

PERFORMANCE AUDIT

DEPARTMENT OF REAL ESTATE

Report to the Arizona Legislature
By the Auditor General
September 1991
91-8

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

September 16, 1991

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Mr. Jerry Holt, Commissioner
Department of Real Estate

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Real Estate. This report is in response to a June 14, 1989, resolution of the Joint Legislative Oversight Committee.

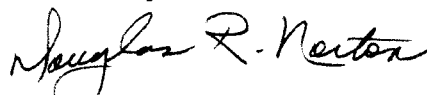
The report identifies several areas in which the Department can improve its effectiveness and efficiency in protecting the public when making real estate transactions. We found the Department does not sufficiently investigate all complaints against licensees by either treating serious allegations as lesser violations or by referring them to other agencies for resolution. In addition, the Department does not monitor compliance with subdivision laws and has not taken sufficient enforcement action in cases involving serious violations of these laws. Finally, the Department has demonstrated a pattern of special treatment and favoritism through the improper granting of licenses to employees and preferential treatment to former officials and select members of the public.

A response from the Department is contained on the yellow pages following the body of this report.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on September 17.

Sincerely,



Douglas R. Norton
Auditor General

DRN:lmn

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Department of Real Estate, pursuant to a June 14, 1989, resolution of the Joint Legislative Oversight Committee. The audit was conducted under the authority vested in the Auditor General by Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Department is under the direction of a Commissioner (appointed by the Governor) who with a staff of 74 employees is responsible for regulating the activities of approximately 50,000 real estate brokers and salespersons. This regulation includes conducting examinations and issuing licenses, investigating complaints, auditing broker trust and property management accounts and transactions, and conducting administrative hearings to determine disciplinary sanctions. By issuing public reports, the Department also regulates the sale of subdivided and unsubdivided lands, time-share projects, membership campgrounds, and cemetery plots. Finally, the Department administers two recovery funds which are intended to provide compensation to victims of licensee and subdivider wrongdoing.

The Department Should Improve Its Investigation of Consumer Complaints (see pages 5 through 13)

The Department needs to strengthen its handling of consumer complaints. We found the Department's Investigations Division does not investigate all complaints meriting an investigation. We identified several instances in which the Division took a very limited view of its authority and dismissed complaints without an investigation. For example, the Division claims it is unable to investigate a complaint received five years after the original real estate purchase. However, our review found that some complaints dismissed in this manner involved specific violations which, by law, are not subject to a statute of limitations. Establishing criteria concerning the severity of a complaint and therefore the type of response needed by the Department may allow the Division to fully investigate all legitimate issues raised in complaints.

Of those complaints that are investigated, we found that over one-third are inadequately resolved. Among these were cases in which the Division used letters of admonishment as disciplinary actions against licensees. We could find no statutory authority for the use of these letters, which were often issued by individual investigators, even when the Division had documentation of significant wrongdoing by the licensees. In addition, we identified cases that appeared to involve real estate violations, such as theft, misrepresentation, and breach of fiduciary duties, in which the Division referred the complaint to other agencies or suggested the complainants file legal action rather than the Department conducting its own investigation.

The Department Needs to Strengthen Regulation of Subdivision Development (see pages 15 through 25)

The Department needs to improve its regulation of subdivisions in order to better protect the public. In the 1960s and 1970s, Arizona land fraud schemes provided the catalyst for the strengthening of regulation designed to protect the public from fraud and misrepresentation in land sales. Despite this need to protect the public, we found the Department has not actively monitored compliance with subdivision laws. Specifically, the Department does not attempt to identify property that has been illegally subdivided, nor does it routinely monitor subdivisions as they are built and sold to assure that the developer complies with the public report. However, both of these problems could be at least partially addressed by working cooperatively with the counties. The Department could do more to identify illegal subdivisions through the assistance of county recorders who could notify the Department of attempts to transfer land without a public report. In addition, the Department can strengthen enforcement by coordinating its subdivision regulatory efforts with those local entities also involved in the regulation of subdivisions.

In addition to the problems associated with monitoring compliance, the Department's enforcement of subdivision laws appears weak. The subdivision law provides the authority and a process for the Department to formally suspend sales when any person fails to comply with the

provisions of the public report. However, the Department more often issues "informal suspensions" for which it has no specific statutory authority nor formal criteria. Further, the Department has adopted an "educational approach" to modify the behavior of violators of subdivision laws. However, in the cases we reviewed, this approach does not appear to have been effective in preventing further violations.

The Department Should Eliminate
Practices of Special Treatment
and Favoritism (see pages 27 through 34)

The Department has demonstrated a pattern of special treatment and favoritism toward some individuals. We identified three specific instances, taking place in 1989 and 1990, in which real estate licenses were improperly granted to Department employees. In each of the three cases, we found that some or all of the statutory requirements for licensure were not met and in most instances were waived by Department officials, including a former Commissioner. These waivers were granted although there is no statutory authority for such action. We also found two former Department officials who received special treatment when obtaining and/or renewing their licenses. Further, one of these officials was apparently given special treatment concerning a complaint with which he was involved. Additionally, we identified two members of the public who were given special treatment when applying for licensure.

In addition to individual cases of favoritism and special treatment, the Department's lack of adequate controls over some licensing functions creates the appearance of impropriety. We found the Department has failed to monitor the reasons and circumstances under which in-house licensing exams are administered. We also found the Department's controls over the granting of continuing education waivers to be weak.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Department of Real Estate, pursuant to a June 14, 1989, resolution of the Joint Legislative Oversight Committee. The audit was conducted under the authority vested in the Auditor General by Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Department is responsible for regulating the activities of approximately 50,000 real estate brokers and salespersons. This regulation includes conducting examinations and issuing licenses, investigating complaints, auditing broker trust and property management accounts and transactions, and conducting administrative hearings to determine disciplinary sanctions.

The Department also regulates the sale of:

- Subdivided lands - land divided into more than three parcels, each of which is less than 36 acres
- Unsubdivided lands - land divided into more than three parcels, each of which is 36 acres or more
- Time-share projects - a project in which a purchaser receives the right to exclusive use of a piece of real property on some periodic basis
- Membership campgrounds - a campground for which a person purchases, through fee or periodic payments, a right to use outdoor recreation facilities
- Cemetery plots - includes burial parks, cemetery plots, mausoleums and crematories

This regulation is primarily accomplished through the issuance of public reports which disclose information about the physical and financial attributes of the property to prospective buyers. A copy of the public report must be provided to prospective buyers before any sale or offer of sale can be made. The Department's activities are presented in Table 1, page 2.

TABLE 1

DEPARTMENT OF REAL ESTATE ACTIVITIES
FISCAL YEARS 1987-88, 1988-89, AND 1989-90

<u>Activity</u>	<u>1987-88</u>	<u>1988-89</u>	<u>1989-90</u>
Broker exams	759	800	885
Salesperson exams	7,526	6,186	7,606
New brokers licenses	1,336	948	932
New salesperson licenses	5,766	4,041	4,968
Broker renewals	3,347	4,619	3,776
Salesperson renewals	11,160	12,051	11,300
Subdivision filings	1,638	1,398	1,427
Subdivision inspections	2,321	724	644
Broker audits conducted	1,111	1,368	1,252
Formal complaints received	649	476	708
Complaints referred to Attorney General	120	138	136
Hearings held	53	32	50
Consent agreements	91	42	68
License suspensions	42	37	31
License revocations	24	14	31
Fines ordered	58	28	62

Source: Department of Real Estate fiscal year 1991-92 budget request

Staffing

The Department is under the direction of a Commissioner, who is appointed by the Governor. For fiscal year 1990-91, the Department was authorized 76 full-time equivalent (FTE) positions⁽¹⁾ (see Table 2, page 3) which are dispersed over six operational divisions, including:

- Administration/Business Management (10 FTEs)
- Broker and Property Management Audits (6 FTEs)
- Education (6 FTEs)
- Investigations (11 FTEs)
- Licensing (20 FTEs)
- Subdivisions (11 FTEs)

In addition, the Department operates a branch office in Tucson, staffed with ten FTEs.

(1) The Department has combined three of the positions into one in order to afford a higher salary for that position. Thus, there are only 74 actual positions.

TABLE 2

DEPARTMENT OF REAL ESTATE
 STATEMENT OF FTEs AND ACTUAL AND BUDGETED EXPENDITURES
 FISCAL YEARS 1989-90, 1990-91, AND 1991-92
 (unaudited)

	<u>1989-90</u> <u>(Actual)</u>	<u>1990-91</u> <u>(Actual)</u>	<u>1991-92</u> <u>(Budgeted)</u>
FTE positions	75	76	76
Personal services	\$1,552,170	\$1,598,132	\$1,760,100
Employee related	367,293	418,927	430,200
Prof. & outside services	82,533	92,011	80,000
Travel - in-state	65,801	57,358	53,500
out-of-state	10,082	3,567	9,000
Equipment	15,952	26,132	8,000
Other operating	<u>512,557</u>	<u>482,114</u>	<u>527,800</u>
TOTAL	<u>\$2,606,388</u>	<u>\$2,678,241</u>	<u>\$2,868,600</u>

Source: Arizona Financial Information System reports for fiscal years 1990 and 1991; State of Arizona, Appropriations Report for the Fiscal Year Ending June 30, 1991; State of Arizona, Annual Budget for Fiscal Year 1992

Revenues And Expenditures

The Department receives funding through a general fund appropriation. Revenues received from licensing and examination applications, and subdivision filings are directly deposited into the State General Fund. Fees are set so that the revenues derived from them will equal at least 95 percent but not more than 110 percent of the anticipated appropriated budget for the Department for the succeeding fiscal year. Table 2 lists the expenditures of the Department for fiscal years 1989-90 through 1991-92.

