persons who, for a fee or salary, provide or supervise the provision of an opinion on the nature, quality, value, or utility

of identified real estate. The Division provides staff support to the Board of Real Estate Appraisers for the licensing of real estate appraisers pursuant to Title XI of the federal Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. We did not include real estate appraisers in the scope of our audit.

Since Fiscal Year 2001, the number of full-time equivalent (FTE) positions appropriated to the Division has remained at 37. To carry out the Division's regulatory mission, these 37 FTE perform various functions including:

- Licensing real estate brokers and registering subdivision developers in accordance with education, examination, experience, insurance, and background check requirements.
- Investigating complaints against licensees and referring cases to the Real Estate Commission for disciplinary action.
- Auditing financial accounts maintained by licensed real estate brokers and subdivision developers.
- Evaluating and approving real estate course curricula and education requirements and publishing data on examination pass/fail rates.

The Division's activities are overseen by the Colorado Real Estate Commission (Commission), whose five members are appointed by the Governor for three-year terms. The Commission provides policy direction for the regulation of real estate brokers and subdivision developers through its rule-making authority. By statute, the Commission hears all matters involving the denial, suspension, or revocation of a real estate broker license.

Fiscal Overview

The Division of Real Estate is entirely cash-funded through the Real Estate Cash Fund. The Division also administers the Real Estate Recovery Fund, which is a victims' assistance fund, as discussed below. The following table shows Division revenues, expenditures, and fund balances for these two funds for Fiscal Years 2000 through 2004. Revenues to the Real Estate Cash Fund increased by nearly 3 percent and revenues to the Recovery Fund decreased by about 58 percent. Expenditures from the Real Estate Cash Fund and the Recovery Fund increased by nearly 14 percent and 20 percent, respectively. Finally, the Real Estate Cash Fund balance grew by 152 percent and the Real Estate Recovery Fund balance fell by 99 percent over the time period shown.

Colorado Division of Real Estate Revenues and Expenditures by Fund Fiscal Years 2000 Through 2004						
	Fiscal Year					Percent Change 2000-2004
	2000	2001	2002	2003	2004	
<i>Revenues</i>						
Real Estate Cash Fund	\$3,049,147	\$3,520,542	\$3,099,376	\$3,577,323	\$3,129,887	2.6%
Real Estate Recovery Fund	\$306,405	\$315,599	\$326,365	\$248,631	\$129,008	-57.9%
Total Revenues	\$3,355,552	\$3,836,141	\$3,425,741	\$3,825,954	\$3,258,895	-2.9%
<i>Expenditures</i>						
Real Estate Cash Fund	\$3,143,385	\$3,200,746	\$3,310,132	\$3,737,370	\$3,570,091	13.6%
Real Estate Recovery Fund	\$190,381	\$242,073	\$198,196	\$215,946	\$228,210	19.9%
Total Expenditures	\$3,333,766	\$3,442,819	\$3,508,328	\$3,953,316	\$3,798,301	13.9%
<i>Fund Balances</i>						
Real Estate Cash Fund	\$481,329	\$801,125	\$590,369	\$430,323	\$1,213,755	152.2%
Real Estate Recovery Fund	\$3,083,250	\$3,156,777	\$3,284,945	\$117,631	\$18,429	-99.4%
Source: Office of the State Auditor's analysis of Colorado Financial Reporting System (COFRS) data.						
Note: Fiscal Year 2003 Real Estate Recovery Fund expenditures do not reflect a \$3.2 million transfer to the State General Fund.						

- Real Estate Cash Fund** - Created by Section 12-61-111.5(2)(b), C.R.S., the Real Estate Cash Fund is the Division's primary operating fund. Real Estate Cash Fund revenues derive from license and registration fees paid by real estate brokers, subdivision developers, and real estate appraisers.
- Real Estate Recovery Fund** - Created by Section 12-61-301(1), C.R.S., the Real Estate Recovery Fund is a victims' assistance fund. Members of the public who have been awarded a civil court judgment as the victims of fraud, willful misrepresentation, or conversion of trust funds by a licensed real estate broker, and who are unable to collect on the judgment, are eligible to file a claim for Recovery Fund benefits. Claims against the Recovery Fund are capped at \$50,000 per real estate transaction or \$150,000 per licensee. The Recovery Fund derives its revenues from surcharges on license renewal fees, license reinstatement fees, interest income, administrative fines, and

General Fund appropriations. In Fiscal Year 2004 the Recovery Fund paid out slightly more than \$228,000 for eight claims.

Audit Scope and Methodology

During this performance audit we evaluated the efficiency and effectiveness of licensing, monitoring, and enforcement activities related to the Division's regulation of real estate brokers. For subdivision developers, our audit focused only on the Division's processes for conducting background checks of applicants. The scope of the audit did not include the Division's education functions (e.g., approval of real estate course curricula) or activities related to the regulation of real estate appraisers. As part of our audit work, we interviewed Division staff and analyzed data, including downloads of more than 180,500 electronic records related to licensing, complaint investigation, and enforcement activities. In addition, we reviewed real estate licensing practices in seven other states (Arizona, Kansas, Kentucky, Nebraska, Oregon, Utah, and Wyoming) and interviewed management and staff from other regulatory agencies in the State.

Audit work was conducted from April through September 2004. We acknowledge the assistance and cooperation extended by the management and staff at the Division of Real Estate, the Department of Regulatory Agencies, and the members of the Real Estate Commission.

Licensing

Chapter 1

Overview

The purchase of a home is generally considered to be the single most expensive purchase most people will ever make, and, according to the Better Business Bureau, “nearly 80 percent of home sales nationwide are made with the assistance of a real estate agent or broker.” Therefore, regulation of the real estate industry not only protects individual consumers from unscrupulous or incompetent real estate agents, brokers, or salespeople, but also makes good economic sense from a broader perspective. Consequently, all 50 states have established entities with some level of responsibility for enforcing real estate laws, including the licensing of real estate professionals.

In Colorado, statutes specify that “it is unlawful for any person, firm, partnership, limited liability company, association, or corporation to engage in the capacity of real estate broker...without first having obtained a license from the Real Estate Commission.” [Section 12-61-102, C.R.S.] Statutes provide that no person is to be granted a license until he or she complies with statutory provisions concerning:

...education, experience, and testing; truthfulness and honesty and otherwise good moral character; and, in addition to any other requirements of this section, competency to transact the business of a real estate broker or real estate salesperson in such manner as to safeguard the interest of the public and only after satisfactory proof of such qualifications, together with the application for such license, is filed in the office of the Commission. [Section 12-61-102, C.R.S.]

It is through these licensing requirements that the State seeks competence and integrity on the part of real estate practitioners. The Real Estate Commission (Commission) and the Division of Real Estate (Division) are responsible for ensuring that individuals granted a real estate broker license meet all of the conditions of licensure.

In addition to requirements outlined above, to obtain and maintain an active real estate broker license, applicants must submit to a fingerprint-based criminal history record check, carry errors and omissions insurance, and pay a \$190 application fee. Once granted, real estate broker licenses must be renewed every three years by

completion of a minimum of 24 hours of continuing education coursework and payment of a \$134 renewal fee. In Fiscal Year 2004 the Division processed just over 4,600 applications for a new broker license, which was a 75 percent increase in applications from Fiscal Year 2000.

During our audit we identified several significant weaknesses in the Division's licensing activities that diminish its effectiveness in fulfilling this critical statutory function. In this chapter we discuss our findings and recommendations related to streamlining the conduct of criminal history record checks on real estate broker license applicants, ensuring the effective and consistent use of criminal history record checks in licensing decisions, strengthening background check requirements for subdivision developers, improving processes and procedures to monitor compliance with errors and omissions insurance requirements, and augmenting other Division functions through more effective use of available data.

Background Checks

Statutes require every applicant for a real estate broker license to submit a set of fingerprints to the Commission. The Commission, operating through the Division, forwards the fingerprints to the Colorado Bureau of Investigation (CBI) for the purpose of conducting a state and national fingerprint-based criminal history record check through the CBI and the Federal Bureau of Investigation (FBI). The cost of a fingerprint check is included in the license application fee. Results from the CBI and FBI searches are reported separately to the Division. In addition to the statutorily required fingerprint-based background check, Commission rules require broker license applicants to disclose prior criminal violations on their application. Division staff also check applicants' names through CoCourts.com, which is the publicly-available portion of the Judicial Branch's Integrated Colorado Online Network (ICON) database of Colorado court records.

Criminal background checks are important for reducing the risk to the public that dishonest and untruthful individuals will be granted real estate broker licenses. During our audit, however, we found that the Division does not effectively administer this process. Specifically, we found:

- **The Division does not submit all applicants' fingerprint cards to the CBI.** In Fiscal Years 2003 and 2004 the Division did not submit fingerprint cards for approximately 425 (10 percent) and 430 (9 percent) applicants, respectively. The Division failed to submit these fingerprint cards because it did not have sufficient funds budgeted to pay for the corresponding criminal background search. The Division underestimated the number of new broker license applications it would receive and, therefore, the number

of fingerprint searches it would need to pay for in each of these fiscal years. Further, we determined that the Division likely underestimated the number of new broker license applications it will receive this year. We estimate the Division's current Fiscal Year 2005 appropriation will not be sufficient to pay for approximately 1,200 required fingerprint-based background checks.

- **The Division does not resubmit unreadable fingerprints.** According to CBI data, approximately 3 percent of the fingerprint cards received in Fiscal Year 2003 and 5 percent of the cards received in Fiscal Year 2004 were unreadable. When fingerprints are unreadable, the CBI conducts a less extensive name search and returns the results and fingerprint card to the Division with a request for a new set of fingerprints. The Division does not require a second set of fingerprints from applicants. Thus, some applicants are granted real estate broker licenses without being subjected to a complete fingerprint search as required by statutes.
- **The Division's fingerprint card tracking logs contain missing data and errors.** The Division maintains a log to track (1) the receipt of fingerprint cards from applicants, (2) the submission of fingerprint cards to CBI for analysis, (3) the return of search results from the CBI and FBI, and (4) the funds available for conducting the fingerprint searches. Our review of this log showed a number of blank date fields as well as errors in cell formulas. Blank date fields mean that the Division cannot effectively track when fingerprint cards are sent to the CBI or that the search results have been returned to the Division. Errors in the cell formulas mean that the Division cannot use the log to accurately monitor funds available for conducting the fingerprint-based background checks.
- **The Division approves license applications before receiving the results of the criminal background checks.** According to Commission rules, the Division will conduct its review of the various components of a license application, such as compliance with education, examination, and insurance requirements, and issue a license within 7 to 10 business days. By contrast, after Division staff submit fingerprint cards to CBI, it takes an average of 12 days to receive the CBI search results and an average of 36 days to receive the FBI search results. Typically, if an applicant satisfies all of the other licensing requirements, staff will approve the application and issue the broker license in the absence of the criminal background check results. The Division lacks data to determine the exact number of licenses that have been issued under these circumstances.

The Division issues real estate broker licenses without the criminal background check results so as not to hold up the licensing process. Although staff may have

some knowledge of an applicant's criminal history through the self-disclosure requirement or Colorado court records search, we question the prudence of issuing licenses before the fingerprint search results are known. Moreover, we question whether this practice is in keeping with statutory intent that criminal history record checks be used to assess the honesty, truthfulness, and moral character of applicants prior to granting a broker license to conduct business in the State. We reviewed five other state licensing agencies that use criminal background checks, including the Division of Gaming (gaming license), the Division of Racing Events (racing license), the Division of Insurance (bail bond agent license), the Board of Nursing (certified nurse aide), and the Emergency Medical Services Division (emergency medical technician certification) within the Department of Public Health and Environment. None of these other agencies issues a professional license prior to knowing the results of criminal background checks.

