GCA LAW PARTNERS LLP

R.E.A.C.H.

By Kenneth R. Van Vleck

Real Estate And Construction Highlights—A Newsletter for Real Estate and Construction Professionals

March 2011 • Vol. VII, Issue No. 2

Ken Van Vleck

Ken is a real estate and commercial litigation attorney at GCA Law Partners LLP

He can be reached at (650) 428-3900

"Brokers [owe a duty] to disclose an impediment to the ability of the seller to convey title free and clear of monetary liens and encumbrances."

Residential Sales – Debt Disclosure

THIS ISSUE

Can a real estate sales person be held liable for the failure to inform potential buyers that the debt on a property exceeds the proposed sales price?

BACKGROUND

California requires that sellers of real property must disclose all material facts of which the seller is aware that might affect the desirability or value of real property. And real estate agents must visually inspect the property, and disclose their findings in a transfer disclosure statement. But what about issues that are not "visually apparent" such as conditions of title or even the amount of secured debt on the property at time of sale? At least one California court has held that the debt is an issue that must be disclosed.

As held by that court, "Particularly in these days of rampant foreclosures and short sales, the manner in which California's licensed real estate brokers and salesmen conduct business is a matter of public interest and concern. When the real estate professionals involved in the purchase and sale of a residential property do not disclose to the buyer that the property is so greatly overencumbered that it is almost certain clear title cannot be conveyed for the agreed upon price, the transaction is doomed to fail. Not only is the buyer stung, but the marketplace is disrupted and the stream of commerce is impeded. When properties made unsellable by their debt load are listed for sale without appropriate disclosures and sales fall through, purchasers become leery of the marketplace and lenders preparing to extend credit to those purchasers waste valuable time in processing useless loans. In the presently downtrodden economy, it behooves us all for business transactions to come to fruition and for the members of the public to have confidence in real estate agents and brokers."[1]

[1] *Holmes v. Summer* (2010)188 Cal.App.4th 1510, 1514.

IN BRIEF

Factual Background

The *Holmes* case presented the "interesting question of whether the real estate brokers representing a seller of residential real property are under an obligation to the buyers of that property to disclose that it is overencumbered and cannot in fact be sold to them at the agreed upon purchase price unless either the lenders agree to short sales or the seller deposits a whopping $392,000 in cash into escrow to cover the shortfall."

The buyers and seller agreed to the purchase and sale of a residential real property for the price of $749,000. But the buyers did not know the property was subject to a first deed of trust in the amount of $695,000, a second deed of trust in the amount of $196,000 and a third deed of trust in the amount of $250,000, for a total debt of $1,141,000. The lenders had not agreed to a short sale. The buyers allege that after they signed the deal with the seller, they sold their existing home in order to complete the purchase of the seller's property. Only then did they learn that the seller could not convey clear title because the property was overencumbered.

Buyers Sued the Agents

The buyers sued the listing brokers, alleging that they had a duty to disclose the significant overencumberance of the home. They demurred to the complaint (asked the court to dismiss the action before it even got started), and the trial court agreed, finding that there was no duty owed to the buyers. The buyers appealed that ruling, and the court of appeal reversed, finding that under the facts of this case, "the brokers were obligated to disclose to the buyers that there was a substantial risk that the seller could not transfer title free and clear of monetary liens and encumbrances."

At the Hearing on Demurrer

Ruling on the demurrer, the trial judge opined that the plaintiff had sued the wrong people. They should have sued the seller, not the listing brokers. As the judge said, "Well, I said this last time, and I repeat it this time. I think you've got a great lawsuit against the seller of the property, but the seller of the property is not a named defendant in this case. I'm guessing that the seller, because the seller is upside down in this, is basically judgment proof. And so you're searching around for a deep pocket. The deep pocket is the brokerage. But the brokerage appears . . . under the circumstances to have done nothing that breached any duty to your client, certainly did not engage in fraud that you allege. Basically I think the ruling in sum is that you picked the wrong target here." It then sustained the demurrer to the first amended complaint without leave to amend.

Often, the Court's ruling on appeal is determined by how the question is framed for the court. Here the parties had two very different views of the question.

According to the buyers, the brokers represented that the property could be purchased for $749,000, and indeed negotiated a sale for that price, even though they knew that the property was encumbered with $1,141,000 in debt. In other words, the brokers knew that the property could not in fact be sold for the price of $749,000, free and clear of monetary liens and encumbrances, unless the lenders agreed to discount the debt on the property by a total amount of $392,000 or the seller put at least $392,000 in cash into the escrow in order to pay off the lenders. As the court of appeal put it, "$392,000 is not exactly 'chump change.' This is a substantial amount of money." Furthermore, the seller had to gain the cooperation of not just one, but two or more lenders to obtain the necessary debt relief. Considering the magnitude of the discrepancy between the sales price and the total debt on the property, the buyers argued the brokers were obligated to disclose the excess debt because it indicated a substantial risk, over and above that inherent in the routine residential sales transaction, that the escrow would not close.

The brokers, on the other hand, argued that they were precluded from disclosing the financial issues

affecting the transaction. They said that for them to have made the disclosure in question would have required them to disclose the seller's confidential financial information or its strategy in determining the price at which it would be willing to sell. The brokers also assert that it would have required them to disclose that the seller might lose money on the property.