The Department also administers two recovery funds, the Real Estate Recovery Fund and the Subdivision Recovery Fund, which are intended to provide compensation to victims of licensee and subdivider wrongdoing. During fiscal year 1990-91, there were 15 claims, totaling \$184,572, paid from the Real Estate Recovery Fund, leaving a fund balance of \$744,923. During the same period, there were no claims paid from the Subdivision Recovery Fund, leaving a fund balance of \$1,130,117.

Audit Scope

Our audit focused on the Department's public protection responsibilities and contains findings in the following three areas:

- The Department's investigation of consumer complaints
- The Department's regulation of subdivision development
- The Department's adherence to statutes and rules regulating the issuance of real estate licenses

In addition, we addressed the 12 statutorily mandated sunset factors.

Our audit was conducted in accordance with government auditing standards. The Auditor General and staff express appreciation to the Commissioner and the staff of the Department for their cooperation and assistance during the audit.

FINDING I

THE DEPARTMENT SHOULD IMPROVE ITS INVESTIGATION OF CONSUMER COMPLAINTS

The Department needs to strengthen its handling of consumer complaints. We found the Department does not investigate all legitimate complaints it receives. In our review of investigated complaints, over one-third appear to be inadequately resolved.

The Investigations Division is responsible for protecting the public through enforcement of real estate statutes and rules, detection of violations, and the pursuit of administrative sanctions. The Division consists of a Consumer Services Section, which provides assistance and information to the general public in the resolution of real estate related problems, and a General Investigations Section, which conducts investigations into alleged violations of real estate statutes and regulations. This section also conducts background investigations of individuals applying for real estate licenses.

According to the Division Director, the Division categorizes complaints as either public assistance requests, preliminary inquiries, or case investigations in order to focus its resources. The Division Director reviews all written complaints⁽¹⁾ in the Phoenix office and classifies them as either a public assistance request, preliminary inquiry or an investigations case. The Director then assigns the complaint to an investigative staff member.⁽²⁾ Discussions with Division staff and a review of Division manuals provided the following information on complaint categories:

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- (1) By statute, the Department can only investigate written complaints. Individuals registering complaints by phone are sent a complaint form by the Department, and requested to complete the form and return it to the Department.
 - (2) In the Tucson Field Office, the Investigations Supervisor reviews, classifies, and assigns complaints.

- Public assistance requests are complaints that the Division Director determines are not within the Division's jurisdiction or lack merit. The Division handles these complaints by sending a letter to the complainant referring the complainant to another agency or suggesting they obtain legal counsel. The Division handled 752 public assistance requests during fiscal year 1989-90.
- Preliminary inquiries are matters that do not merit a formal case investigation, but do require inquiries and a contact with the licensee and public to resolve the problem. Preliminary inquiries involve a minimum amount of phone contact in order to achieve an informal resolution. The complainant is notified by phone or letter of the complaint's resolution. During fiscal year 1989-90, the Division conducted 265 preliminary inquiries.
- Investigation cases are complaints that, according to Division policy, are thoroughly investigated and either closed or referred for administrative action. Actions available to the Department include fines, suspensions, and license revocations. These actions may be imposed after a hearing before an administrative law judge or as the result of a consent agreement between the Department and the licensee. Complainants are notified of the Division's investigative determination by letter. The Department investigated 708 cases during fiscal year 1989-90.

Not All Complaints That Warrant Investigation Are Investigated

The Department does not investigate all complaints meriting investigation. Although the system of categorizing complaints was established to more effectively utilize Department resources, we found that some complaints with serious allegations were not investigated. The lack of criteria for determining the appropriate level of investigation for a complaint may contribute to the Department's failure to investigate these cases.

Categorizing complaints - Dividing complaints into categories was established by the current Investigations Division Director as a way to more effectively use the Division's resources. The intent of the procedure is to allow the Division to evaluate each complaint based on its allegations and to focus efforts on the most serious problems. The procedure is a logical approach to a workload that consisted of more than 1,700 consumer complaints during fiscal year 1989-90.

Some complaints not investigated - In our review we found 18 percent of the complaints received by the Division were inappropriately categorized as public assistance requests and preliminary inquiries and, as a consequence, did not receive an investigation.⁽¹⁾ In these instances the Division was unnecessarily narrow in the way it interpreted the issues raised by the complainant.

Our review of public assistance requests and preliminary inquiries handled by the Division identified 48 cases (18 percent) that should have been investigated as cases. In these instances the Division took a very limited view of its authority, citing various reasons for not investigating these complaints. The reasons cited include statute of limitations, lack of jurisdiction, and the decision that the complaint would be better handled through civil action. In doing so, the Division failed to acknowledge the seriousness of the allegations, using the limitations as a means to dismiss the complaints without investigation.

As an example of this practice the Division often misinterprets its statute of limitations in turning down cases. The Division claims that it is unable to investigate a complaint received five years after the original purchase, yet our review of state statutes and regulations revealed that A.R.S. §32-2153.B. specifically mentions certain acts which are not subject to any time limitations. These acts include substantial misrepresentation, false promises, fraud, and transacting business without a license.

The 48 cases cited above included issues that should have been investigated, as illustrated in the following examples.

- In July 1990, a complainant sent in a detailed letter of problems alleging land fraud and asking if the developer could be called to task. The complainant states that she purchased 40 acres in a subdivision in 1974. She moved to the property in 1988 and discovered that many of the promises made by the developer and licensee had not materialized. Specifically, she alleges several

(1) We selected a statistical sample of 270 public assistance requests and preliminary inquiries from the 618 public assistance requests and preliminary inquiries handled by the Phoenix office during calendar year 1990.

instances of misrepresentation, including the lack of county roads accessing the subdivision as promised in advertising brochures, and incorrect information about certain easements and property lines. The complainant also alleges that an advertised "recreational lake" is in actuality a large, dry, stock pond located on State land. The Division responded: "Please be advised that the Department's ability to investigate a real estate broker's or developer's activity is limited to five (5) years after the original purchase."

We contacted the complainant to clarify several points raised in her letter and learned that the developer continues to advertise county roads and to market and sell property in this area. The complainant also alleges that over \$1 million was placed into trusts for road construction, but that only a very small percentage of it was spent on roads with the remainder of the funds being unaccounted for. Finally, the complainant alleges the developer's agent is acting as a property manager for some owners and is fraudulently charging them for materials and/or labor he is not supplying.

Comments - The violations of misrepresentation and false promises alleged in this complaint are not subject to a statute of limitations and should have been investigated by the Division. Furthering the need to investigate this complaint is the fact that the developer is still marketing this property and according to the complainant is continuing to violate real estate rules and regulations. The complainant has since contacted the Attorney General's office after receipt of the Division's response. In addition, in May 1991, another complainant wrote to the Governor complaining of land fraud by this developer. The Governor referred the complaint to the Real Estate Commissioner who instructed the Division to investigate this new complaint.

- A complainant wrote to the Department in 1990 claiming licensee misrepresentation concerning a real estate transaction in 1985. The complainant was told by the real estate licensee that a wash on the property was not a problem because it was always dry. A bad storm flooded the complainant's property, which led her to contact the Flood Control District where she learned that her property is in a flood area. The complainant was also given a copy of the flood plain information showing that the property was in a flood area. The flood plain information contained notations, indicating that the licensee had received the information prior to the closing of escrow. The complainant claims that the licensee failed to disclose this information to her. The Division refused to investigate, claiming that the complaint was a contract dispute. However, staff notations in the file indicate that the incident occurred too close to the statute of limitations for the Division to proceed with an investigation.

Comments - Even though misrepresentation is not subject to any time limitation and is an investigatable violation, the Division apparently elected not to investigate this complaint because of a supposed statute of limitation. Furthermore, the Division viewed this complaint as a contract dispute rather than misrepresentation.

- An April 1990 complainant claims that the listing real estate agent involved in her transaction intentionally misrepresented the property lines of a parcel of land the complainant purchased. The complainant states that the property lines she was verbally told of, as well as a copy of the Multiple Listing Service listing sheet and the map showing the property lines were inaccurate. Furthermore, the complainant states that she discovered after the sale that the listing agent was in possession of a survey of the property showing accurate property lines which was done prior to the sale. The complainant never received this survey, nor was it mentioned in the purchase contract. The Division responded that this was a contract dispute and would not be investigated. The complainant was not satisfied with the Division's response and requested another review of her complaint. The Division once again refused to investigate; however, this time they stated that "We invite you to refile your complaint in the event that you obtain a judgment against the [respondent]."

Comments - In both responses the Division failed to address the issue of misrepresentation by a licensee, characterizing the complaint as a contract dispute, over which the Department lacks jurisdiction. Furthermore, the Division sent a contradictory message when it invited the complainant to refile if she obtains a judgment. This statement, which the Division uses, appears to place the burden of protecting the public against licensee violations on the complainant and not on the Department.