Restructure Process

As a result of the problems we identified, we question whether the current process for conducting fingerprint-based background checks is operating as effectively as it should. Specifically, we question whether the Division should continue to act as a "middleman" between applicants and the CBI by processing fingerprint cards and payments for the fingerprint searches. We found that other state licensing agencies do not carry this responsibility. For example, the Division of Insurance and the Emergency Medical Services Division, respectively, do not accept fingerprint cards or payment for criminal background checks from applicants for bail bond agent licenses or certification as an emergency medical technician. Rather, statutes require applicants for these professions to submit their fingerprint card and payment directly to CBI. In addition, of the seven other state divisions of real estate we contacted, six states (86 percent) require fingerprint-based background checks of license applicants. Three of these six states (Kentucky, Nebraska, and Utah) require the fingerprint search to be completed prior to submitting an application for a real estate license.

The Division needs to restructure and streamline its processes to ensure that all fingerprint cards are submitted to the CBI timely and that applicants are not granted real estate broker licenses until all requirements, including fingerprint-based criminal background checks, are met. Requiring applicants to submit fingerprint cards and payment for the background check directly to the CBI has two advantages. First, the Division would no longer need to forecast the number of fingerprint cards it will have to process or require a specific line-item appropriation for funding the background checks. The Division would need to reduce the application fee for a new broker license accordingly. Second, the Division would no longer need to maintain a fingerprint card tracking log, thereby allowing staff to spend more time reviewing the results of background checks and other licensing requirements. Requiring applicants to complete the background check prior to submitting a license

application, or withholding the licensing decision until the CBI search results are known, would ensure that unreadable fingerprints are reprocessed and that the results of the fingerprint-based background checks are used in licensing decisions as intended by statutes.

Recommendation No. 1:

The Division of Real Estate should streamline the process for conducting criminal background checks of real estate broker license applicants and ensure the effective use of search results by:

- a. Seeking statutory change and revising application requirements as appropriate to require applicants to submit fingerprint cards and payment for the required state and national fingerprint-based criminal history record check directly to the Colorado Bureau of Investigation. Search results should still be reported directly to the Division.
- b. Requiring real estate broker license applicants to have a completed fingerprint-based criminal history records check prior to applying for a license, or withholding issue of real estate broker licenses at least until the results of the Colorado Bureau of Investigation record check have been reported to and evaluated by the Division.

Division of Real Estate Response:

Agree.

- a. Implementation Date: 2005 Legislative Session. The Division, in conjunction with the Department, is slated to introduce a proposed bill in the 2005 Legislative Session requiring that broker applicants initiate and pay for background checks directly through the Colorado Bureau of Investigations. This will eliminate the necessity for appropriation and Division resources devoted to such processes.
- b. Implementation Date: March 2005. The Division will propose rule(s) for consideration of adoption by the Commission in the March 2005 rule-making hearing, requiring that background checks be completed prior to application for a broker license, and in the interim, hold issuance of licenses until at least the CBI report is received. This approach will allow notice of the Rule and new procedure to be disseminated to interested parties (i.e. schools offering education courses, Realtor Boards,

brokerage firms) and the application forms and licensing information available at the test sites and on the Division Web site to be amended, so that stakeholders are apprised of the new requirements.

Licensing Decisions

When Division staff identify applicants with criminal histories, they review relevant information such as the nature of the criminal charges, terms of the sentence or probation, personal statements, and letters of recommendation. Staff then prepare a summary report for the Commission for use in making the final licensing determination. Unlike establishing compliance with licensing requirements, such as payment of the licensing fee and passing the real estate broker examination, the decision to approve or deny an application based on criminal history is not as straightforward. Statutes state that “no real estate broker’s license . . . shall be denied, suspended, or revoked except as determined by a majority vote of the members of the Commission.” [Section 12-61-105(3), C.R.S.] Thus, Division staff regularly forward license applications from individuals with identified criminal histories to the Commission for a final licensing decision. During our audit we found that the Commission’s licensing decisions are inconsistent and rationale for licensing decisions is unclear.

We reviewed a sample of 30 applications from individuals with criminal histories that Division staff referred to the Commission between August 2002 and July 2004. The Commission denied 9 applications (30 percent), issued 13 restricted real estate broker licenses (43 percent), and issued 8 real estate broker licenses without restrictions (27 percent). A restricted license typically means that the licensee agrees under stipulation with the Commission to operate under the direct supervision of another licensed broker and to disclose their criminal history to their employing broker. Additional restrictions may include prohibition from managing escrow accounts or engaging in certain types of real estate transactions.

Although most of the applications we reviewed were granted a license, we identified instances in which individuals with the same or similar types of offenses were given different licensing decisions. Individuals with real estate–related crimes, such as theft, forgery, and fraud, did not appear any more or less likely to be issued a real estate broker license than individuals with non-real estate–related crimes, such as drug charges or assault.

- **Theft, Forgery, or Fraud-Related Crimes.** Of the 30 applications we reviewed, 13 applicants (43 percent) had prior felony and misdemeanor charges and convictions involving theft, forgery, or fraud-related offenses.

In one case, the Commission denied a license to an applicant who was charged with two felony counts of fraud and theft and who pled guilty to attempted theft (Class 5 Felony). However, in a second case, the Commission issued a restricted license to an applicant who was charged with three counts of felony theft, and four counts of felony forgery. This individual pled guilty to one count of theft (Class 4 Felony) and one count of forgery (Class 5 Felony). The Commission issued a restricted license to a third applicant who was charged under a federal indictment with misappropriating customer funds and forging customers' signatures on loan applications while working at the New York Stock Exchange, and who pled guilty to embezzlement by a bank officer. Finally, in a fourth case, the Commission issued a broker license without restrictions to an applicant who was charged with felony theft and criminal trespass, and who pled guilty to first degree trespass (Class 5 Felony) and theft (Class 2 Misdemeanor).

- **Drug-Related Crimes.** Of the 30 applications we reviewed, 10 applicants (33 percent) had prior felony and misdemeanor charges and convictions for drug-related offenses. In one case, the Commission denied a license to an applicant who pled guilty to possession of a controlled substance with intent to distribute (Class 3 Felony). However, in another case, the Commission issued a restricted license to an applicant who pled guilty to this exact same charge. Of the eight remaining applicants with drug-related charges, four were issued a restricted license, while four were issued a real estate broker license without restrictions.
- **Other Serious Crimes.** Of the 30 applications we reviewed, 6 applicants (20 percent) had prior felony and misdemeanor charges and convictions related to other serious crimes such as robbery, trespass, and sexual assault. In one case, the Commission issued a restricted license to an applicant who pled guilty to conspiracy to commit simple robbery (Class 5 Felony). However, in another case, the Commission issued a license without restrictions to an applicant who pled guilty to aggravated robbery with claim of a deadly weapon (Class 3 Felony). Finally, the Commission denied a license to an applicant who pled guilty to attempted sexual abuse on a child (Class 2 Felony), but issued a real estate broker license without restrictions to an applicant who pled guilty to first degree sexual assault (Class 3 Felony).

Statutory Guidance

Currently statutes do not provide the Commission with specific guidance for licensing decisions. Section 12-61-102, C.R.S., requires licensees to comply with standards of truthfulness, honesty, and otherwise good moral character. At the same time, statutes also state “the fact that a person has been convicted of a felony or offense involving moral turpitude shall not, in and of itself, prevent the person from applying for and receiving a professional license.” [Section 24-5-101(1)(a), C.R.S.] Within these boundaries, the Commission has broad discretion when evaluating the criminal history of a real estate broker license applicant.

The Commission should consider whether additional statutory criteria and guidelines are warranted. We identified other Colorado state licensing agencies whose enabling statutes outline criminal acts that disqualify applicants from seeking professional licensure. For example, applicants for a gaming license (Division of Gaming) are disqualified from consideration for licensure if they have been convicted of any felony crime within the last 10 years, or if they have been convicted of a misdemeanor involving a gambling-related offense, theft by deception, fraud, or misrepresentation. Applicants for a bail bond agent license (Division of Insurance) are disqualified from consideration if they have been convicted of any felony crime within the last 10 years regardless of whether the conviction resulted from conduct in or related to the bail bond business. Finally, applicants for a racing license or registration (Division of Racing Events) are disqualified from consideration if they have been convicted of any gambling-related offense, theft by deception, or any crime involving fraud or misrepresentation within the last 10 years.

Criteria and Guidelines

The Commission has not promulgated rules or developed other specific written criteria and guidelines to assist with making consistent licensing decisions for applicants with identified criminal histories. In August 2000 staff from the Attorney General’s Office provided the Commission with a memorandum outlining a brief summary of applicable statutes, decisions, and other issues related to the licensing process. Although this memorandum contained information related to licensing and rehabilitation considerations, it clearly states it is “provided for general information purposes only.” Discretion is a necessary part of Commission decision-making. However, sufficient guidance is also necessary to protect against arbitrary and capricious licensing decisions.

Based on our survey of commissioners, we found the Commission needs to resolve differing opinions on how the seriousness of specific crimes, the relevance of certain crimes to the real estate industry, the importance of completing sentences, and the

potential for future public harm affect licensing decisions. To eliminate possible allegations of arbitrary or capricious decisions and to better protect the public, the Commission needs to develop written policies and guidelines, especially in the absence of more specific statutory criteria. For example, while neither the Board of Nursing nor the Board of Health has mandatory disqualification criteria established in statutes, the Board of Nursing has developed a detailed matrix outlining decision criteria for individuals with criminal histories who apply for licensure as a certified nurse aide. The Board of Health has recently adopted rules outlining those factors to be considered when an emergency medical technician certificate is denied or otherwise limited based on a felony or misdemeanor conviction.

Documentation

The Commission does not adequately document the relevant decision criteria and rationale used when denying or issuing licenses to individuals with criminal backgrounds. In their responses to our survey, commissioners indicated that Division staff recommendations are an important part of their licensing decisions. However, Division staff recommendations regarding licensing decisions are not documented in the application file or in the Commission meeting minutes. As a result, we lacked the information necessary to determine the basis for licensing outcomes in our sample or whether those outcomes were reasonable. According to Division staff, there are legal considerations related to documenting the details of licensing decisions. We believe it is important that the Division weigh these potential legal risks against the benefits to the public and real estate brokers from adequately documenting the rationale for licensing decisions.

Presently the Commission lacks assurance that it appropriately or consistently uses the results of criminal history background checks to prevent dishonest, untruthful, or otherwise at-risk individuals from entering the real estate profession. This raises questions of inequitable treatment of license applicants and leaves commissioners and Division staff vulnerable to potential abuses of the process. While we recognize that discretion and judgment are necessary, the Commission should, at a minimum, have standard written criteria, guidelines, and documentation standards to ensure accountability for its licensing decisions.

Recommendation No. 2:

The Real Estate Commission should work with Division of Real Estate staff to ensure that licensing decisions for individuals with criminal histories are appropriate, consistent, and equitable by:

- a. Assessing the need for additional statutory guidance, including mandatory disqualification criteria, and seeking statutory change as appropriate.
- b. Establishing standard written decision criteria and guidelines that, at a minimum, include specific crimes and factors to be considered in the review of applications.
- c. Assessing and implementing appropriate standards for documenting the rationale, decision criteria, and staff recommendations relevant to licensing outcomes.

Real Estate Commission Response:

Agree.

- a. Implementation Date: May 2005. The Division will, in conjunction with legal counsel and Commission discussion, assess the need for additional statutory guidance, including mandatory disqualification criteria by May 2005.
 - b. Implementation Date: February 2005. The Division will establish standard written decision criteria (factors to be considered) and guidelines for the Commission in its deliberations on license applicants with criminal backgrounds by February 2005.
 - c. Implementation Date: July 2005. The Division (by February 2005) will seek an Attorney General opinion on the propriety for recording in the minutes of Commission meetings, the rationale, decision criteria, and staff recommendations pertaining to licensing matters involving criminal background. Such assessment will include analysis of potential legal ramifications associated with such process, including potential conflict with the Administrative Procedure Act, deliberative process privilege, immunity issues, open meetings and records provisions, and other legal concerns associated with publication of these matters prior to final agency action on the affected application. Any resulting policy, procedure, and guidelines will be implemented by July 2005.
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Subdivision Developers

In addition to licensing real estate brokers, the Division also issues certificates of registration to subdivision developers operating in the State. A subdivision is defined as real property divided into 20 or more interests solely intended for residential use, including timeshares, conversions of existing structures into a common interest community (e.g., loft/condominium conversions), and groups of proprietary leases in a cooperative housing corporation. Statutes require developers to register with the Division “before selling, leasing, or transferring or agreeing or negotiating to sell, lease, or transfer, directly or indirectly, any subdivision or any part thereof.” [Section 12-61-402, C.R.S.] Registration requirements are in place to ensure that subdivision developers give full and fair disclosure of information related to the subdivision and the developer prior to offering property for sale, lease, or transfer. As of June 30, 2004, there were approximately 180 subdivision developers registered with the Division.