Lack of criteria may contribute to problem - The Division's lack of well established criteria for defining public assistance requests, preliminary inquiries and case investigations may contribute to its failure to fully investigate all legitimate issues raised in complaints. In numerous interviews with the Division Director and staff, as well as a review of Division manuals, we ascertained that there are no written, formal criteria for determining when a complaint should be defined as a public assistance request, a preliminary inquiry, or case investigation. This lack of criteria is made more serious by the fact that the classification, and thus the decision to investigate a complaint, is determined solely by one person in each office.

In addition, lack of criteria also allows the Division to control its workload, perhaps inappropriately. The Division Director admitted that as workloads increase, it is possible that the Division might not view cases the same way as when workloads are smaller. We noted that the allegations of misrepresentation and false promises alleged in the public

assistance requests and preliminary inquiries appeared to be comparable to allegations contained in the case investigations we reviewed, further suggesting that circumstances may influence the way in which the Division handles complaints.

Complaint Investigations Are Inadequately Resolved

In our review of consumer complaints which the Division actually investigated (case investigations), we found that thirty-five percent are inappropriately resolved.⁽¹⁾ In many instances the Division uses letters of admonishment as a form of disciplinary action, rather than seeking legitimate administrative sanctions. In other instances, the Division is not adequately investigating complaints, referring them instead to other regulatory agencies or the courts for resolution.

Letters of admonishment/written censure - The Division uses letters of admonishment as a disciplinary action without statutory authority. These letters have been used inappropriately. Furthermore, the Division misleads complainants when informing them of actions taken.

The Division used letters of admonishment as a form of discipline in eleven percent of the cases we reviewed. However, a review of the real estate statutes revealed that the Department lacks the statutory authority to send out letters of admonishment.⁽²⁾ Consequently, a letter of admonishment cannot be used as a form of discipline, nor can it be used as evidence of prior disciplinary actions if the Department receives subsequent complaints since the licensee has not had an opportunity to refute the conclusions of the letter.

Our review of case investigations showed that letters of admonishment had been sent inappropriately. Although Division manuals list no criteria as to when a letter of admonishment can be sent, the Division Director

(1) We reviewed 89 of the 253 highest priority cases the Division received for calendar years 1988, 1989, and 1990.

(2) Although the Department does not have the statutory authority to issue letters of admonishment, several other state regulatory authorities have such authority. These advisory letters, often called letters of concern, are public documents issued by these agencies when there is insufficient evidence to merit direct action against the licensee.

claims that an informal policy governs the use of these letters. According to the Director, individual investigators determine when to send these letters and generally send them in cases involving a breach in normal procedures, inappropriate actions, or when they believe they will have difficulty proving a violation. The Director further stated that letters of admonishment cannot be used in cases involving theft, fraud, or illegal subdivision activity. As illustrated by the following examples, we found that letters were sent in cases where the Division had documented proof of a violation and/or a confession by the licensee, and in circumstances in which the informal policy would preclude the use of letters of admonishment.

- The Division received a complaint from HUD alleging that a real estate licensee had altered an earnest money deposit receipt and used this receipt as proof of deposit on a HUD purchase. During a meeting with the Division investigator, the licensee admitted that she altered the receipt. The Division responded to HUD that there was insufficient cause for administrative action and that while the respondent did alter the receipt, there was no injured party. Thus, the licensee will be issued a written censure.

Comments - The licensee confessed to committing a fraudulent act and as such the Department should have taken action against her license. Instead, the investigator sent a letter of admonishment to the respondent even though the Division Director stated that letters of admonishment cannot be used in cases of fraud.

- The Division received a complaint and extensive documentation from the Director of the Gila County Development Office concerning what "...appears to involve a deliberate systematic attempt" to circumvent subdivision regulations and Gila County's Minor Land Division Ordinance. The documentation provided reveals the formation and existence of illegal subdivisions, and appears to indicate that the acts were deliberate. The Division reviewed the materials and found that a licensed broker and two unlicensed individuals violated subdivision laws. However, no action was taken against the two unlicensed individuals because they agreed to abide by subdivision laws in the future. The licensed broker was sent a letter stating she was "expected to know subdivision requirements and to inform prospective clients of these requirements." Furthermore, the Division responded to the complainant that the broker had been "censured" for her conduct, yet there is no mention of admonishment or censure in the letter to the licensee.

Comments - The investigator sent a letter of admonishment to the licensee even though the Division Director stated that letters of admonishment cannot be used in cases of illegal subdivision activity.

Not only does the Division lack statutory authority to send letters of admonishment, but it also misleads complainants when informing them of the results of investigations. Letters to complainants typically use the phrases "letter of admonishment" or "written censure" and suggest that the Division has taken disciplinary action. However, the tone of the letters actually sent to licensees is much milder, and the letters do not always mention an admonishment or censure, even when the Division informs the complainant that they have done this. Thus, the practical effect on the licensee may be considerably less than the complainant would expect based on communications from the Department.

Referring cases involving real estate violations - The Division is not investigating some real estate violations, referring them instead to other regulatory agencies or the courts. As illustrated by the following example, this results in a lack of enforcement action taken against licensees since the Department is the legitimate agency to handle these violations.

- The Department received a complaint from a mortgage company charging misrepresentation and fraud by a licensed real estate salesperson. The complainant alleged that the licensee participated in a real estate transaction whereby an individual obtained financing on a home by significantly inflating its value and misrepresenting his down payment. In a sworn statement to the Department, the licensee acknowledged his participation in the scheme. In his letter closing the case, a Division investigator informed the complainant that a criminal conviction against the licensee would be necessary in order for the Department to take administrative action on his license. Further, although the investigator acknowledged some doubt about whether a criminal investigation would actually be conducted, he advised the complainant that the case had been referred to the local police department for investigation. However, according to a Division investigator, the police did not investigate the case.

Comments - Although the Department received significant evidence indicating acts of misrepresentation and fraud by a licensee during the course of a real estate transaction, violations clearly within the Department's statutory authority, the case was closed and referred to another agency for investigation. As a result, no action, neither administrative nor criminal, was taken against the licensee.

We identified four additional cases that appeared to involve real estate violations which the Division referred to other agencies or the courts for resolution. In these cases, complaints were submitted to the Division alleging various violations of real estate law, such as theft, misrepresentation, and breach of fiduciary duties. The Division did not adequately investigate the complaints, referring them to other agencies for resolution. Division files contain no information about the action taken, if any, by these other agencies.

RECOMMENDATIONS

1. The Department should investigate all legitimate complaints. The Department needs to establish written criteria to ensure that complaints are appropriately categorized as public assistance requests, preliminary inquiries or case investigations based on the issues raised in the complaints.
2. The Department should obtain the necessary statutory authority to issue letters of admonishment and to use them as a disciplinary action. Until such time as statutory authority is granted, the Department should stop using these letters of admonishment as a form of discipline.
3. The Department needs to fully investigate and take appropriate action on violations of real estate law within its jurisdiction rather than referring such cases to other agencies.

FINDING II

THE DEPARTMENT NEEDS TO STRENGTHEN REGULATION OF SUBDIVISION DEVELOPMENT

The Department of Real Estate needs to improve its regulation of subdivisions. Although subdivision regulation is intended to protect purchasers from fraud and misrepresentation in land sales, the Department has not actively monitored compliance with subdivision laws and has taken only limited enforcement action against violators. The Department could obtain additional resources for monitoring and enforcement by coordinating its subdivision activities with local governments.

Subdivision Regulation Is Intended to Protect Real Estate Purchasers

The Department regulates the sale of subdivided land in Arizona in order to protect the public from fraud and misrepresentation. During the 1960s and 1970s, individuals purchasing land in Arizona were often the victims of land frauds. In some cases, the developer would solicit purchasers through mail order campaigns that included pictures and promises of a retirement paradise. However, when the purchasers visited their property they discovered that it was barren land.⁽¹⁾ In another scheme the developer did not record the transfer of the deed, and then fraudulently sold the land to other purchasers. Still another ploy was to promise numerous site improvements (roads, parks, utilities, etc.) but never install them.

Arizona's subdivision laws, initially enacted in 1937, were strengthened in the late 1970s in order to address these problems. A.R.S. §32-2183.D requires subdividers to obtain a public report from the Department prior

(1) The types of frauds committed during this era are illustrated by Lake Mead Rancheros, a 1961 offering in Mohave County. The Real Estate Commissioner at the time called this one of the most glaring examples of misrepresentation of lot sales in the West. The property was advertised nationally as fully developed, yet it had no utilities, no roads, and the nearest water was a coin-operated tank 12 miles away. In addition, the subdivision was over 100 miles from the lake for which it was named.

to offering subdivided land for sale.⁽¹⁾ The public report requirement applies to all land offered for sale in Arizona, regardless of its location. The public report is based on information submitted by the developer and verified by the Department. It discloses information, such as ownership status, proposed amenities, restrictions on the use of the property, adequacy of the water supply, and the developer's financial ability to complete the project. Purchasers can use this information to evaluate the lands offered for sale. After a project is approved and its public report issued, the Department may suspend the public report, hence preventing further sales, if a developer fails to comply with the report's provisions.

The Department Has Not Adequately Enforced Subdivision Statutes

The Department's enforcement of subdivision requirements appears to be weak. Little is done to identify illegally subdivided property, nor does the Department monitor the developer's activities to ensure that the subdivision is constructed as specified in the public report. In addition, when violations are identified, the Department does not adequately pursue the violators nor take sufficient enforcement action against them. Further, existing statutes do not allow most victims of subdivider wrongdoing access to recovery funds administered by the Department.

Illegal subdivisions - The Department does little to identify or prevent the illegal sale of property in subdivisions. There are several types of illegal sales: one is the sale of land without obtaining a public report, another is failure to comply with the public report, and a third is the sale of land for which the public report has been suspended. The Department does not attempt to identify property which has been divided and sold without a public report or to identify sales which do not comply with the specifications of the public report. According to the Director of Subdivisions, the Department has no easy way to do so and has chosen

(1) A.R.S. §32-2101.40 defines subdivided land as "...improved or unimproved land or lands divided or proposed to be divided for the purpose of sale or lease, whether immediate or future, into four or more lots, parcels or fractional interests...."

to use its available resources in other areas. In order to prevent the sale of land for which the public report has been suspended, the Department relies on title companies. When the Department suspends a report, the suspension is recorded with the county recorder. Thus, when a title search is conducted as a part of the sale, the suspension is identified. According to the Director of Subdivisions, a title company should not go through with a sale of suspended property. However, the use of a title company in the sale of land is not required, and, therefore, sales can proceed after a public report is suspended.

However, other methods of identifying the illegal sale of property may be available to the Department. Some local government planning and zoning officials we contacted stated that they have arranged for county recorders and/or county assessors to notify them of unusual or suspicious land splits. These arrangements enable the local officials to determine if the land splits require local action or approval. County recorders are the logical officials to identify illegally subdivided land. They handle the transfer of title when property is sold and are able to identify when property is divided and recorded as separate parcels.

A similar arrangement could be made between the Department and county recorders for identifying illegal subdivisions. According to the President of the Arizona Association of County Recorders, the recorders recognize illegal subdivisions as a major problem and would welcome the opportunity to assist the Department in the identification of illegal land splits.

Subdivision monitoring - The Department does not routinely monitor subdivisions as they are built and sold to assure that the developer complies with the public report. The Division Director asserts that due to a lack of resources, the Department is not able to monitor the development of the subdivision to assure that it is actually constructed and marketed according to the public report. In our review we noted instances where developers deviated substantially from the terms of the public report in building their subdivisions. In one case we found that a developer marketed property under terms different from those specified

in the public report. Another deviation has had significant consequences for purchasers, as illustrated in the following example.

- As of September 1991, neither the fire hydrants nor the egress road had been installed in a subdivision despite the assurance in the public report issued in 1983 that they would be. The Department did not monitor the development of the subdivision to ensure compliance with the public report and thus it was not until a complaint was received from the homeowners association in October 1990 that the Department became aware of the noncompliance. Although many people purchased property in the subdivision over the last eight years, the city refuses to issue any building permits until the subdivision is brought into compliance with zoning codes.

Comments: Based on the public report for this subdivision, purchasers could reasonably expect it to meet local zoning requirements. The developer's failure to comply with the public report, as well as the Department's failure to monitor the subdivision and ensure timely compliance, has prevented purchasers from building on their land and may subject them to additional costs for the installation of those items necessary to meet zoning requirements.

The Department should periodically monitor subdivision activities to ensure that the developer complies with the terms of the public report. Such monitoring could be conducted in cooperation with local governments (as described on page 22) and would enable the Department to identify potential problems such as the one described above and take action to protect the purchasers who rely on the public report in making their decisions.

Weak enforcement action - The Department's enforcement of subdivision laws appears weak. Most actions are "informal" actions, based on vague criteria. Penalties are relatively minor and do not effectively preclude continued violations.

Although the subdivision law provides the authority and a process for the Department to formally suspend sales when any person fails to comply with the provisions of the public report, the Department more often circumvents this process by issuing "informal suspensions."⁽¹⁾ The

(1) According to the Director of Subdivisions, the difference between a formal and informal suspension is that formal suspensions are recorded with county recorders and can prevent sales. Informal suspensions are not recorded; the Department relies on the good faith of the developer to refrain from sales until the problem is corrected.

Department has no specific statutory authority to issue informal suspensions and no formal criteria for when those suspensions are to be issued. Individual subdivision representatives⁽¹⁾ use their discretion to determine when informal suspensions are appropriate, basing their decision upon how serious the offense was, the developer's history with the Department, and their "gut reaction."

Further, the informal suspension process lacks any real controls. The Department does not track the number of informal suspensions issued. Instead, individual representatives rely on their memories to track these suspensions. Thus, no summary information on the number of informal suspensions could be provided. Moreover, suspensions are not reviewed to ensure that the representatives' decisions are consistent.

The lack of controls creates the potential for subjective judgment and favoritism. However, developing written criteria and issuing written consent agreements in the place of informal suspensions would help to minimize these problems. The Department's legal counsel agrees that requiring a written consent is essential. A written consent would, at a minimum, specify what actions the developer should take, the time frame for taking the action, and the consequences of failing to act. Such agreements would ensure that there is no mistake between the parties regarding the remedy and the discipline. In addition, it would establish a record which might become important in considering sanctions for subsequent violations.

When the Department does take action against violators, penalties appear to be weak. Although we did not review all actions taken by the Department, our review identified cases where developers had long histories of violations or where the violation had the potential for significant financial impact. However, enforcement actions taken in these cases do not appear to have been adequate. Instead of penalizing developers for violating the subdivision laws, the Department has adopted

(1) The Department's subdivision representatives are responsible for ensuring developer compliance with public report requirements.

an approach whereby it attempts to inform developers of their legal responsibilities and promote compliance with the law. The educational approach adopted by the Department to modify the behavior of the offenders does not appear to have been effective in preventing further violations in the cases we reviewed. The following examples illustrate the lack of effective action against violators.

Example 1

- From 1983 through 1987 the Department received several complaints regarding the sales practices of a broker, but took no disciplinary action. In 1987, the Department was informed that the broker had offered 18 lots for sale in Maricopa County without obtaining the required public report. During its investigation, the Department also found that the broker had offered nearly 170 lots located in three northern Arizona counties over the preceding several years without obtaining the necessary public reports. In October 1988, the Department and the broker agreed to a consent order, based solely on the illegal offering of the 18 lots in Maricopa County, in which the broker agreed to a revocation of his license, a civil penalty of \$1,500, and to cease subdividing land in Arizona. Due to the interstate nature of the 170 northern Arizona offerings, Department officials attempted to refer the case to HUD. After an initial rejection, HUD officials accepted the case in mid-1989, but then returned it one year later saying they were unable to proceed with an investigation. However, even after the rejection by HUD, no effort was taken by the Department to address the 170 lots in northern Arizona. This includes a failure by the Department to suspend the sale of the land to prevent further violations. In early 1991 the Department learned that the ex-broker continues to offer land he owns in Arizona to foreign investors without the required public reports.

Comment: According to the Division Director, this case represents perhaps the largest recent illegal land sale case in Arizona. However, the action taken addressed only a few of the violations and involved a small civil penalty. No action has been taken against the ex-broker for the 170 lots in northern Arizona which he illegally offered for sale, and no action has been taken to stop his current illegal activity. The revocation of the broker's license, while appropriate, does not prevent further sales, since the ex-broker owned the property in northern Arizona, and no license is required to sell one's own land.

Example 2

- A real estate broker marketed a subdivision in a manner which was clearly out of compliance with the provisions of its public report. This broker sold property via agreements for sale, whereby the developer retains title to the property until the property is

completely paid for, rather than by deeds of trust as were specified in the public report. As a result, the purchasers may not have been aware that they did not have title to their home. The Department learned that the subdivision was being sold via agreements of sale in February 1988, but did not suspend sales until May 1989, 15 months later, when the developer went out of business.

Comment: Despite evidence that the broker was not complying with the public report in marketing the subdivision, the Department took no action to require the developer to comply with the report nor did the Department amend the report to reflect actual marketing practices. No action was taken against the broker, the corporate officers, or the development company. No penalties were assessed, and no licenses revoked. In fact, the only disciplinary action taken was to suspend sales after the developer went bankrupt. The broker is still licensed to do business in Arizona.

The Department's limited action in these and other cases we identified does not appear to effectively protect the purchasers of subdivided real estate in Arizona.⁽¹⁾ The cases illustrate the ability of subdividers to circumvent the key provision of the law - the public report - with little consequence. As a result, purchasers may continue to be at risk when buying property in subdivisions. This continued risk occurs despite the efforts of the Legislature to provide protection to consumers through the subdivision law.