During our audit we found that the Division’s criminal history review of subdivision developer applicants is insufficient. We also identified errors in the Division’s electronic data records for subdivision developer registrations. These problems limit the Division’s ability to provide assurance that the public is served by honest subdivision developers who are able to and will deliver what is promised to the consumer.

Background Checks

Statutes require individuals to disclose on their application for a subdivision developer registration any felony convictions within the last 10 years. Unlike real estate broker license applicants, statutes do not grant the Division authority to obtain fingerprints from subdivision developer registration applicants for purposes of conducting criminal history record checks through the CBI or the FBI. In addition, we found that while the Division has access to Colorado criminal court records data, staff do not use this database to search subdivision developer applicants for prior criminal activity on a statewide basis. Consequently, the Division’s criminal history review of subdivision developer applicants is based largely on information self-reported by the applicant.

We worked with Judicial Department staff to conduct criminal court records searches through the Integrated Colorado Online Network (ICON) for a sample of 29 subdivision developers based in Colorado. Of the 29 names searched, 2 yielded a possible match. Our ICON search for one subdivision developer yielded a possible match to an individual with a criminal conviction for theft (Class 4 Felony). The second subdivision developer had a common name and our ICON search yielded

matches to 11 separate individuals, each with felony charges and convictions including theft, burglary, and forgery. However, due to lack of sufficient identifying information, such as full legal name or date of birth, we were unable to positively link our search results to the two sampled developers. Neither developer disclosed prior criminal activity on their application. The Division should follow up on the results of our audit work to determine whether the two subdivision developers we identified had prior criminal convictions that were not properly disclosed and take action as appropriate.

Although statutes do not require applicants to disclose non-felony crimes, our ICON search also revealed that 3 of the 29 sampled developers had prior misdemeanor convictions for harassment, soliciting for prostitution, and carrying a concealed weapon.

Since statutes require applicants to disclose felony crimes, it appears that the General Assembly intended that criminal history be a factor in the Division's review of subdivision developer registration applications. However, the Division should have sufficient authority and capability to conduct criminal background checks independent of information provided by the applicant. Conducting national searches is important, since 49 percent of the active subdivision developers are based outside the State. The only way to conduct a national search is through a fingerprint-based FBI criminal history record check. Moreover, the Division should capture identifying information, such as full legal name or date of birth, on the application to better facilitate statewide searches of Colorado criminal court records.

Electronic Records

Statutes specify that all certificates of registration for subdivision developers shall expire on December 31 following the date of issuance unless renewed by payment of a renewal fee. Our analysis of data from the Division's electronic licensing system revealed that 370 of the 555 (67 percent) subdivision developer certificates of registration on record with the Division had expired, yet the system listed the registration status as "active." Some of the active certificates of registration we identified had expired as far back as December 1987. According to Division staff, the licensing system was never programmed to place subdivision developer registrations on "inactive" status when the expiration date comes due. We found that the Division has known about these problem subdivision developer records for several years. However, staff only began to systematically correct the problem records during our audit.

Without proper system controls, the Division cannot ensure that expired certificates of registration are appropriately placed on inactive status. This increases the risk that subdivision developers will continue to operate in the State without an active

certificate of registration and that public consumers of Division data will be supplied with incorrect registration information.

Recommendation No. 3:

The Division of Real Estate should improve its registration of subdivision developers by:

- a. Seeking statutory authority to require a state and national fingerprint-based criminal history record check of subdivision developer applicants through the Colorado Bureau of Investigation and the Federal Bureau of Investigation.
- b. Capturing sufficient identifying information, such as full legal name and date of birth, on the subdivision developer application for purposes of performing statewide searches of Colorado criminal court records databases.
- c. Correcting the problem subdivision developer records we identified and implementing proper system controls to ensure that certificates of registration for subdivision developers do not remain active past their expiration date.

Division of Real Estate Response:

Agree.

- a. Implementation Date: 2005 Legislative Session. The Division would welcome legislation requiring that subdivision developer applicants initiate and pay for background checks directly through the Colorado Bureau of Investigation prior to issuance of certification. Additional rules related to this requirement will be developed for adoption by the Commission upon implementation of the proposed statutory authority. Such legislation should consider exemption for publicly traded entities.
- b. Implementation Date: January 2005. The Division will amend its application forms and criteria (by January 2005) to capture sufficient identifying information for purposes of performing statewide searches of Colorado criminal court records databases.
- c. Implementation Date: August 2005. The Division is in the process of correcting the current database of inactive subdivision developers and will accomplish this task prior to the conversion of the new database and

records management system that is scheduled for full operational capacity by August 2005.

Errors and Omissions Insurance

Pursuant to Section 12-61-103.6, C.R.S., every real estate broker must maintain a policy of errors and omissions insurance as a condition of holding an “active” license. When a real estate broker does not have errors and omissions insurance, the Division places the license on “inactive” status, thereby prohibiting the licensee from engaging in real estate brokerage activity. Errors and omissions insurance is a specific form of professional liability insurance that covers mistakes while a broker is acting in a professional capacity on behalf of another party. For example, real estate brokers, acting on behalf of a seller, may misrepresent facts (an error) or fail to disclose known information (an omission) to a buyer. In many cases, the broker can be held responsible for these mistakes, even if the mistake was unintentional. Errors and omissions insurance is intended to provide the public with a reasonable level of financial protection from losses suffered as a result of these mistakes. Losses resulting from fraud or other intentionally dishonest, criminal, or malicious acts are not covered by errors and omissions insurance.

Statutes further direct the Commission to make errors and omissions insurance available to all licensed real estate brokers by contracting through a competitive bidding process for a group insurance policy (Group Plan). Although the Commission contracts for a group errors and omissions insurance policy, statutes do not require brokers to participate in the Group Plan. Brokers are permitted to obtain errors and omissions insurance coverage through an independent insurer provided that the independent coverage complies with minimum requirements established by the Commission. In the remainder of this chapter, we discuss deficiencies we identified with the Division’s internal controls to monitor insurance coverage for those brokers who do not participate in the Group Plan, as well as gaps in the Division’s use of data on errors and omissions insurance claims. We discuss broader policy concerns regarding the Division’s errors and omissions insurance program later in Chapter 3.

Group Plan Participation

From January 1998 through December 2003, the Group Plan was administered under contract with Williams Underwriting Group, Inc. The Commission secured a new contract beginning in January 2004 with Rice Insurance Services Company (RISC) to administer the Group Plan. The current contract is set to expire in December 2006 with options to renew for another two years thereafter. We obtained a download of licensing data from the Division and found that as of May 2004, approximately 19,600 real estate brokers (54 percent of the total active license population) participated in the Group Plan through RISC. Another approximately 15,550 real estate brokers (43 percent of the total active license population) retained their errors and omissions insurance through the prior Group Plan administrator, Williams Underwriting Group. On a daily basis, RISC and Williams Underwriting Group upload insurance data into the Division's licensing system for purposes of identifying brokers without current errors and omissions insurance and placing these individuals' licenses on "inactive" status. We reviewed a sample of 20 real estate brokers who maintain errors and omissions insurance through RISC and Williams Underwriting Group and did not identify any errors in our sample. This provided us with reasonable assurance that the daily electronic data match is working properly.

Non-Group Plan Participation

Based on our analysis of licensing data, we determined that approximately 1,275 real estate brokers, or 3 percent of the total active license population, maintain errors and omissions insurance coverage through an insurer that is not currently or formerly affiliated with the Group Plan. We reviewed a sample of 25 of these brokers and found that the Division does not have sufficient controls in place to monitor errors and omissions insurance coverage for brokers who obtain insurance independently. Specifically, we found:

- **Unauthorized insurance companies and agencies.** The errors and omissions insurance policy covering 2 of the 25 sampled brokers did not appear to comply with a Commission rule requiring independent insurers to be authorized and licensed by the Division of Insurance before writing policies of errors and omissions insurance in the State. We worked with Division of Insurance staff, and at the time of our review, the insurance company for one broker did not appear to be authorized to write real estate errors and omissions policies. The insurance agency selling the policy to the second broker did not appear to be licensed by the Division of Insurance as an insurance producer. During our audit, the Division of Insurance management reported they need more information from the Division of Real Estate before they can make a conclusive determination on these two cases.

The Division of Real Estate should continue to work with the Division of Insurance to follow up and determine whether the insurance company and insurance agency we identified in our sample were in compliance with state insurance statutes and take action as appropriate.

- **Licensing system errors.** The Division's electronic licensing system does not appropriately identify and inactivate licenses of real estate brokers without errors and omissions insurance coverage. During our review we identified two real estate brokers who had active licenses, despite the fact that one broker's independent errors and omissions insurance policy had been expired for nearly three months, and the independent errors and omissions insurance policy maintained by the second broker's employer had been expired for approximately eight months. We also found an incorrect policy expiration date for a third broker.

Inadequate Controls

Commission rules require real estate brokers with independent errors and omissions insurance coverage to submit an affidavit to the Division certifying that the policy complies with all applicable requirements. While it is a good practice to require affidavits of independent errors and omission insurance coverage, the problems we identified are evidence that affidavits provide minimal assurance that insurance requirements are actually being met. Affidavits were on file at the Division for all 25 sampled real estate brokers we reviewed, including those discussed above.

Currently Commission Rule D-14(c)(3)(vii) includes language stating "the Commission will make no independent determination of whether individual policies meet the requirements [for independent errors and omissions insurance]." We question the appropriateness of a regulatory body passing rules prohibiting active monitoring of critical requirements and aspects of the industry it is charged with overseeing. The Division needs to take steps to ensure that real estate brokers who choose not to participate in the Group Plan maintain complying policies of independent errors and omissions insurance. These steps should include searching Division of Insurance databases for unauthorized or unlicensed companies and referring discrepancies to the Division of Insurance. The Division should also modify the affidavits used to certify independent errors and omissions insurance coverage. Our discussions with Division of Insurance management indicated that searches of the Division of Insurance databases as well as any subsequent investigations of insurance companies would be enhanced by capturing more information such as the insurance company's full legal name and National Association of Insurance Commissioners (NAIC) identification number, as well as the name and license number of the individual agent and agency selling the policy.

Ensuring that licensed brokers maintain a policy of errors and omissions insurance as mandated by statutes is an essential part of protecting the public. Lack of effective controls increases the risk that real estate brokers will hold active licenses and engage in real estate transactions without appropriate errors and omissions insurance coverage. Lack of errors and omissions insurance coverage increases the risk to the public that financial losses resulting from unintentional errors and mistakes made by real estate brokers will not be recovered.

Recommendation No. 4:

The Real Estate Commission should repeal the provisions of Rule D-14(c)(3)(vii) prohibiting determination of whether errors and omissions policies independent from the contracted group policy comply with Commission requirements.

Real Estate Commission Response:

Partially agree. Implementation Date: March 2005. The Commission does not agree that a full repeal of Rule D-14 (c)(3)(vii) is appropriate, however it does propose a revision to Rule D-14 (c)(3)(vii) to include verification by Division staff of proper registration of insurers and producers with the Division of Insurance and authorization to transact insurance business in the State of Colorado, and inclusive of those procedural matters addressed in Recommendation No. 5. Such revised rule is to be considered for adoption by the Commission at the March 2005 rule-making hearing. In the interim, the Division has developed a procedure and is performing such verifications with the Division of Insurance.

Recommendation No. 5:

The Division of Real Estate should develop formal procedures to ensure that independent errors and omissions insurance policies maintained by licensed real estate brokers comply with Commission rules and state statutes. At a minimum, these procedures should include:

- a. Working with the Division of Insurance to verify that independent errors and omissions insurance policies are obtained through insurance companies and insurance producers authorized and licensed to transact business in the State. Questions of inappropriate behavior by insurance companies or insurance agencies should be referred to the Division of Insurance for further investigation.

- b. Modifying the independent errors and omissions insurance affidavit to capture more complete identifying information on the insurance company and insurance agency affiliated with the policy.
- c. Improving electronic licensing system functionality to properly identify and inactivate licenses of real estate brokers whose independent errors and omissions insurance has expired.

Division of Real Estate Response:

Agree.

- a. Implementation Date: Implemented. The Division has developed and implemented procedures to work with the Division of Insurance to verify that independent errors and omissions insurance providers are properly registered and authorized to conduct business. These procedures include notification to the Division of Insurance of companies or agencies involved in questionable activities.
- b. Implementation Date: January 2005. The Division will amend its affidavit forms and criteria (by January 2005) to capture sufficient identifying information on the insurance company and insurance agency affiliated with the policy to facilitate confirmation of proper registration.
- c. Implementation Date: August 2005. The Division's electronic database and records management system (developed almost 20 years ago) is inadequate to support many of the Division's business operations and management needs, such as tracking and controls. The current system lacks the functionality to monitor and control compliance with many business rules, including functionality to properly identify and inactivate licenses of real estate brokers whose independent errors and omissions insurance has expired. The Division, in conjunction with the Department, developed (June 2004) a Request for Proposal for a Records Management System (RFP) that will fully support the business needs of the Division as it relates to operations and management. This system will include web-based support of e-government capabilities, internal and external user functionality, interface of data transfer, tracking and monitoring, analysis reports, controls and accountability. The RFP was released October 20, 2004. Bid responses are due November 30, 2004, with a contract date of January 15, 2005. The RFP calls for full functionality in support of the Division's system needs by August 2005. The Division anticipates that the new Records Management System will dramatically improve effectiveness and efficiency by eliminating the

Division's stand-alone tracking systems, many of which are paper based. It is anticipated that the new RMS will include the functionality to properly identify and inactivate licenses of real estate brokers whose independent errors and omission insurance has expired.

Use of Claims Data

Under the terms of the contract, the Group Plan administrator supplies the Division with quarterly reports on the number of open and closed errors and omissions insurance claims, the dollar value of claim payments, the costs of legal defense on the claims, and the allegation or basis for the claim. While this is important information, we found the Division has not been proactive in analyzing existing errors and omissions insurance claims data or pursuing additional data when necessary. Specifically, the Group Plan contract specifies that errors and omissions insurance claims data are to be reported by claim number only, not by the name of the real estate broker. There are no claims reporting requirements for independent errors and omissions insurance policies. Thus, the Division lacks the data necessary to identify brokers with multiple insurance claims, to relate insurance claims to complaint data, or to further investigate the basis for insurance claims. In October 2001 the Commission expressed concern that the Division does not receive the names of brokers who have had errors and omissions insurance claims against them.

We identified a number of ways the Division could analyze errors and omissions insurance claims data to enhance its education, monitoring, and enforcement efforts:

- **Identify brokers with multiple claims.** We obtained data from the current Group Plan administrator on 93 errors and omissions claims filed against 81 real estate brokers between January and June 2004. Although the claims data are for a limited time period, we identified instances of multiple claims against brokers. Of the 81 brokers represented by the data, 10 brokers (12 percent) had 22 claims against them (an average of 2.2 claims per broker). These multiple claims represent 24 percent of all errors and omissions insurance claims filed during the time period we examined. Multiple errors and omissions insurance claims over a given time period could indicate a lack of competency on the part of the broker. In such cases, it is reasonable to expect that the Division should pursue additional discipline against the broker. Other states with state-contracted group errors and omissions insurance programs (Idaho, Kentucky, and Louisiana) regularly track errors and omissions claims by individual broker and by real estate firm. Real estate brokers with multiple errors and omissions insurance claims against them represent a greater risk and are more expensive to insure. Failing to

identify and address patterns of multiple errors and omissions insurance claims could lead to higher group premiums and difficulty obtaining competitive bids for the Group Plan contract in the future.

- **Relate insurance claims to complaint data.** We searched the Division's complaint records and found that 4 of the 10 brokers we identified with multiple errors and omissions claims against them also had complaints on record with the Division. For example, we identified one broker who had three complaints filed against her in August and October 2003 alleging dishonest dealings and two errors and omissions claims filed against her in February 2004 alleging breach of contract and breach of duty. While we were unable to discern whether the complaints and the errors and omissions insurance claims were related to the same real estate transactions, these data demonstrate a pattern of behavior for this individual broker that should warrant additional attention from Division staff.
- **Monitor the basis for claims.** We analyzed data on the 93 errors and omissions insurance claims filed under the Group Plan between January and June 2004 and determined that the most frequently occurring errors and omissions insurance claims alleged misrepresentation or nondisclosure (e.g., broker misrepresented the property or did not disclose latent defect with property), breach of duty, breach of contract, negligence, fraud, or problems with escrow funds. The Division should analyze the basis for frequently occurring errors and omissions insurance claims to help focus its educational and other outreach efforts to prevent future errors and omissions claims. Moreover, the Division's enforcement staff should be aware of and regularly monitor the status of claims alleging fraud or other intentionally dishonest, criminal, or malicious acts committed by the broker. This is important because if the broker committed acts that were intentionally fraudulent or dishonest, errors and omissions insurance will not cover losses to the public resulting from such behavior.

Because of the way in which errors and omissions insurance claims data have been gathered and reported since the program's inception, existing claims data cannot support the types of analyses we describe. Without the ability to identify patterns of behavior and tie errors and omissions insurance claims activity to specific brokers or firms, the Division cannot use this information to augment its existing education, monitoring, and enforcement functions and ensure public protection against incompetent and other at-risk real estate brokers.

Recommendation No. 6:

The Division of Real Estate should improve the collection and use of errors and omissions insurance claims data by:

- a. Working with the current Group Plan administrator to gather and report on claims data in a manner that permits tracking of claims activity by individual real estate broker, real estate firm, and other relevant characteristics.
- b. Analyzing errors and omissions insurance claims data on a regular basis to identify patterns of activity among individual real estate brokers and real estate firms that should warrant additional monitoring and investigation. At a minimum, such analysis should include identifying brokers with multiple claims, relating claims to complaint data, and monitoring the basis for claims.

Division of Real Estate Response:

Agree.

- a. Implementation Date: March 2005. The Division will negotiate with the group policy insurance provider to amend the existing contract to allow the Division to receive claims data and information that permits tracking of such data by individual licensees and real estate firms. Such negotiations for contract amendment will begin following the release of the audit report by the Legislative Audit Committee. It is anticipated that the contract amendment can be accomplished by December 2004 with subsequent claims data available by March 2005.
 - b. Implementation Date: March 2005. Beginning March 2005, the Division will analyze errors and omissions insurance claims data on a quarterly basis to identify patterns of activity among individual real estate brokers and firms that warrant additional monitoring and investigation.
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Monitoring & Enforcement

Chapter 2

Overview

In Chapter 1 we discussed problems related to the licensing of real estate brokers. The Real Estate Commission (Commission) and the Division of Real Estate (Division) are responsible for ensuring that real estate brokers, once licensed, remain qualified, honest, and competent to transact business in such a manner as to safeguard the public. Therefore, the Division and the Commission conduct activities aimed at monitoring the ongoing behavior of licensees to ensure they uphold the standards and fulfill the requirements associated with the privilege of being a licensed real estate broker in the State. Among its monitoring responsibilities, statutes direct the Commission to investigate all written complaints filed against real estate brokers and to conduct financial audits of real estate broker-controlled business accounts. If a complaint investigation or financial audit identifies inappropriate behavior or a license law violation, statutes grant the Commission authority to take disciplinary action against licensees. In this chapter, we discuss our findings and recommendations related to the Commission's and Division's ongoing monitoring and enforcement efforts. We identified weaknesses related to effective complaint management and enforcement practices that compromise the State's ability to protect the public from incompetent and dishonest real estate professionals.

Complaints Against Licensees

Statutes state that “the Commission, upon its own motion, may, and, upon the complaint in writing of any person, shall, investigate the activities of any licensee or any person who assumes to act in such capacity within the State.” [Section 12-61-113, C.R.S.] Thus, complaint resolution is a primary means by which the Division serves the public. According to the Division's complaint data, the Division received and investigated an average of about 840 complaints per year in each of the last four fiscal years. On average, just over two-thirds of these complaints (68 percent) were from members of the public, including other brokers, with the remaining complaints generated by the Division through its own monitoring efforts. Complaints range from minor allegations, such as unintentional misrepresentation, to more serious allegations of theft, fraud, and engaging in brokerage activity without a license. The Division's complaint data show that for the period July 1999 through May 2004, the five most frequent complaint allegations were unworthiness and incompetency (20

percent), noncompliance with continuing education requirements (18 percent), intentional misrepresentation (15 percent), dishonest dealings (8 percent), and unintentional misrepresentation (6 percent). It is important to note that, as we discuss in the next section, our audit identified problems with the accuracy of the Division's complaint data. Therefore, these summary statistics are provided for descriptive purposes only.

Complaint Management

When the Division receives a complaint against a real estate broker, it is assigned to an investigator. If a complaint is within the Division's jurisdiction and the investigator determines the complaint has merit, a formal case is opened. Complaints outside the Division's jurisdiction, such as complaints against title companies or mortgage brokers, are referred to the appropriate agency. Division staff reported that some complaints can be handled easily by a telephone call or by a letter to the complainant. Other complaints are more complex and may require more lengthy investigation. Staff also reported that during the last several fiscal years, complaints have become increasingly more complex to investigate.

To manage the complaints it receives, the Division uses an electronic database known as the Agency Records Management System (ARMS). In addition to ARMS, the Division relies on multiple, stand-alone logs maintained by individual investigators and administrative staff to track complaint information. We reviewed the Division's processes and systems for managing and maintaining complaint-related information. Overall, we determined that the Division lacks a comprehensive, integrated complaint management system to provide accurate, easily accessible information on complaints against licensees from receipt through disposition. Specifically, we found the following:

- **Basic data on the number of complaints assigned for investigation does not reconcile.** We analyzed three of the Division's primary complaint logs and found that summary complaint figures frequently differ between the manual logs and ARMS. For the time period July 2001 through April 2004, there were 1,945 complaints assigned in the Division's complaint log, 2,016 complaints assigned in the Chief of Enforcement's complaint log, and 1,967 complaints assigned in the Agency Records Management System.
- **Errors exist in electronic records.** We obtained a download of ARMS data and identified a number of errors and inconsistencies. Specifically, we found that of 3,942 complaint records dated July 1999 through May 2004, 284 (7 percent) had assigned dates that preceded the date the complaint was received, 119 (3 percent) had two different resolution dates, and 36 (1 percent) had a resolution date that preceded the date the complaint was made.

We also identified 14 of 282 open complaint records (5 percent) with a resolution date.

Due to discrepancies between the Division's various complaint tracking systems, it is not possible to reliably determine the total number of complaints received during the period under review. Moreover, errors and inconsistencies in the complaint data lead us to question the overall reliability of summary reports and statistics generated from these data.

System Fragmentation

The problems we identified are symptoms of a fragmented complaint management system. Staff record and compile complaint data in 14 separate logs. Three logs are electronic databases and staff manually maintain the remaining 11 logs. There is no single log, electronic or manual, that consolidates all complaint information. For example, one log records the date the complaint was assigned to an investigator, but does not record the date the complaint was received by the Division. This date is recorded in a different log. In addition, we found that staff do not use the same date when entering information on the various logs. Accurate, reliable, and accessible complaint information is essential for effectively managing investigator resources, evaluating individual staff performance, providing feedback to complainants about the status of complaints, accounting for all complaints filed against real estate brokers, and measuring the Division's overall performance in this area.