Existing statutes hinder access to recovery funds - Beyond the Department's weak enforcement of subdivision laws, current statutes hinder access to a recovery fund administered by the Department and designed to compensate persons harmed by subdividers. A.R.S. §32-2196 directs the Real Estate Commissioner to establish a Subdivision Recovery Fund and, based on a court judgment, pay claims of up to \$10,000 per transaction to the purchaser of an unimproved subdivision lot who is injured by fraud or misrepresentation of a subdivider. As such, purchasers of improved subdivided land are ineligible for the protection provided by the fund. Adding to this problem is the Department's interpretation that the mere planning of improvements by a subdivider

(1) The Department has been slow to act in the case cited on page 18 where the developer failed to install fire hydrants and exit roads as specified in the public report. Eight months after receiving the complaint, the Department still had not taken any action to compel the developer to correct the situation or to prevent future problems.

makes the lot improved land and therefore not covered by the fund. This overly restrictive access to the fund is illustrated by the small number of claims paid from it, reported by Department officials to be only four in the last fifteen years. Further, this limited access has allowed the fund balance to grow to \$1,130,117 as of June 30, 1991. However, a statutory revision making purchasers of improved lots eligible for reimbursement from the Subdivision Recovery Fund could provide additional protection to those injured by the illegal acts of a subdivider.

**The Department Can Streamline Subdivision Review
by Coordinating with Local Entities**

The Department can obtain additional resources to strengthen enforcement by streamlining the subdivision review process. The similarities between the Department's subdivision review activities and those of local governments provide opportunities for utilizing work currently performed by city and county staff. To improve its effectiveness and efficiency, the Department could coordinate its efforts with those of the local entities involved in the regulation of subdivisions.

Similarities between Department and local government activities - Several of the Department's activities in approving subdivision public reports are similar to activities of local governments that also regulate subdivision development. Department subdivision representatives review developers' applications for public reports and supporting documents to: 1) confirm compliance with subdivision laws and rules; 2) identify any conditions that might affect the buyer's use or enjoyment of the property; and 3) identify any responsibilities or obligations the purchaser may have to assume. Once the application has been reviewed, a subdivision representative inspects the site to assure that the property is as described in the application; that the utilities are being installed as promised; that there are no additional nuisance factors which should be described in the report; and that the developer is meeting established deadlines.

Developers must comply with local requirements as well. For example, the developer must obtain a recorded plat, approved by local authorities

prior to applying for a public report from the Department. The plat, which is a detailed set of plans for building the subdivision, contains technical information on the proposed layout, drainage, water, utilities, street improvements, etc. Plans are generally reviewed by a number of local entities including: 1) city or county engineers, 2) planning and zoning officials, 3) fire and police departments, 4) public health staff, and 5) parks and recreation officials. Table 3 shows the areas where these local activities overlap with those of the Department.

TABLE 3
COMPARISON OF SUBDIVISION REGULATORY ACTIVITIES
PERFORMED BY THE DEPARTMENT AND THOSE
PERFORMED BY LOCAL ENTITIES

<u>Task</u>	<u>Performed by the Department</u>	<u>Performed by the majority of entities sampled</u>
Document review		
Review financial/legal aspects of sale	X	
Conditions, covenants, & restrictions	X	X
Review advertising/promotional plan	X	
Provide disclosure information to buyer		
Utilities cost	X	
Road maintenance costs	X	
Site inspection		
Technical assurances		
Compliance with planning & zoning		X
Permanent access to property	X	X
Water supply	X	X
Sewage	X	X
Utilities installation	X	X
Roads construction	X	X
Field inspection	X	X
Identify nuisance factors	X	(a)
Inspect amenities (pools, club house)	X	

(a) Although many of the local entities did not inspect for nuisance factors, most were confident that the zoning department addressed this. If planning and zoning declared the land a residential area, then there were no nuisance factors of consequence.

Source: The Department of Real Estate, and an Auditor General survey of 18 of the cities and counties in Arizona regarding subdivision regulation. Cities and counties were selected so that both urban and rural areas were represented.

Coordination and cooperation with local governments - These similarities create the potential for reducing departmental involvement in approving public reports. The Department could streamline its review process and thus devote more effort to enforcement by accepting the site inspections done by those local governments which are adequately staffed to conduct these inspections. In addition, the Department could make arrangements to have those same local entities review the amenities as a part of their site inspection. Currently the Department appears to review many of the same items that the local governments review. The only item examined by the Department that is not routinely checked by most of the local governments is the construction of the proposed amenities (swimming pools, club houses, golf courses, etc.)

Local authorities whom we contacted agreed that it would be possible to work out an agreement with the Department whereby local inspectors would examine the construction of amenities and inform the Department of the status. In addition, the Department appears to duplicate the efforts of local authorities in the technical reviews it conducts. For example, the Department evaluates access to the parcels, availability and quality of water, and sewage treatment facilities, each of which, in most cases, has already been reviewed by the local authorities.

The Legislature may wish to provide the Department with specific authority to implement this procedure. We believe the Department has statutory authority to utilize the reviews and investigative work done by local entities. A.R.S. §32-2181.01.A gives the Commissioner the authority to exempt an applicant from any or all of the provisions of the subdivision statutes provided that they are not essential to the public interest. Therefore, the Commissioner could accept the site inspections conducted by the local entities and not require Department staff to reinspect the sites. (This option appears to be most feasible in cities and counties that have strong professional planning, zoning and other development staff.) However, while the Department favors this concept, the Department's Attorney General representative disagrees with our interpretation of A.R.S. §32-2181.01.A, and feels a statutory change will be necessary for the Department to utilize work conducted by the local entities.

Coordinating with local governments will enable Department subdivision staff to devote additional time to enforcement activity. However, we were unable to estimate the potential time savings because the Department does not keep records of the amount of time spent on reviewing applications and inspecting subdivisions. The possibility for savings, particularly for inspections outside of the Phoenix and Tucson areas, warrants further evaluation.

RECOMMENDATIONS

1. The Legislature should consider amending A.R.S. §32-2196 to make purchasers of improved subdivided land eligible for reimbursement from the Subdivision Recovery Fund.
2. The Legislature should consider amending A.R.S. §32-2181.01.A to provide specific authority for the Department to utilize reviews and investigative work conducted by local entities.
3. The Department should work with county recorders to establish procedures by which recorders notify the Department of attempts to transfer land without public reports.
4. The Department should more effectively monitor developers' compliance with public reports, including a) periodic audits of developers' records to assure that public reports are distributed as required by law, and b) in cooperation with local governments, where feasible, following up on subdivision development to ensure that it is constructed and marketed in accordance with the public report.
5. The Department should discontinue its use of informal suspensions and formalize its procedures for suspending public reports by establishing criteria for suspensions and using signed consent agreements that clearly document the terms of suspension.
6. The Department should exercise its existing authority to take stronger effective enforcement action against those who violate the subdivision laws.

7. The Department should review the feasibility and potential cost savings of coordinating its subdivision regulatory activities with those of local governments. Such coordination should focus on eliminating activities that duplicate the efforts of local entities.

FINDING III

THE DEPARTMENT SHOULD ELIMINATE THE PRACTICES OF SPECIAL TREATMENT AND FAVORITISM

The Department has demonstrated a pattern of special treatment and favoritism to some individuals. Specifically, the Department has improperly granted licenses to employees and extended preferential treatment to former officials and select members of the public. In addition, inadequate controls over some licensing functions create the appearance of impropriety.

Licenses Improperly Granted To Employees

We identified three specific instances in which real estate licenses were improperly granted to Department employees. Although statutes require those applying for licensure to meet certain minimum qualifications, in each of the three cases some or all of the statutory requirements were not met and in most instances were waived by Department officials, including the former Commissioner.

Statutes require minimum qualifications - Arizona Revised Statutes §§32-2124 and 32-2132 dictate that each applicant for an original real estate broker's or salesperson's license meet specific minimum qualifications for licensure. The requirements for a real estate salesperson's license include:

- Completing a real estate course of at least 90 hours or the equivalent and satisfactorily passing an exam on the course
- Passing a written exam administered by the Commissioner and designed to determine the applicant's knowledge of the English language, real estate conveyances, principles of business and land economics, the obligations between principal and agent, the canons of business ethics, and the provisions of Arizona's real estate statutes and rules
- Paying applicable examination and licensing fees

The statutory requirements for a real estate broker's license include these provisions, plus an additional requirement of three years "actual experience" as a licensed salesperson, or real estate broker in another state, during the five years immediately preceding application for licensure.

Statutory requirements waived - We found three Department employees who received real estate licenses through the waiver of some or all statutory requirements for licensure. These waivers were granted by a former Commissioner and/or other Department officials although there is no statutory authority for the waiver of these requirements. The specifics of the three cases are as follows.

Employee 1

In September 1990 this employee received a real estate broker's license although he did not meet several statutory requirements, including three years experience as a licensed salesperson during the previous five years, completion of 90 hours of real estate course work, and taking the written licensing exam. A Licensing Division official indicated that the license was issued because the Commissioner waived these requirements. When asked about this case, the former Commissioner stated he waived the requirements because he thought the employee would be leaving the Department and he wanted to be sure the employee was licensed as he had been before joining the Department. However, the employee had been licensed as a salesperson, not as a broker, before joining the Department.

Employee 2

In August 1990 this employee received a real estate salesperson license although he had not completed 90 hours of real estate course work and taken the written licensing exam. According to a Licensing Division official, the license was issued at the direction of the Commissioner who waived these requirements. When asked about this case, the former Commissioner stated he waived the requirements because the employee was retiring from the Department and he wanted to return to the employee the license he had to give up when he joined the Department several years earlier. However, the Commissioner lacked the statutory authority to grant such waivers, as well as the authority to reinstate a license.

Employee 3

Shortly before leaving the Department, this employee received a broker's license although he failed to meet the three years experience requirement. Additionally, the certification for the employee's 90 hours of real estate course work was merely signed-off by a Department Education Division employee. The employee stated that she was instructed by the Director of the Education Division to certify the 90 hours of course work although there was no documentation to support it. The former Education Director could not recall whether she gave those instructions.

The present Commissioner is aware of these inappropriately granted licenses and with the assistance of the Attorney General's Office is currently acting to remove the licenses from the three individuals.

Favorable Treatment to Former Officials and Members of the Public

The Department has extended favorable treatment to former officials and select members of the public. Through our work, we identified two former Department officials who received special treatment in the licensing or complaint resolution process. Additionally, we found two members of the public who were given special treatment when applying for licensure.

Former officials received special treatment - Our review found that a former Commissioner received special treatment when obtaining and renewing a license and in the resolution of a complaint case. In addition, a former Assistant Commissioner was given favorable treatment in the renewal of a license. Below are summaries of these instances.

Former Commissioner

Upon leaving the Department in 1986, the former Commissioner obtained a real estate broker's license although he did not have the statutorily required three years experience during the preceding five years. He had not been actively licensed for more than 25 years. Further, on his last day as Commissioner, he took the broker's licensing exam which, based on a notation on the application, was administered in the Deputy Commissioner's office.

At the time of his license renewal in 1988, the former Commissioner requested that the Commissioner allow him to use time spent at a real estate regulatory conference and teaching two real estate courses to fulfill the majority of his continuing education requirements. The

Commissioner granted this request; although according to the then Director of the Education Division, it was the Department's policy not to accept such undocumented activities as continuing education credits.

Also in 1988, the Department investigated the activities of a real estate brokerage firm, identifying several serious violations involving property management irregularities, including the embezzlement of approximately \$6,000, and the payment of referral fees by the firm to unlicensed individuals and companies. During much of the time the documented violations took place, the former Commissioner was employed as the firm's designated broker, a position which, according to Department interpretation, made him responsible for the activities of the firm as well as for the licensees employed by the firm. However, while the Commissioner took disciplinary action against the firm and the licensees, he failed to take any action against the former Commissioner. This occurred although we found similar cases before and after this case in which the Commissioner took an action against the designated broker.

Former Assistant Commissioner

More than three years after leaving the Department, the former Assistant Commissioner⁽¹⁾ applied for and received a real estate salesperson license. Upon renewing his license, the former Assistant Commissioner was granted a waiver of the continuing education requirements by the Director of the Education Division, although there was no reason given for the waiver. Further, the former Director of the Education Division cannot recall why the waiver was granted.

Special treatment to members of public - Beyond the preferential treatment received by former Department officials, we found two members of the public who were given preferential treatment when obtaining licenses from the Department. As summarized below, in each of these instances this treatment appears to have been given at the direction of the then Commissioner.

Case 1

In August 1990, the Commissioner instructed the Education Division Director to process the documentation necessary to certify an applicant for a real estate broker's license and administer an in-house licensing exam to the individual (rather than require him to take the exam offered monthly by the Department's contract testing service). Although she had some concerns about the documentation provided by the applicant, including the use of a college math course

(1) The Department has since changed the title of this position to deputy commissioner.

taken approximately 36 years earlier to satisfy 45 of the 90 hours of the prelicensing education requirements, at the direction of the Commissioner, the Education Division Director certified the applicant's education and experience requirements necessary for licensure, and scheduled an in-house licensing exam. As a result, the applicant received a real estate broker's license in October 1990.

When asked about this case, the former Commissioner told us the applicant was his neighbor and that after leaving the Department, he was employed as a real estate broker by the applicant's real estate company.

Case 2

In March 1989, the Department administered an in-house real estate salesperson licensing exam to an applicant who had failed the exam offered by the contract testing service several times before. According to the former Education Division Director, the Commissioner instructed her to administer the in-house exam to the applicant "as a favor" because the applicant had provided him information regarding possible illegal real estate activities. In addition, a notation on the exam application indicates the Commissioner waived the exam fee, although he did not have the authority to do this. Finally, the applicant initially failed the test but was given credit for two answers which allowed her to pass the exam. The Department could not provide documentation to show why the credit was given for the two answers.

Inadequate Controls Create Appearance of Impropriety

In addition to individual cases of favoritism and special treatment, the Department's lack of adequate controls over some licensing functions creates the appearance of impropriety. The Department has failed to monitor the provision of in-house licensing exams. In addition, controls need to be exercised over the granting of continuing education waivers.

Failure to monitor in-house licensing exams - The Department has failed to monitor the reasons and circumstances under which in-house licensing exams are administered. While the Department has given in-house licensing exams to several individuals over the past few years, there are no criteria dictating when and to whom the exams will be offered. This lack of criteria, as well as the lack of documentation associated with the admission of the exams, raises questions about the validity of some exam results. Further, according to Department officials, the in-house exams were copies of exams previously administered by the contract testing service.

According to Department records, from 1988 to January 1991, 15 license applicants were given either a salesperson or brokers licensing exam administered by Department employees.⁽¹⁾ These 15 applicants were allowed to take this in-house exam rather than the corresponding monthly exam offered at several locations throughout the State by the Department's contract testing service.

Although the Department administers in-house exams, we were unable to identify any written or uniform criteria concerning when and to whom these exams will be offered. According to current and former Department officials, the practice of offering in-house exams was designed to address those situations in which applicants experienced some hardship, such as a handicap, religious beliefs, or financial hardship, in taking the exam as scheduled by the contract testing service. However, based on information provided by the Department, while there were a variety of reasons for allowing the applicants to take the in-house exam, 8 of the 15 applicants had failed the test offered by the contracting testing service on two or more previous occasions. Despite their previous poor performance, 14 of the 15 applicants passed the in-house exam.

In addition to a lack of written criteria concerning when to offer the in-house exam, the Department's documentation of who took the exam, why they were allowed to take it, as well as the results of the exam are lacking. For example, in our review of the in-house exam process, we found:

- Records regarding who had taken in-house exams prior to 1988 had been destroyed
- There is no single listing of who had been given in-house exams

(1) Statutes and rules governing the real estate licensing process appear to allow the Department the authority to offer in-house licensing exams. Arizona Revised Statutes §32-2124.E. instructs the Commissioner to administer an examination in order to determine each applicant's knowledge of certain areas related to real estate. In addition, administrative rule R4-28-402 stipulates that a licensing examination will be held each calendar month and "...at such other times as the Commissioner deems necessary."

- There was no documentation indicating why in-house exams were necessary
- Critical documentation including the exam questions and answers keys were not maintained by the Department

This lack of documentation is particularly significant since 3 of the 15 applicants were given credit for one or more incorrect answers. In each instance, granting this credit allowed the applicant to pass the exam. However, because the exam questions and answers were not maintained, Department officials were unable to support the reasons for granting the credits, leaving some uncertainty about the validity of the exam results.

Controls needed over continuing education waivers - The Department needs to implement controls over the granting of continuing education waivers. Although the Commissioner appears to have broad authority in this area, additional controls could reduce any appearance of favorable treatment.

The statutes give the Commissioner considerable authority regarding continuing education requirements. A.R.S. §32-2130.A. stipulates that all licensees must obtain 24 hours of continuing education to renew their license. This statute also allows the Commissioner to waive this requirement "...for good cause shown." In response to this, through administrative rule and department policy, the Commissioner has adopted a policy of waiving the continuing education requirement for Department employees who maintain an inactive real estate license, as well as for members of the State Legislature and all statewide elected office holders who maintain a license.

While the Commissioner has the authority to grant these waivers, the controls over the process appear weak. Specifically, the Department, in the past, has not always documented the basis upon which the waivers were granted. As illustrated by the granting of a continuing education waiver to a former Assistant Commissioner (see page 30), without sufficient documentation, the granting of these waivers can be perceived as favoritism.

RECOMMENDATIONS

1. The Department should ensure that all applicants demonstrate full compliance with all statutory requirements for licensure. In doing so, the Department should refrain from granting special treatment to current and former department officials or to members of the public.
2. The Department should establish controls over its administration of in-house licensing exams to include criteria for the circumstances under which the exams will be offered and the maintenance of adequate documentation to support this criteria and the exam results.
3. The Department should establish controls over the granting of waivers for continuing education requirements to include requiring documentation of the reasons why waivers are granted.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2354, the Legislature should consider the following 12 factors in determining whether the Department of Real Estate should be continued or terminated.

1. The objective and purpose in establishing the Department

The legislation establishing the State Real Estate Department contains no statement of objective and purpose for the Department. However, in its fiscal year 1990 annual report the Department defined its goals as follows:

"The goals of the Department are to protect the public; to increase the proficiency, competency, knowledge, and integrity of its licensees; and to regulate the state real estate industry consistent with existing law in a manner which inspires public confidence."

In order to carry out this responsibility to the public, Arizona law empowers the Department to license and regulate real estate brokers, salespeople, and partnerships; investigate complaints regarding real estate transactions, regulate the offering and sale of subdivided land, unsubdivided land, cemeteries, time-shares, and membership campgrounds; administer the real estate and subdivision recovery funds; distribute educational material; and regulate real estate schools, instructors, and courses.