In addition, the Division has not developed written policies and procedures for managing and tracking complaints. The electronic database (ARMS) also lacks proper system controls to prevent data entry errors. Furthermore, the Division needs to adopt quality control procedures, such as supervisory review, to ensure the consistency of complaint processing and to identify and correct errors and inconsistencies in complaint data. The Division has been working toward integrating all complaint logs into a comprehensive electronic system. The Division should continue moving toward this goal.

Recommendation No. 7:

The Division of Real Estate should ensure effective complaint management and accurate complaint data by:

- a. Developing standard, written policies and procedures for logging, maintaining, and reporting on complaint information.

- b. Improving electronic system controls and edits.
- c. Reviewing tracking logs on a regular basis for reconciliation purposes.
- d. Integrating manual logs into a central, comprehensive electronic system that tracks complete data on complaints from intake through disposition.

Division of Real Estate Response:

Agree.

- a. Implementation Date: February 2005. The Division will develop standard, written policies and procedures for logging, maintaining, and reporting on complaint information by February 2005, following determination of system support capabilities available upon award of the RFP for the new Records Management System described in Response No. 5 (c).
 - b. Implementation Date: August 2005. The Division will improve its electronic system controls and edits pertaining to complaint management upon implementation of the new Records Management System (as described in Response No. 5 (c)).
 - c. Implementation Date: August 2005. The Division will utilize the expected comprehensive management tools of the new Records Management System upon its implementation (as described in Response No. 5 (c)).
 - d. Implementation Date: August 2005. The Division will integrate its many stand-alone manual and electronic tracking systems and logs into the central comprehensive electronic system anticipated by the RFP for Records Management System (as described in Response No. 5 (c)).
-

Complaint Prioritization

When the Division receives a complaint, Division staff assess its seriousness. If staff determine that an investigation is warranted, they assign it one of three priority levels. As the table below shows, each priority level also has an expected timeline for completing the complaint investigation.

Colorado Division of Real Estate Complaint Priority Levels and Investigation Time Frames		
Priority Level	Priority	Time Frame for Completion
1	High	90 days
2	Moderate	120 days
3	Low or Routine	180 days
Source: Office of the State Auditor's analysis of Division of Real Estate data.		

We analyzed data on open complaints as of May 2004 and found the Division does not comply with its own prioritization requirements or complete investigations within required timelines. Specifically:

- Inconsistencies exist between priority levels and the seriousness of complaints.** We compared the assigned priority level with the complaint allegation for a sample of 15 open complaints. We found that 2 of the 15 complaints had priority levels inconsistent with the nature of the complaints. One complaint alleged unlicensed activity, a serious license law infraction. However, staff assigned this complaint the lowest priority level. The second complaint alleged what, according to Division staff, is a relatively minor infraction, yet staff assigned this complaint the highest priority level. In addition to our sample, we identified two other complaint cases alleging theft or conversion of funds. In both cases, staff assigned a moderate priority level. According to Division staff, complaints with a potential for direct harm to the public, such as theft, conversion of funds, and engaging in brokerage activity without a license, should be assigned the highest priority.
- Priority levels are not updated.** Staff do not formally update priority levels assigned to complaints as complaint investigations progress and circumstances change. The priority level initially assigned to a complaint is used throughout the investigation. The Division's system should allow consideration of factors, such as new information or additional complainants, that could warrant a change in priority level. The current system relies heavily on investigators' personal recollections of the specifics of each case.
- Highest priority is rarely assigned.** During our audit, staff reported that the majority of cases are assigned a moderate or routine priority level. While it is reasonable to expect that most complaints will not be of the most serious nature, at the time of our review, only 3 of the 237 open complaints (1 percent) had been assigned the highest priority level. As reported earlier, staff

told us that complaint investigations were becoming increasingly more complex. One would expect more complex investigations to be frequently associated with more serious or complex complaint allegations. Yet, this does not seem to be the situation given the relatively few high-priority investigations.

- **Complaint cases are frequently not resolved within the prescribed time frames and time frames are unusually long.** We analyzed data on all open complaints as of May 2004. As seen in the following table, we found that 49 out of 237 open complaints, or about 21 percent, remained open longer than the timelines associated with the assigned priority level.

Colorado Division of Real Estate Complaint Investigation Timeliness by Priority Level (Open Complaints as of May 25, 2004)						
Priority Level (Time Frame)	Days Open					Total
	1-90	91-120	121-180	181-270	Over 270	
Priority Level 1 (90 days)	2	0	1	0	0	3
Priority Level 2 (120 days)	44	9	16	17	2	88
Priority Level 3 (180 days)	86	12	35	13	0	146
Total	132	21	52	30	2	237

Source: Office of the State Auditor's analysis of Division of Real Estate data.
Note: Boldface line indicates complaints not investigated within established time frames.

Reassess Current System

The Division needs to improve its system for prioritizing and managing complaints. An effective complaint management system assists with assigning and allocating resources, monitoring complaint and workload trends, evaluating staff performance, supplying management and policymakers with needed operational information, and providing the parties to complaints with timely and accurate information on the status of investigations. Both the Arizona Department of Real Estate and the Oregon Real Estate Agency prioritize the complaints they receive. In addition, the Texas Sunset Commission has identified systems for prioritizing complaints as a "best practice"

approach for any regulatory agency. Weaknesses in the Division's current system, however, diminish its effectiveness.

Since the Division adopted the prioritization process in 1987 it has not reassessed its effectiveness. We believe it is time for the Division to do so, including determining whether existing timelines for complaint disposition are appropriate and reasonable. Timelines should be adjusted based on a review of experiences to date. As part of an assessment, the Division should adopt written policies and procedures to guide staff in prioritizing complaints and in documenting the factors considered in assigning priority levels. Finally, regular supervisory review should occur to ensure staff are applying appropriate procedures and guidelines.

Recommendation No. 8:

The Division of Real Estate should reassess the current complaint priority system and adopt written policies and procedures for assigning and evaluating priority levels throughout complaint investigations and for regularly reviewing open complaints to ensure timely investigation and disposition.

Division of Real Estate Response:

Agree. Implementation Date: January 2005. The Division will reassess the current complaint priority system and adopt written policies and procedures (by January 2005) for assigning and evaluating priority levels throughout complaint investigations and for regularly reviewing open complaints to ensure timely investigation and disposition.

Dismissed Complaints

After a complaint investigation is completed, Division staff determine whether the complaint should be dismissed or referred to the Commission for further consideration. Staff typically dismiss complaints if they lack merit, cannot be supported by evidence, or are outside of the Division's jurisdiction. Staff also may dismiss complaints if a settlement has been reached between the parties. Staff use their own judgment and rely on their institutional knowledge and experience in deciding whether to dismiss complaints or to refer them to the Commission. Since the beginning of Fiscal Year 2002, the Division has received and investigated about 2,000 complaints. Of this number, approximately 450 (22 percent) complaints were referred to the Commission and approximately 1,550 (78 percent) complaints were dismissed

by Division staff. It is reasonable to expect that many, if not most, complaints would not necessitate referral to the Commission. However, we are concerned with the high number of dismissed complaints, particularly in the absence of any criteria or documentation to guide and support the decisions made by staff.

We reviewed the investigative files for a sample of 10 dismissed complaints in which a settlement was reached between the parties. Staff told us the Division does not facilitate or participate in the settlement process. We identified two dismissed complaints involving serious allegations we believe Division staff should have referred or brought to the attention of the Commission:

- One complaint alleged that a licensed broker used \$3,500 in funds from an escrow account to pay off a personal gambling debt. The complainant, a real estate firm, supplied the Division with documentation supporting the allegations. According to the investigative report, the broker made a payment of \$3,500 to settle the matter. Subsequently, the real estate firm contacted the Division reiterating its concern with the broker's actions. Documentation in the investigative file indicates that Division staff dismissed this case as a settlement and did not refer it to the Commission because the broker reimbursed the funds in question. Division staff later reported to us that the case was dismissed because it did not fall within the Division's jurisdiction. Regardless, we do not believe this case or cases like it should be dismissed without further scrutiny by the Commission. Based on documentation in the investigative file, it appears the broker inappropriately used funds from an escrow account to repay a gambling debt. The presence of a gambling debt, combined with the broker's access to funds, provides motivation and opportunity, increasing the risk of fraudulent activity. Division staff should not have discretion to dismiss cases of this nature without referral to the Commission. In addition, as we discuss later in this chapter, Division staff should refer potentially criminal activities to appropriate law enforcement agencies.
- Another complaint alleged dishonest dealings in that a licensed broker failed to honor a rental service agreement. According to the complaint, after the complainant paid the broker a fee, the broker never provided the agreed-upon service. The Division closed this case as a settlement because, according to the investigative report, the broker refunded the rental service fee as a result of the investigation. In reviewing the complaint files, we identified 10 additional complaints against this broker for similar business practices, all of which had been dismissed. This appears to be a pattern of behavior for this broker; however, Division staff never made the Commission aware of any of these complaints.

The Division needs to develop written policies and procedures outlining the criteria to be used when dismissing complaints. Examples of relevant decision criteria could include the seriousness of the complaint, the type of violation, the quality of evidence supporting the allegations, and prior complaints against the same broker. The Division's auditing section has developed criteria for the disposition of its financial audit findings. Without similar written criteria to guide the disposition of complaint investigations, the Division runs the risk of appearing subjective and inequitable in its treatment of complainants and brokers. Finally, the Division cannot ensure that the Commission is sufficiently apprised of serious license law violations so that the Commission can review these cases and take appropriate action.

Recommendation No. 9:

The Division of Real Estate should ensure the appropriate and consistent disposition of complaint investigations by developing formal written policies, procedures, and decision criteria to be used when dismissing complaints or referring complaints to the Real Estate Commission.

Division of Real Estate Response:

Agree. Implementation Date: March 2005. The Division will reassess the current complaint evaluation process and develop formal written policies, procedures and decision criteria (by March 2005) to be used when dismissing complaints or referring complaints to the Commissioners.

Commission Decisions

Statutes authorize the Commission to discipline real estate brokers for a variety of violations and infractions, including misrepresentation or false advertising; converting, diverting, or commingling funds of others; demonstrated unworthiness or incompetency; violating provisions of the Colorado Consumer Protection Act; and failing to exercise reasonable supervision over the activities of licensed employees. In addition, by statute, the Commission may take the following disciplinary actions:

- Impose an administrative fine not to exceed \$2,500 for each separate offense.
- Censure a licensee, place a licensee on probation, temporarily suspend a license, or permanently revoke a license.

- Issue a letter of admonition for instances of broker misconduct which do not warrant formal action, but which should not be dismissed.

Typically, if the Commission censures a broker or takes any action on a broker's license, such as suspension or revocation, the disciplinary action is made public. That is, the censure or the license action is published in the Division's quarterly newsletter and included on the Division's Web site. Administrative fines and other actions, such as restitution or additional continuing education requirements, may or may not be publicized. Letters of admonition are not made public.

As mentioned previously, Division staff referred approximately 450 complaints to the Commission since the beginning of Fiscal Year 2002. The majority of these complaints, approximately 425 complaints (94 percent), resulted in some type of license action, administrative fine, probation, restitution, continuing education, or a combination thereof. About 25 complaints (6 percent) resulted in a letter of admonition.

We reviewed a sample of 49 disciplinary cases involving 49 different licensed brokers from Fiscal Years 2002 through 2004. As described below, we had concerns regarding the actions taken by the Commission in a number of these cases:

- **Similar infractions received significantly different disciplinary actions.** During a one-year period, the Commission heard complaints against three separate real estate brokers for operating unlicensed property management companies. However, in each case the Commission imposed different discipline. One broker received a \$1,000 fine and notice of the discipline was published in the Division's newsletter and on its Web site. The second broker received a \$250 fine and was required to complete eight hours of continuing education. The third broker received only a \$500 fine.