2. The effectiveness with which the Department has met its objective and purpose and the efficiency with which the Department has operated

The Department could improve its effectiveness and efficiency in meeting its goal of protecting the public from land sale fraud. Our review shows that the Department does not monitor compliance with subdivision laws and has not taken sufficient enforcement action in cases involving serious violations of these laws. The Department can increase its efficiency in subdivision regulation by coordinating its activities with local governments (see Finding II).

We also found that the Department's ability to protect the public is limited because it does not consistently investigate consumer complaints, and many complaints that are investigated are inadequately resolved (see Finding I).

3. The extent to which the Department has operated within the public interest

The Department has generally operated in the public interest by enforcing entry standards and standards of professional conduct within the real estate industry. However its granting of favorable treatment in the licensing process has not been in the public interest because individuals who have not met licensing requirements have been granted licenses (see Finding III).

4. The extent to which rules and regulations promulgated by the Department are consistent with the legislative mandate

Although the Department's rules have been certified by the Attorney General as consistent with the legislative mandate, R4-28-303.K, which requires brokers to assume responsibility for the acts of sales people they employ, appears to exceed the Department's statutory authority. Specifically, while A.R.S. §32-2153.A.21 permits the Commissioner to discipline brokers who fail to reasonably supervise employees, R4-28-303.K exceeds this statute by holding brokers responsible for all acts of their employees.

5. The extent to which the Department has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public

During recent efforts to promulgate rules, the Department has encouraged input from the public by: 1) forming a committee of persons representing various segments of the real estate and legal communities to draft rules; 2) holding public meetings throughout the state to discuss proposed rules; 3) publishing information regarding the proposed changes and the upcoming public meetings in the

Department bulletin; and 4) presenting information on the proposed changes to a variety of professional organizations.

The Department also informs the profession and the public by publishing a bulletin which is distributed to all licensees, all relevant boards and associations, all real estate schools and colleges that teach real estate courses, and to anyone else requesting a copy. Between 50,000 and 54,000 bulletins are sent out with each mailing. The bulletin contains information on recent changes in rules and departmental requirements; an article by the Consumer Representative explaining the subject of the majority of the recent complaints; a list of all Department administrative actions taken since the past bulletin was published; and an overview of any relevant current events.

The Department also allows public access to its information on licensees. Interested persons may call the Department and receive information on the status of a real estate person's license. In response, the Department will provide information on 1) the type of license the person has (salesperson, broker, etc.); 2) the name of the licensee's broker (unless the licensee is a designated broker him-or herself); 3) the address of the licensee's office; and 4) the date the license will expire. If requested, the Department will also furnish the caller with information on the licensee's disciplinary history including the number of complaints filed against the licensee in the past three years, the substance of those complaints, and the action which was taken by the Department.

Information over three years old is available upon request. If the person is willing to make an appointment and visit the Department offices, he or she may review any complaint files on the licensee in question.

6. The extent to which the Department has been able to investigate and resolve complaints that are within its jurisdiction

Although A.R.S. §32-2108 provides the Commissioner with clear authority to investigate complaints, the Department has not

sufficiently investigated all complaints against licensees. The Department has inappropriately handled some complaints of alleged serious violations against licensees, treating them as lesser violations. Thus, the Department has not conducted an adequate investigation of the allegations. We also found that the Department uses letters of admonishment without statutory authority and refers cases for which it has jurisdiction to other agencies for investigation (see Finding 1).

7. The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under the enabling legislation

The Attorney General is the legal counsel for the Department and is authorized by A.R.S. §32-2111 to act for the Commissioner in all legal actions or proceedings. According to the Department's Attorney General representative this includes the authority to prosecute violations of the real estate statutes.

8. The extent to which the Department has addressed deficiencies in its enabling statute which prevent it from fulfilling its statutory mandate

The Department has actively addressed deficiencies in the enabling statutes over the years. The most notable recent effort was the passage of Senate Bill 1054 in 1989 which reworded and reorganized approximately 70 statutes to increase consistency and uniformity in the regulation of the real estate industry. The legislation also made the following substantive changes: 1) increasing the relicensure education requirements for obtaining a salesperson's license from 45 hours to 90 hours; 2) requiring applicants for subdivision public reports, and applicants for the operation of membership campgrounds or cemeteries to submit fingerprints and disclose their criminal history, if any exists; 3) creating a "publications revolving fund" to develop, print, and distribute real estate laws and rules, and consumer information pamphlets; and 4) moving from regulation of membership campgrounds to licensure and a modified public report system.

9. The extent to which changes are necessary in the laws of the Department to adequately comply with the factors listed in the Sunset Law

Based on our audit work, we recommend that the Legislature consider amending A.R.S. §32-2196 to make purchasers of improved subdivided land eligible for reimbursement from the Subdivision Recovery Fund.

10. The extent to which the termination of the Department would significantly harm the public health, safety or welfare

Termination of the Department and the resulting deregulation of real estate professionals could pose a threat to public safety and financial security. Real estate purchases are substantial investments involving complex transactions. Real estate laws and licensing requirements protect the public while making these purchases.

Through its licensing function the Department screens applicants to exclude the unknowledgeable and the unscrupulous. In addition to protecting the public's financial security, the Department also screens all applicants for licensure to ensure the public's physical security. Finally, through the public report process, the Department helps protect the public from fraud and misrepresentation by disclosing important attributes associated with the sale of subdivided land.

11. The extent to which the level of regulation exercised by the Department is appropriate and whether less or more stringent level of regulation would be appropriate

The Department has generally exercised an appropriate level of regulation. However, the system for licensing brokers appears unnecessarily complex. The Department currently issues five different types of broker's licenses:

- Designated broker - an officer or member of a corporation who is designated to act as the broker for the corporation, the license is recorded under the corporate name

- Self-employed broker - the owner of the corporation
- Associate broker - works for another broker and is a partner in the corporation
- Doing business with and for - a broker who is employed by another broker
- Doing business with and for corporate - a broker who is employed by a designated broker and whose license is recorded under the corporation name

To simplify its licensing process and records, the Department should combine these five categories into perhaps as few as two. By statute, all real estate firms must be under the direction of either a designated broker or a self-employed broker. The remaining three categories appear designed to address the specific needs of the industry rather than to fulfill any regulatory need. For example, a doing business with and for broker acts under the direction of a designated or self-employed broker, much like a real estate salesperson does. In addition, the doing business with and for corporate category was apparently established to allow corporate licensees to work under the direction of a designated or self-employed broker. Yet, of the nearly 12,000 brokers licensed in the state, only 118 are licensed under this corporate category. Finally, there appears to be no statutory basis for the associate broker category; only 53 are licensed in the State.

12. The extent to which the Department has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished

The Department has made use of private contractors for several services. Private security firms and various law enforcement agencies fingerprint license applicants, and a private testing firm administers the licensing exam. In addition, the Department contracts for administrative law judges when deemed necessary or cost effective.

FIFE SYMINGTON
GOVERNOR



JERRY A. HOLT
COMMISSIONER

State of Arizona
Department of Real Estate

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Douglas R. Norton
Auditor General
2700 N. Central Avenue
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Dear Mr. Norton:

Enclosed are written comments made in response to the Sunset Review and Performance Audit of the Arizona Department of Real Estate. The comments are divided into three sections: General Comments, Legislative Proposals and Response to Recommendations.

Let me take this opportunity to praise your staff and their work. The audit team was very courteous and professional during the countless hours they spent with ADRE staff.

The audit findings represent real depth of effort on their part, and audit recommendations represent, on the whole, sound management practices. While some differences of opinion persist as to audit finding details, we find the audit recommendations to be substantially correct, reasonable and, in most cases, within the Department's ability to implement.

The audit has come at a propitious time. As the recently appointed Real Estate Commissioner, I welcome the opportunity to make changes within the prudent bounds of good management and legal authority. A number of the audit recommendations have already been acted upon. Others are in process. But without those recommendations, it might have taken months to come to many of the same conclusions which your audit has illuminated.

The audit experience has been very positive. The Department appreciates the findings and is committed to implementing your recommendations within the confines of resource limitations.

Sincerely,

A handwritten signature in black ink, appearing to read "Jerry Holt", is written over the word "Sincerely,".

Jerry Holt
Commissioner

JH:cd
Enclosures

ARIZONA DEPARTMENT OF REAL ESTATE

Response to Auditor General's Sunset Review and Performance Audit

September 11, 1991

I. GENERAL COMMENTS

A number of disagreements persist with respect to detail and comments used by the Auditor General in substantiating his conclusions and recommendations. However, if the findings were altered to reflect the Department's view in every instance, no substantial change would result to the audit's recommendations, or to the Department's response to the recommendations. This being the case, it is simply not productive to further debate these points.

With regard to examples which set forth lack of good investigative procedure, improper actions or lack of appropriate follow-up, two previously closed cases have been reopened and at least one new investigation initiated. As detailed in Responses to Recommendations, the Department plans internal review and management changes to improve investigative effectiveness while protecting and preserving the public interest.

There are also numerous examples in the audit findings which illustrate lack of written procedures, resulting in inconsistent treatment of licensees and license applicants. Steps have been taken to implement internal procedures to ensure more consistency. These steps are also detailed in Responses to Recommendations.