We also identified one broker who, after being licensed, was convicted of two felony counts of conspiracy to commit criminal impersonation and two counts of felony forgery. The Commission imposed a license suspension of no less than 30 days to continue until court-ordered restitution in the criminal case was paid. In another case, a broker failed to disclose a felony criminal conviction for theft on his license application. The Commission revoked this broker's license.

- **Disciplinary actions are reduced.** If a real estate broker does not agree with the Commission's decision on disciplinary action, the broker may present a counteroffer to the Commission. The Commission may reject the counteroffer, thereby upholding the original action, accept the counteroffer as proposed, or reject the counteroffer but amend the original action. We identified five

brokers in our sample who made counteroffers to the Commission. As detailed in the following table, the Commission subsequently reduced the discipline for four of these brokers. We found inadequate justification and documentation of the conditions warranting these substantial reductions in discipline.

Colorado Division of Real Estate Reductions in Disciplinary Action		
Violation	Original Action	Revised Action
Theft/Conversion of Funds	Revoke license	15-day suspension
Theft/Conversion of Funds	Revoke license	1-year suspension
Willful Misrepresentation	Revoke license	60-day suspension, 16 hours of continuing education
Dishonest Dealing	90-day suspension, \$1,000 fine, and \$3,000 restitution	Public Censure, \$500 fine, 16 hours of continuing education
Source: Office of the State Auditor’s analysis of Commission disciplinary cases from Fiscal Years 2002 through 2004.		

Overall, the Commission needs to strengthen the effectiveness and deterrent value of its enforcement actions in several ways. Similar to our findings related to licensing decisions, the Commission lacks defined criteria for use in determining disciplinary actions against brokers whom the Commission has found to have acted inappropriately or in violation of license law. The four commissioners who responded to our survey identified several factors, such as intent, public harm, prior complaints, and staff recommendations, as factors they consider when determining disciplinary sanctions. We agree these are all reasonable and relevant factors. However, the Commission needs to articulate the factors it considers. This should include formal progressive discipline policies, particularly for repeated violations of the same policy or license law. The Transportation Section of the Public Utilities Commission recently created policies and procedures outlining the factors it takes into consideration when determining disciplinary actions, including standards for progressive discipline, and assessing and reducing penalties.

The Commission’s counteroffer process can be a valuable tool for both the Commission and disciplined real estate brokers because it allows for adjustments when additional evidence is provided warranting reductions in discipline. However, the Commission needs to document the reasons why reductions are warranted.

Finally, the Commission needs to determine whether to make all disciplinary actions public. As stated previously, while actions taken against broker licenses are always published in the Division's newsletter and on the Division's Web site, administrative fines and other remedial actions are not necessarily made public.

The Commission's primary responsibility is to protect the public by enforcing Colorado's real estate laws. This includes disciplining real estate brokers found to have violated such laws. Without standard written policies and procedures and adequate documentation justifying disciplinary decisions, the Commission cannot ensure that disciplinary actions taken against real estate brokers are equitable and remain consistent with the severity of the infraction, that repeat offenders are more severely disciplined, or that reductions in disciplinary action are appropriate.

Recommendation No. 10:

The Real Estate Commission should strengthen the effectiveness of its disciplinary actions by working with Division staff to:

- a. Develop written criteria and guidelines for use in determining disciplinary actions against real estate brokers. At a minimum, these guidelines should include the factors to be considered when determining the appropriate discipline, provisions for progressive discipline, and standards for accepting counteroffers from disciplined brokers.
- b. Assess and implement appropriate standards for documenting the rationale, decision criteria, and staff recommendations relevant to disciplinary actions.
- c. Make information regarding disciplinary actions more widely available and easily accessible to the public.

Real Estate Commission Response:

Agree.

- a. Implementation Date: June 2005. The Division, in conjunction with legal counsel and Commission discussion, will (by June 2005) develop criteria and guidelines for use in determining disciplinary sanctions to be imposed against real estate brokers. Such assessment will include analysis of potential legal ramifications associated with the various means of establishing such guidelines. It is anticipated that the resulting guidelines will include the factors to be considered when determining the appropriate

discipline, provisions for progressive discipline and standards for accepting counteroffers.

- b. Implementation Date: August 2005. The Division (by July 2005) will seek an Attorney General opinion on the potential legal consequence of establishing documentation of the specific rationale, decision criteria and staff recommendations regarding disciplinary sanctions decisions within the minutes of the Commission or in the disciplinary files. Such assessment will include analysis of potential legal ramifications associated with such process, including potential conflict with the Administrative Procedure Act, deliberative process privilege, immunity issues, open meetings and records provisions, and other potential legal concerns associated with publication of these matters prior to the entry of a final agency order imposing discipline. Any resulting recommendation will be implemented by August 2005.
- c. Implementation Date: March 2005. The Division currently provides records of real estate broker discipline on its Web site. This online system makes certain scanned documents related to disciplinary actions taken on all Colorado licensees available to the public via the Internet. Stipulations, Final Agency Orders, Suspensions and Revocations in effect within the last 10 years, are among the documents that are available. The Division will consider what it must do to make such disciplinary actions more widely available and easily accessible to the public, and make recommendations for implementation of such additional measures by March 2005.

Compliance Monitoring

When the Commission takes disciplinary action, it specifies the time period within which the broker must comply with the terms of the action. The various terms or provisions of a disciplinary action against a single broker may have different compliance dates. For example, a broker may be required to pay restitution within 20 days and complete additional education requirements within 90 days. The broker is to provide the Division with proof of his or her compliance. Different staff within the Division are responsible for tracking compliance with the various terms of every disciplinary action.

We reviewed documentation on the disciplinary actions for the previously identified sample of 30 real estate brokers against whom the Commission took action between

July 2001 and May 2004. Following were the specific actions taken against these brokers:

- 19 brokers (63 percent) were required to complete between 2 and 24 hours of additional continuing education.
- 14 brokers (47 percent) were assessed administrative fines ranging from \$250 to \$2,500.
- 9 brokers (30 percent) had their licenses suspended for five days to one year.
- 7 brokers (23 percent) were publicly censured.
- 6 brokers (20 percent) were required to pay restitution.
- 3 brokers (10 percent) were placed on probation for two to four years.
- 1 broker (3 percent) had his license revoked.

We found that the Division did not sufficiently monitor compliance with the terms of the disciplinary actions for at least 10 of these 30 brokers to ensure the terms were met. Specifically, we found:

- **Division errors.** We determined the Division did not appropriately suspend licenses for 2 of the 30 brokers (7 percent). The Commission suspended one broker's license for six months. However, according to data from the Division's records management system, ARMS, no suspension occurred. A second broker's license was to be suspended until full payment of restitution. We found, however, that the Division reinstated the broker's license prior to payment of full restitution.
- **Noncompliance.** Six brokers (20 percent) did not comply with disciplinary actions. In three cases, brokers did not provide the Division with proof of restitution payments, and in two other cases, brokers did not provide proof they had completed additional continuing education requirements. The sixth broker completed the additional continuing education requirements, but completion did not occur until almost seven months after the due date.
- **Substitutions and extensions.** We identified four brokers (13 percent) who met compliance with the terms of their disciplinary actions only after Division staff either accepted alternatives to specified Commission actions or extended due dates. For example, disciplinary action against one broker required completion of 16 hours of additional continuing education within 60 days.

However, Division staff accepted classes that were taken almost two years before the disciplinary action occurred. Disciplinary action against another broker required payment of restitution by July 30, 2003. Division staff extended the payment due date by one month. In neither of these cases did documentation exist explaining the adjustments made by staff. Moreover, we found no evidence that the Commission has delegated authority to Division staff to extend due dates on restitution payments.

During our audit we also found that the Division is reluctant to pursue additional action when compliance with disciplinary action is not met. When disciplinary actions are taken against real estate brokers, the Commission includes provisions for additional sanctions if the broker does not comply with the terms of an imposed disciplinary action. However, we found the Division has pursued additional sanctions for noncompliance only once since July 1999. Failing to pursue additional action against brokers who have not complied with the terms of disciplinary actions undermines the disciplinary process and leads us to question the overall effectiveness of the Division's enforcement of real estate license laws.

In July 1991 the Commission delegated to Division staff the authority to modify due dates for payment of administrative fines and to make course substitutions for continuing education requirements. More recently, during our audit, the Commission delegated to Division staff additional authority to extend deadlines for completing continuing education requirements and to negotiate schedules for payment of administrative fines. Although the Commission has delegated to Division staff the authority for these activities, the Division has not adopted the needed controls to ensure the appropriate use of this delegated authority. In particular, the Division lacks policies and procedures to guide staff in monitoring compliance. There are no clearly defined criteria outlining when, why, and how Division staff can or should make changes to Commission-established disciplinary actions. The lack of defined policies and procedures can lead to confusion and inconsistencies in the administration of enforcement actions. In addition, staff do not adequately document proof of compliance. For example, proof that four brokers paid administrative fines was not contained in the disciplinary files. Although Division staff ultimately were able to provide us with the necessary documentation, it was not readily available. Maintaining adequate documentation provides a record that enforcement actions were exacted and compliance with corrective actions was fulfilled. In addition, maintaining documentation in a standard, easily accessible location, such as the disciplinary files, increases the efficiency of administrative operations. Finally, the Division lacks a comprehensive mechanism for tracking compliance with disciplinary actions. Currently several different staff members use computerized monthly calendars to track compliance. However, these individual calendars are not linked together, and shared access is limited. Summary information is not regularly provided to Division management for use in the needed supervisory review.

Inadequate compliance monitoring compromises the effectiveness of the Commission and the Division's enforcement functions. Without sufficient controls, such as those discussed above, the Division cannot provide the Commission and members of the public with assurance that real estate brokers found to have acted inappropriately or in violation of license laws are disciplined and have complied with the terms of disciplinary actions.

Recommendation No. 11:

The Division of Real Estate should ensure that real estate brokers comply with the terms of disciplinary action by:

- a. Developing and implementing policies and procedures outlining the compliance monitoring process. At a minimum, these policies and procedures should provide decision criteria, processes for supervisory review, and documentation standards.
- b. Developing a more comprehensive compliance tracking log and regularly reporting compliance statistics to Division management and the Commission.
- c. Regularly pursuing additional sanctions against real estate brokers when the terms of disciplinary actions are not met.

Division of Real Estate Response:

Agree.

- a. Implementation Date: March 2005. The Division will (by March 2005) develop policies and procedures related to the current use of its electronic compliance tracking system. Such policies and procedures should be amended as needed to address the functionality of the new Records Management System capabilities (as discussed in Response No.5 (c)).
 - b. Implementation Date: August 2005. The Division will improve its electronic system tracking and controls pertaining to compliance management upon implementation of the new Records Management System described in Response No. 5 (c).
 - c. Implementation Date: Ongoing. The Division will regularly pursue additional sanctions against brokers when the terms of disciplinary action (as may be amended by delegation of authority) are not met.
-

Additional Enforcement Powers

The Division does not have a formal policy for referring all criminal acts or potentially criminal acts committed by licensed brokers to the appropriate judicial authorities. Through complaint investigations and financial audits, Division staff may identify instances in which a licensed broker has engaged in or has potentially engaged in criminal activity such as theft, fraud, or embezzlement. In addition, by statute, it is a misdemeanor for anyone to act as a real estate broker without a license. However, the Division staff are not required by statutes, Commission rule, or internal policy to refer these and other criminal activities to appropriate law enforcement authorities. During our audit Division staff indicated that they have worked in conjunction with the Attorney General's Office and have made criminal referrals in the past. However, staff also stated they typically do not refer some lower-profile cases or cases involving minor violations because local district attorneys would be unlikely to pursue them. The decision to pursue criminal charges is a decision that should be made by appropriate law enforcement authorities and not by Division staff.

Other state agencies are mandated by statutes or by other directives to refer criminal activities encountered in the conduct of their official functions to the proper authorities. As a matter of policy, the Division of Registrations refers criminal or potentially criminal activity, including operating without a professional license, to local district attorneys. Referring criminal or potentially criminal acts committed by brokers, or unlicensed individuals, acting as brokers, to appropriate law enforcement agencies is in keeping with the Division's mission to protect the public from dishonest real estate practitioners. Moreover, the Division, as an agent of state government, needs to demonstrate due diligence in the conduct of its responsibilities. Ultimately, the Division will be held accountable for its actions and not the actions of other entities or authorities who may choose not to pursue criminal charges.

Recommendation No. 12:

The Real Estate Commission and the Division of Real Estate should promulgate rules or seek statutory change to require the referral of criminal or potentially criminal acts uncovered in the conduct of their responsibilities to the Attorney General's Office or to local district attorneys, as appropriate.

Real Estate Commission and Division of Real Estate Response:

Agree. Implementation Date: October 2005. The Commission and the Division would welcome statutory change to require the Real Estate Commission to refer criminal or potentially criminal acts uncovered in the Commission's audit and enforcement activities to the Attorney General's Office, local District Attorneys or other appropriate criminal authority. Corresponding rules will be promulgated in October 2005.

Financial Audits

Statutes assign the Division's director the duty to conduct financial audits of licensees' business accounts. Commonly referred to as "escrow" or "trust" accounts, these accounts contain third-party funds, such as earnest money for the purchase of property or security deposits for rental properties, over which the licensed real estate broker has a custodial responsibility. The Division conducts financial audits of real estate brokerage accounts on a routine basis using risk-based criteria to select the accounts to be audited. The purpose of the audits is to verify that brokers handle and account for third-party funds in a manner that protects the public interest. The Division's auditors evaluate accounts for fraudulent or inappropriate activity such as diversion of funds for personal use, conversion of funds to another owner, or commingling of funds belonging to separate individuals.

According to Division data, estimated daily escrow account balances maintained by real estate brokers averaged \$417.4 million during the last three fiscal years. The Division audits approximately 9 percent (\$39 million) of these account balances each year. As the table below shows, the Division conducted financial audits of about 1,500 brokers between Fiscal Year 2002 and Fiscal Year 2004. As a result of these audits, the Division identified almost \$3.4 million in missing or unaccounted funds. At the time of our audit, more than one-half, or \$1.8 million, of these fund "shortages" had not been replaced.

Colorado Division of Real Estate Escrow Account Shortages Identified Fiscal Years 2002 Through 2004				
	Fiscal Year			Total
	2002	2003	2004	
Brokers Audited	488	626	402	1,516
Shortages Found	\$1,034,936	\$1,744,541	\$604,874	\$3,384,351
Shortages Replaced	\$688,111	\$305,077	\$585,026	\$1,578,214
Shortages Remaining	\$346,825	\$1,439,464	\$19,848	\$1,806,137
Percent of Shortages Remaining	33.5%	82.5%	3.3%	53.4%
Source: Office of the State Auditor's analysis of Division of Real Estate data.				

Division staff reported that the real estate brokers responsible for the unrecovered shortages detailed above have been unable to repay the missing funds and that in such cases, the Division sought revocation of the brokers' licenses. For example, one broker is responsible for almost all of the shortages remaining from Fiscal Year 2002. The Commission revoked this broker's license in August 2004. Four brokers are responsible for the more than \$1.4 million in unpaid shortages from Fiscal Year 2003. The Commission revoked two of the brokers' licenses and suspended indefinitely the license of the third. According to Division staff, the Commission does not have jurisdiction to revoke the fourth broker's license because the shortages involved activity that is exempt from the real estate brokerage laws. Staff were unable to explain satisfactorily the reason for including the approximately \$700,000 from this shortage in the Division's audit statistics. If this particular shortage is beyond the Division's jurisdiction or the Commission's authority to address through repayment or disciplinary action, then it is unclear why it appears among the escrow account shortages identified in Division audits.

Ensuring that fund shortages are repaid and that accounting errors are corrected is an important part of the Division's monitoring and enforcement efforts. The Division should continue to pursue disciplinary action against real estate brokers responsible for unpaid shortages identified in its audits. As noted in the prior recommendation, any audit that identifies the apparent illegal use of escrow funds should be referred immediately to appropriate law enforcement. This is especially important when a real estate broker or an individual under the broker's employ has actually diverted, converted, or otherwise misappropriated escrow funds for personal use.

Recommendation No. 13:

The Division of Real Estate should continue its efforts to ensure that all escrow and trust account shortages identified through financial audits are replaced and that disciplinary action is taken when appropriate.

Division of Real Estate Response:

Agree. Implementation Date: Ongoing. The Division will continue its efforts to ensure that all escrow and trust account shortages identified through financial audits are replaced and that disciplinary action is taken when appropriate.

Policy Issues

Chapter 3

Overview

In carrying out its statutory duties, the Division serves two distinct client groups—the real estate professionals it regulates and the public it protects. During our audit we determined that the Division’s focus is primarily on the first of these groups: real estate professionals. Much of the Division’s day-to-day operations include licensing, educating, insuring, and disciplining real estate brokers. However, as discussed throughout this report, we identified weaknesses in these basic regulatory functions that raise questions about the Division’s ability to protect the public and ensure the integrity of the industry. We believe the Division could do more to serve the consumers of the State. In this chapter we present findings and recommendations related to improving the Division’s orientation toward public consumers.

Consumer Issues

We reviewed the Division’s efforts to identify consumer complaints against brokers, help members of the public navigate the complaint process, and keep the public apprised of complaints and disciplinary actions against brokers. We found that the Division needs to focus more of its attention and resources in each of these areas to ensure it is the first point of contact for real estate–related consumer issues.

Citizen Complaints

We found that members of the public frequently file real estate–related complaints with agencies or entities other than the Division of Real Estate. Most significantly, we found that the Consumer Protection Section of the Attorney General’s Office does not routinely refer real estate–related complaints against businesses who may have violated the Consumer Protection Act or other consumer laws to the Division of Real Estate. Rather, as indicated on the Attorney General’s Web site, consumers are advised to contact the Better Business Bureau (BBB). We contacted the BBB and found it received more than 120 complaints against real estate brokers or firms during the past year. Complaints included allegations of misrepresentation and unfulfilled contract obligations. According to BBB data, one real estate firm received 120 separate complaints during the last 36 months. In contrast, our review

of the Division's complaint data showed that the Division received only two complaints against this same real estate firm during the same time period.

The Division should take steps to establish itself as the primary agency for real estate-related consumer complaints in the State. This should include coordinating complaint handling efforts with the Better Business Bureau, the Attorney General's Office, and other entities such as the Colorado Association of Realtors. Members of the public become frustrated when they cannot find the appropriate organization or resource to handle their complaints and regulatory problems. The Division needs to work with other consumer protection agencies to improve the communication and sharing of real estate-related complaint information.

Standard Complaint Form

Currently the Division requires individuals to file complaints in writing. However, the Division does not provide a standard complaint form for this purpose. Developing and using a standard complaint form provides a number of benefits. First, complaint forms simplify the process and increase the likelihood that complaints will be filed. Second, complaint forms assist complainants with including key information needed by the Division to substantiate and investigate a complaint. Finally, using a standard complaint form could help the Division better document and track complaints from receipt through disposition. For example, online submission of complaints could be made to automatically populate the Division's electronic complaint database.

Of the seven states we surveyed, six states (Arizona, Kentucky, Nebraska, Oregon, Utah, and Wyoming) have a standard complaint form available on their public Web site. Several other agencies in the State also provide standard complaint forms online, including the Attorney General's Office, the Public Utilities Commission, the Board of Pharmacy, and the Board of Dental Examiners, to name a few. The Public Utilities Commission also provides an online comment form that allows members of the public the opportunity to register their opinion on a particular "hot topic" or agency decision. The Division needs to develop a standard complaint form, make this form available on its Web site, and move toward online submission of complaints. Finally, the Division should explore other avenues, such as an online comment form, that allow members of the public to provide instant feedback and input on Commission and Division activities.

Publicizing Disciplinary Actions

As we mentioned in Chapter 2, the Division publishes formal disciplinary actions, such as public censure, license suspensions, and license revocations, in its quarterly

newsletter. The Division also makes electronic copies of the legal documentation for disciplinary actions available on its Web site. Although these practices serve to provide some level of communication to the public, the Division could do more. First, the Division should include more consumer-focused information in its quarterly newsletter. This would create a broader interest in the newsletter and a more effective vehicle for communicating the results of disciplinary actions to consumers. Currently the newsletter contains information primarily geared toward real estate brokers. Second, the Division needs to make sure that disciplinary information provided to the public is concise and understandable. The disciplinary information on the Division's current Web site is presented through complex legal documents. Finally, the Division should ensure that disciplinary actions and complaint information is linked to licensing information available through the Division's online licensing database. Currently when a member of the public searches the online database, the search results will show that a real estate broker is actively licensed, but the search results will not show that several complaints have been filed against the broker or that the broker's license has been publicly censured. Of the seven other states we surveyed, two states (Kansas and Nebraska) link licensees' disciplinary history with online license search results.

Effective enforcement rests to a large extent on the Division's ability to effectively publicize information on complaints and disciplinary actions against real estate brokers. Dissemination of this information helps the public and other licensees to police the industry. Moreover, without easily accessible and identifiable information on complaints and disciplinary actions, the public cannot make informed choices when obtaining real estate brokerage services.

Recommendation No. 14:

The Division of Real Estate should enhance its position as the primary agency for consumer issues related to licensed real estate professionals by:

- a. Working with consumer protection agencies, such as the Attorney General's Office and the Better Business Bureau, to develop more formal processes for referring and sharing information on real estate-related consumer complaints.
- b. Using the Division's Web site to better publicize disciplinary actions taken against licensed real estate brokers to the public. This should include linking summaries of disciplinary action to online license search results.
- c. Developing a standard complaint form for filing consumer complaints against licensees and providing for online submission of complaint forms.

- d. Exploring other ways to solicit feedback and input from the public on Commission and Division activities.

Division of Real Estate Response:

Agree.

- a. Implementation Date: March 2005. The Division will (by March 2005) develop and implement recommendations for more formal processes for referring and sharing information on real estate-related consumer complaints with various consumer protection agencies. Such methods may include Memoranda of Understanding, transfer of complaint data, and reciprocal linking of Web sites.
 - b. Implementation Date: August 2005. The Division currently provides records of real estate broker discipline on its Web site. This online system makes certain scanned documents related to disciplinary actions taken on all Colorado licensees available to the public via the Internet. Stipulations, Final Agency Orders, Suspensions and Revocations in effect within the last ten years, are among the documents that are available. The Division believes that the anticipated capabilities of the new Records Management System, will allow the public to perform an online search of brokers and to review a summary of any discipline that exists, as well as a link to the actual Final Agency Order. The Division anticipates this capability to be available by the full system implementation deadline (August 2005) of the new Records Management System as described in Response No. 5 (c).
 - c. Implementation Date: August 2005. The Division will develop a standard complaint form for filing consumer complaints by January 2005 and also provide for online submission of complaint forms coincident with the capabilities of the new Records Management System as described in Response No. 5 (c).
 - d. Implementation Date: April 2005. The Division currently utilizes an online customer service survey and has utilized mailed surveys to members of the public who have recently purchased or sold a home to ask their opinions related to brokerage relationships and the contract documents used by the industry. The Division will explore additional ways to solicit feedback and input from the public on Commission and Division activities by forming a focus group tasked with making its recommendations by April 2005.
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Errors and Omissions Insurance

As we discussed in Chapter 1, statutes require every real estate broker with an active license to maintain a policy of errors and omissions insurance to cover losses suffered as a result of unintentional mistakes made by a licensed real estate broker in the conduct of their professional service. In this sense, the errors and omissions insurance program is intended to protect the public consumer in real estate transactions. However, we are concerned that the State's errors and omissions insurance requirement could lapse unnecessarily, leaving the public vulnerable to possible financial loss in real estate transactions.