II. LEGISLATIVE PROPOSALS

A number of possible legislative proposals may result from the Sunset Review and Performance Audit findings. Among them are:

1. Expand Department disciplinary authority to include lesser disciplinary actions such as "Letters of Admonishment," "Reprimand" and "Written Censure," so that responses to relatively minor offenses can be made without having to take strong disciplinary measures. This may additionally include putting a licensee on "probationary" status.
2. Permit within the scope of A.R.S. §32-2181.01.A the latitude of authority for the Commissioner to give blanket acceptance for site inspections conducted by counties or municipalities. Application of such authority by the Commissioner could reduce duplication of subdivision inspections by the Department and local government.
3. Clarify the apparent conflict between R4-28-303.K and §32-2153.A.21. Although the Attorney General's staff advises the

Department that there is no conflict, the Auditor General's legal advisor believes that, "while A.R.S. §32-2153.A.21 permits the Commissioner to discipline brokers who fail to reasonably supervise employees, R4-28-303.K exceeds the statute by holding brokers responsible for all acts of their employees."

4. Expand the use of the Subdivision Recovery Fund in §32-2196 to allow eligibility for recovery fund reimbursements for purchasers of *improved* subdivided land as well as for *unimproved* subdivided land.

5. Allow employees of the Department who are required to place their licenses in inactive status to renew such licenses while continuing inactive, without having to pay renewal fees.

In July 1991 the Real Estate Commissioner created the Commissioner's Select Committee on Real Estate Rules and Laws. The purpose of the Committee is to review real estate related rules and laws with the intent of suggesting changes to modernize, repeal, update and/or streamline these rules and laws. The Committee consists of 55 members from the public and all areas of the regulated industry aided by 10 ADRE staff members. Nine subcommittees of the Committee are presently actively engaged in this review.

The above five legislative proposals will be submitted to the Committee for inclusion in its review of rules and laws. After further review by the Real Estate Advisory Board, the Office of the Governor plus public comment, it is anticipated that a number of legislative recommendations from the Committee will be submitted for consideration in the 1993 legislative session.

III. RESPONSES TO RECOMMENDATIONS

The Department respectfully submits the following responses to the Sunset Review and Performance Audit recommendations:

A. Investigations (reference page 13 of audit)

Audit Recommendation 1:

The Department should investigate all legitimate complaints. The Department needs to establish written criteria to ensure that complaints are appropriately categorized as public assistance requests, preliminary inquiries or case investigations based on the issues raised in the complaints.

Department Response:

1. We agree the Department should investigate all legitimate complaints.

2. The Investigations Division has adopted written criteria to ensure that complaints are properly categorized and acted upon as a Public Assistance Request (P.A.R.), Preliminary Inquiry (Prelim), or Case Investigation. However, as demonstrated by audit findings, adherence to these written criteria appears to be lax, indicating a further need to firm up the link between theory and practice.

3. Department response to the audit findings will include a review, by internal performance audit, of the sufficiency of written criteria and procedures followed for complaint categorizations, assignment of complaints, case loads, and follow-through on complaints. Appropriate training, personnel reassignment and other corrective actions will be taken as necessary to ensure future compliance.

Audit Recommendation 2:

The Department should obtain the necessary statutory authority to issue letters of admonishment and to use them as a disciplinary action. Until such time as statutory authority is granted, the Department should stop using these letters of admonishment as a form of discipline.

Department Response:

On September 1, 1991, the Department ceased the practice of issuing "letters of admonishment" and "written censure" as means for disciplinary actions. Instead, when stronger action is not appropriate, the Department will issue "administrative warnings" which will serve as a notice of violation and strong future action if compliance does not result. Additionally, legislation will be considered to create statutory authority for official reprimand and censure actions.

Audit Recommendation 3:

The Department needs to fully investigate and take appropriate action on violations of real estate law within its jurisdiction rather than referring such cases to other agencies.

Department Response:

Audit Findings appear to uncover a pattern of referral of complaints to other agencies as a substitute for Department

action. While it is certainly appropriate to inform complainants of other possible legal remedies, any complaint within the purview of the Department should be vigorously pursued. Remedial education for key Department staff appears to be appropriate and will be implemented via violation/jurisdiction workshop for Investigations and Subdivisions Divisions staff to be conducted by the office of the Attorney General. Other staff may also be included.

B. Subdivisions (reference pages 25 and 26 of audit)

Audit Recommendation 1:

The Legislature should consider amending A.R.S. §32-2196 to make purchasers of improved subdivided land eligible for reimbursement from the Subdivision Recovery Fund.

Department Response:

The Department agrees that expanded use of the Subdivision Recovery Fund should be explored. Legislation may be considered to permit reimbursements in cases involving improved subdivided lands as well as unimproved subdivided land. Such legislation should include possible adjustments as to who pays into the fund, level of fees, maximum amount of payouts, reimbursement qualifications, and administrative adjustment of available fund monies.

Audit Recommendation 2:

The Legislature should consider amending A.R.S. §32-2181.01.A to provide specific authority for the Department to utilize reviews and investigative work conducted by local entities.

Department Response:

The Department agrees that such specific authority to utilize reviews and investigative work by counties and municipalities should be explored to reduce duplication of activities.

Audit Recommendation 3:

The Department should work with county recorders to establish procedures by which recorders notify the Department of attempts to transfer land without public reports.

Department Response:

To better monitor illegal subdividing, the Department will seek to establish procedures with county recorders in which they would report certain property conveyances to the Department.

Audit Recommendation 4:

The Department should more effectively monitor developers' compliance with public reports, including a) periodic audits of developers' records to assure that public reports are distributed as required by law, and b) in cooperation with local governments, where feasible, following up on subdivision development to ensure that it is constructed and marketed in accordance with the public report.

Department Response:

In order to more effectively monitor subdivision compliance with public reports, within present resource constraints:

1. The Subdivisions Division will develop a weighted random sampling procedure to assure public reports are distributed as required by law.
2. The Subdivisions Division will pursue cooperation with local governments to follow up on subdivision development to ensure that construction and marketing is in accordance with the public report.

Audit Recommendation 5:

The Department should discontinue its use of informal suspensions and formalize its procedures for suspending public reports by establishing criteria for suspensions and using signed consent agreements that clearly document the terms of suspension.

Department Response:

Beginning August 26, 1991, the Department discontinued its use of "informal suspension" of sales for subdivisions not in compliance with the law or public report. The Department now uses a "consent to suspend sales" agreement which is signed by the subdivider and which clearly documents the terms of the consent. Such consents will be delivered to the Administration Division to ensure compliance.

Audit Recommendation 6:

The Department should exercise its existing authority to take stronger effective enforcement action against those who violate the subdivision laws.

Department Response:

In order to ensure appropriate effective enforcement action against subdivision violators, the future investigation of these violations will be conducted by the Subdivisions Division instead of the Investigations Division. Current Subdivisions Division employees are former Department investigators, and that, coupled with their exclusive depth of knowledge of subdivision laws, makes them ideally qualified to perform such investigations. In practice, the Subdivisions Division is already handling the most complex of the subdivisions investigations. It is anticipated that transfer of all subdivision violation investigations from the Investigations Division to the Subdivisions Division will take place by October 1, 1991.

Audit Recommendation 7:

The Department should review the feasibility and potential cost savings of coordinating its subdivision regulatory activities with those of local governments. Such coordination should focus on eliminating activities that duplicate the efforts of local entities.

Department Response:

The Department agrees that many of its regulatory activities are duplicating those of local governments.

- 1.** The Department will determine the extent of the ability and willingness of local governments to monitor subdividing activities, including conducting inspections, on behalf of the Department.
- 2.** Although authority does not currently exist in law to delegate the Department's regulatory review responsibilities to local government, if the Department determines that both ability and willingness of local government exists to coordinate subdivision activities, a legislative proposal may be made to give the needed delegatory authority to the Department.

C. Administrative Practices (reference page 34 of audit)***Audit Recommendation 1:***

The Department should ensure that all applicants demonstrate full compliance with all statutory requirements for licensure. In doing so, the Department should refrain from granting special treatment to current and former Department officials or to members of the public.

Department Response:

The Department now requires that all applicants for licensure be in full compliance with all statutory requirements. Complete review of all applicants' course work for pre-licensure and renewal is now an integral procedure in the Education Division's approval process. For instance, a recent Attorney General memorandum sets forth definite criteria to be used in such evaluation. Also, a proposed rule has been drafted by the Attorney General to address procedures for waiving continuing education requirements.

Audit Recommendation 2:

The Department should establish controls over its administration of in-house licensing exams to include criteria for the circumstances under which the exams will be offered and the maintenance of adequate documentation to support this criteria and the exam results.

Department Response:

The Department anticipates it will cease administering in-house examinations within the next few months. The Department is currently negotiating a change to electronic testing and because such testing will be conducted five days per week instead of once a month, there will be no further need for in-house testing. Procedures for the administration of in-house testing, however, have been established and implemented.

Audit Recommendation 3:

The Department should establish controls over the granting of waivers for continuing education requirements to include requiring documentation of the reasons why waivers are granted.

Department Response:

Since June 1991, documentation of the reasons for granting continuing education waivers has been required. Individuals now requesting such a waiver must submit their request in writing, with justification. Upon granting the request, the written waiver and justification are included in the licensee's file. A proposed rule draft by the Attorney General's Office, setting forth policy criteria for granting a waiver, is being reviewed for implementation.