Statutes state, "If the Commission is unable to obtain errors and omissions coverage to insure all licensees who choose to participate in the group program at a reasonable annual premium...*the errors and omissions insurance requirement...shall not apply during any year for which coverage cannot be obtained* (emphasis added)." [Section 12-61-103.6(2)(a), C.R.S.] Thus, while the errors and omissions insurance requirement exists to protect the public, the Division can only fulfill this requirement if it is able to secure a reasonable contract. To date, the Division has always been able to secure a contract for group errors and omissions insurance. However, we identified several factors that could make this increasingly difficult in the future:

- **Real estate market forces.** At the time of our review, the annual premium for the Division's group errors and omissions insurance plan (Group Plan) was \$230 per licensee. This was the highest premium of the 12 states with state-contracted group errors and omissions insurance programs. According to the current and former Group Plan administrators, Colorado is atypical when compared with the other 11 states that have state-contracted group errors and omissions insurance plans. First, the Group Plan administrators believe property values and legal fees are much higher in Colorado, which are two primary factors driving Colorado's errors and omissions insurance premiums. Higher property values increase the losses paid on claims and higher legal fees increase the expenses paid on claims. Second, the Group Plan administrators believe Colorado has a growing population with more new home construction and home sales, which typically increase the number and value of errors and omissions insurance claims.
- **Few bidders.** In October 2003 the Commission issued a Request for Proposal from interested parties to bid on the Group Plan contract for Plan Years 2004 through 2006. The Commission received two bids. Williams Underwriting Group, the former Group Plan administrator for Plan Years 1998 through 2003, was initially awarded the new contract. However, Williams withdrew from the contract in December 2003 after losing its errors and omissions insurance carrier. Ultimately, the Commission was able to award the contract to the second bidder, Rice Insurance Services Company.

We found that other states have also experienced problems obtaining state-contracted group plans. For example, the Alabama legislature recently repealed its errors and omissions insurance requirement because the State of Alabama could not obtain a group errors and omissions insurance contract and its licensees were not required to carry errors and omissions insurance for two licensing cycles in a row.

Statutes permit payments from the Real Estate Recovery Fund in those instances when errors and omissions insurance is not available. However, the problems we found with the Recovery Fund (discussed later in this chapter) indicate the Recovery Fund is not an effective substitute for errors and omissions insurance.

Only 12 states, including Colorado, require real estate licensees to carry errors and omissions insurance. These same states also provide for a state-contracted group insurance policy. Thus, in 38 states errors and omissions insurance is not a requirement for licensure and real estate professionals carry errors and omissions insurance voluntarily. There are a number of stakeholders affected by Colorado's policies related to errors and omissions insurance, including state regulators, the public, the real estate broker community, and the errors and omissions insurance industry. The State should work with these stakeholders to ensure an appropriate level of public protection by considering whether real estate brokers with active licenses should be required to carry errors and omissions insurance and, if so, whether coverage should be required even in the absence of a state-contracted group insurance policy.

If the State chooses to continue with the errors and omissions insurance requirement, an argument can be made that contracting for a group insurance policy could be carried out by non-government entities, such as real estate firms or professional trade organizations. According to data published by the National Association of Realtors, 69 percent of real estate firms with independent contractor licensees and 43 percent of firms with salaried licensees offer errors and omissions insurance coverage to their employees. As we discussed in Chapter 1, we reviewed a sample of 25 real estate brokers with independent errors and omissions insurance coverage. We found that 23 (92 percent) of these brokers had errors and omissions insurance through their employers. Although it does not presently contract for a group insurance plan, the National Association of Realtors publicly endorses a specific errors and omissions insurance carrier to its members. Obtaining a group insurance policy can be an effective way of reducing insurance premiums. However, the State also needs to evaluate whether a state-contracted group policy is the optimal arrangement for obtaining errors and omissions insurance.

Recommendation No. 15:

The Real Estate Commission and the Division of Real Estate should work with relevant stakeholders to critically assess and evaluate (1) the errors and omissions insurance requirement for all licensed real estate brokers, and (2) whether a state-contracted group policy is the optimal arrangement for the State. The Division should seek statutory change as appropriate.

Real Estate Commission and Division of Real Estate Response:

Agree. Implementation Date: January 2005. The Department of Regulatory Agencies will convene an ad hoc task force of real estate professionals and stakeholders to review issues brought forth in the audit with respect to the errors and omissions insurance program. The task force will report to the Division, the Commission, and the Executive Director of the Department of Regulatory Agencies by January 30, 2005. Per the recommendations of the task force, the Department may propose legislation during the 2005 or 2006 Legislative Sessions.

Real Estate Recovery Fund

The Real Estate Recovery Fund (Recovery Fund) was established in statutes to provide limited financial recourse to individuals who are found under civil court judgment to be victims of fraud, willful misrepresentation, or conversion of trust funds by a licensed real estate broker, and who have been unable to collect on damages awarded by the civil court judgment. Thus, similar to errors and omissions insurance, the Recovery Fund is another program created to protect the public consumer in real estate transactions. Cumulatively, a total of about \$884,000 was paid on 28 Recovery Fund claims between Fiscal Year 2001 and Fiscal Year 2004. This is an average of about \$221,000 in payments on seven claims per year, or about \$32,000 per claim.

During our audit we reviewed statutes and data related to the Division's administration of the Recovery Fund. As we discuss in the following sections, we identified a number of issues that lead us to question whether the Recovery Fund effectively provides protection and redress to members of the public who have suffered financial losses as a result of fraud and other intentional misconduct by licensed real estate brokers.

Burdensome Requirements

Currently statutes impose a number of strict legal and administrative requirements that may discourage individuals with legitimate losses from applying for and receiving payment from the Recovery Fund. For example, statutes require the following:

- **Civil court judgment.** Before any claim for payment from the Recovery Fund can be awarded, the individual must first have filed a civil lawsuit and won a judgment finding that the real estate broker committed fraud, willful misrepresentation, or conversion of trust funds. A consumer cannot receive recovery for negligence if the broker had a policy of errors and omissions insurance in effect at the time of the action.
- **Notice of civil suit.** Applicants must give written notice to the Commission that a civil action lawsuit has been filed against a broker and may result in a claim for payment from the Recovery Fund. This notice must be given within 90 days of the filing of the civil lawsuit. Thus, even if an individual has been awarded a civil court judgment against a real estate broker for fraud, unless timely notice of the lawsuit was given to the Commission, statutes do not permit payment of the claim.
- **Demonstrated inability to collect.** The Recovery Fund is only liable for reimbursement of actual and direct out-of-pocket losses, court costs, and reasonable attorney fees that remain unpaid on the judgment. Applicants must demonstrate that they have reasonably undertaken other legal means (e.g., seizure of assets or property, liens) to recover the judgment award. Thus, it is not sufficient that an individual be awarded damages in a civil suit against a real estate broker. To receive payment from the Recovery Fund, the individual must also be unable to collect on the judgment.

Payments Limited

As mentioned previously, statutes restrict Recovery Fund payments to reimbursement of actual and direct out-of-pocket losses, court costs, and reasonable attorney fees that remain unpaid on the judgment. In addition, statutes limit Recovery Fund payments—protection against intentional actions of real estate brokers—to a maximum of \$50,000 per real estate transaction and a maximum of \$150,000 against any single broker. In contrast, errors and omissions insurance—protection against unintentional actions of real estate brokers—provides a minimum of \$100,000 coverage per claim, and an annual aggregate limit of \$300,000 per licensed individual. Reimbursable attorney fees are limited to no more than 25 percent of the amount of actual and direct out-of-pocket losses paid. The Recovery Fund is not liable for losses attributable to pain and suffering or mental

anguish. Finally, the Recovery Fund is only liable for claims based on civil judgments against individual brokers; suits against real estate companies are not eligible.

It is possible that losses resulting from fraud, misrepresentation, or conversion of trust funds by a real estate broker could well exceed the payment limits imposed by statutes. Thus, the existing limits and restrictions could discourage individuals with legitimate losses from applying for payment from the Recovery Fund. As mentioned previously, Recovery Fund payments between Fiscal Year 2001 and Fiscal Year 2004 averaged nearly \$32,000 per claim. Of the 28 Recovery Fund claims paid during this time period, 10 (36 percent) were for the statutory maximum of \$50,000.

Financing of the Fund

Statutes define five different revenue sources for the Recovery Fund, including surcharges on license renewal fees, license reinstatement fees, administrative fines, interest income, and appropriations from the General Fund. Statutes designate surcharges on license renewal fees as the primary revenue source for the Recovery Fund. Specifically, the Commission must collect surcharges on license renewal fees if, on January 1 of any year, the Recovery Fund balance is less than \$350,000. However, surcharges on license renewal fees have not been assessed since Fiscal Year 1995 because the Recovery Fund balance did not fall below \$350,000 until Fiscal Year 2004. Appropriations from the General Fund have never been used and statutes authorizing this option are to be repealed effective July 1, 2005. Finally, statutes specify that revenues from surcharges on license renewal fees in excess of \$500,000 must be transferred to the Real Estate Cash Fund, the Division's primary operating cash fund. This statutory provision has not applied because, as discussed earlier, surcharges on license renewal fees have not been assessed since Fiscal Year 1995. Statutes do not impose maximum limits on the other sources of revenue for the Recovery Fund, such as administrative fines or interest income.

We determined that these statutory provisions—multiple revenue sources and a maximum revenue limit tied to only one of these revenue sources—combined with low levels of claim activity in recent years, worked to grow the Recovery Fund balance to about \$3.3 million by the end of Fiscal Year 2002. In Fiscal Year 2003 the General Assembly transferred \$3.2 million from the Recovery Fund to the General Fund to help balance the State's budget. We are concerned that the Recovery Fund's financing and claims payment mechanisms provided for in statutes do not work together to prevent the buildup of an excessive fund balance.

Consider Alternatives

It is clear that the Recovery Fund was not intended to be a primary or exhaustive remedy for the illegal or inappropriate actions of real estate brokers. However, due to issues described above, the State needs to evaluate and consider alternatives to the Recovery Fund's present structure and propose the option that best protects the public from fraud and other intentional misconduct by licensed real estate brokers. This evaluation should be done in conjunction with evaluations of the errors and omissions insurance requirements as discussed previously.

Option 1: Retain the Recovery Fund, With Changes

This option would continue the Recovery Fund, but ensure fiscal soundness and increased public benefit. To accomplish these changes, the Recovery Fund should have a single dedicated revenue source based on license fees and defined minimum and maximum thresholds that apply to the entire fund balance. License fees and thresholds should be sufficient to maintain an adequate fund balance for covering approved claims, without building an excessive fund balance. Requirements for filing claims and obtaining payments from the Recovery Fund should be streamlined, avoiding restrictions that prevent individuals from filing legitimate claims. Finally, payment limits should be reevaluated and set at levels that reasonably cover potential financial losses.

Option 2: Repeal the Recovery Fund

This option would repeal the Recovery Fund. Of the seven other states we surveyed, we found that three states (Nebraska, Oregon, and Utah) do not have a real estate recovery fund. On its face, the Recovery Fund appears to have broad public benefits, but in truth, the Recovery Fund only directly benefits a very small number of individuals each year. Moreover, the Recovery Fund is not intended to deter or prevent illegal behavior by real estate brokers. The Recovery Fund could be eliminated and resources reallocated to further enhance activities that prevent fraud and protect the public.

Recommendation No. 16:

The Real Estate Commission and the Division of Real Estate should critically assess the Real Estate Recovery Fund and evaluate available policy alternatives. At a minimum, this assessment should consider changing various fiscal and administrative requirements for the Recovery Fund or repealing the Recovery Fund altogether. The Commission and Division should furnish a report on these and other

policy alternatives to the General Assembly by July 1, 2005, and seek statutory change as appropriate.

**Real Estate Commission and Division of Real Estate
Response:**

Agree. Implementation Date: January 2005. The Department of Regulatory Agencies will convene an ad hoc task force of real estate professionals and stakeholders to review issues brought forth in the audit with respect to the Real Estate Recovery Fund. The task force will report to the Division, the Commission, and the Executive Director of the Department of Regulatory Agencies by January 30, 2005. The Commission and Division will report policy alternatives to the General Assembly by July 1, 2005. Per the recommendations of the task force, the Department may propose legislation during the 2005 or 2006 Legislative Sessions.

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