California Disclosure Law

Two seminal California cases summarize the current residential real property disclosure laws: *Lingsch* and *Alfaro*, (cited in footnote below). The buyers correctly argued, "It is now settled in California that where the seller knows of facts materially affecting the value or desirability of the property which are known or accessible only to him and also knows that such facts are not known to, or within the reach of the diligent attention and observation of the buyer, the seller is under a duty to disclose them to the buyer."[2] When the seller's real estate agent or broker is also aware of such facts, "he [or she] is under the same duty of disclosure." A real estate agent or broker may be liable "for mere nondisclosure since his [or her] conduct in the transaction amounts to a representation of the nonexistence of the facts which he has failed to disclose."

As summarized by the Court: "According to the buyers, the monetary liens and encumbrances on the property affected both the value and the desirability of the property. Because the brokers were aware of the magnitude of the debt, and should have known that the buyers were not aware of the same, the brokers had a duty to disclose the problem. By their silence, the brokers represented the nonexistence of any impediments to the transfer of title free and clear of monetary liens and encumbrances. The brokers, on the other hand, contend there is no connection between the amount of debt on the property and the value or desirability of the property, at least where, as here, the seller agrees to sell the property free and clear of monetary liens and encumbrances. In other words, the physical characteristics and intrinsic desirability of the property are distinct from the financing."

BROKER AND AGENT LIABILITY

The court sided with the buyers, finding that the brokers' argument "misses the big picture." It surmised that while a buyer may be harmed by acquiring title to a property with undisclosed defects, such as hazardous waste or soils subsidence problems, a buyer may also be harmed by entering into an escrow to purchase property when it is highly likely that, unbeknownst to the buyer, the escrow will never close. The court relied upon the rule expressed in *Lingsch* that the disclosure obligations are intended "to protect the buyer from the unethical broker and seller and to insure that the buyer is provided sufficient accurate information to make an informed decision whether to purchase." Although there is no fiduciary duty by a listing agent to a buyer, the Court nevertheless recited the law that "a real estate agent is clearly under a duty to exercise reasonable care to protect those persons whom the agent is attempting to induce into entering a real estate transaction for the purpose of earning a commission."

Here, the buyers sold their existing home in order to purchase the seller's property and were damaged when the seller failed to convey title. Whether or not the brokers knew the buyers would need to sell their existing home in order to complete the transaction, the Court held, "it should be perfectly foreseeable to an experienced real estate agent or broker that one who is purchasing a $749,000 residence may need to sell an existing residence in order to make the move."

[2] *Lingsch v. Savage* (1963) 213 Cal.App.2d 729, 735 and *Alfaro v. Community Housing Improvement System & Planning Assn., Inc*. (2009) 171 Cal.App.4th 1356, 1382

Although the duty to disclose a physical property defect was not at issue, the Court observed that real estate agents or brokers have been held to have a duty to disclose matters that do not pertain to physical defects, but otherwise affect the desirability of the purchase.

The Court cited several cases of broker liability for non-disclosure, including:

- duty to disclose neighborhood nuisance
- duty to disclose murders on the property
- duty to disclose that improvements were constructed in violation of building codes or zoning regulations.
- duty to disclose conditions re: inspection and date of deposit

And now we can add to that (non-exhaustive) list, the "duty of the brokers to disclose an impediment to the ability of the seller to convey title free and clear of monetary liens and encumbrances."

The court held that to "impose a duty on the brokers here to disclose information alerting the buyers that the sale was at high risk of failure would be to further the purpose of protecting buyers from harm and providing them with sufficient information to enable them to wisely choose whether to enter into the transaction."

Liens Were Disclosed in Escrow

The brokers argued that the buyers knew about the liens before close of escrow, because those very liens were disclosed during the escrow process. But the Court dismissed that argument. "The brokers had a duty to disclose the liens before the buyers signed the agreement. Only then could the buyers weigh the risks of entering into an agreement, and preparing their finances and related affairs to facilitate completion of the purchase, considering there was a significant possibility the transaction would fall through. Disclosing the liens only after the buyers had entered into the escrow failed to protect them in this context."

The Debt Disclosure Rule Simplified

Using the Court's own words, "the rule we articulate in this case is simply that when a real estate agent or broker is aware that the amount of existing monetary liens and encumbrances exceeds the sales price of a residential property, so as to require either the cooperation of the lender in a short sale or the ability of the seller to put a substantial amount of cash into the escrow in order to obtain the release of the monetary liens and encumbrances affecting title, the agent or broker has a duty to disclose this state of affairs to the buyer, so that the buyer can inquire further and evaluate whether to risk entering into a transaction with a substantial risk of failure."

CONCLUSION

California cases recognize a fundamental duty on the part of a realtor to deal honestly and fairly with all parties in the sale transaction. Here, the Court found that "a sense of rudimentary fairness would dictate that buyers in a case such as this should be informed before they open escrow . . . that there is a substantial risk that title cannot be conveyed to them."

NEXT ISSUE

Two new cases discuss condominium owners association maintenance obligations, and liability for breach of those obligations.

R.E.A.C.H. Distribution List

- If you are not receiving this newsletter directly, please send me your e-mail address and I will add you to the R.E.A.C.H. Distribution List.
- Please feel free to redistribute R.E.A.C.H., unedited and with credit to the author. Or if you would like this newsletter sent directly to others in your organization, please send me their e-mail addresses and I will add them to the distribution list.
- Archived issues of R.E.A.C.H. may be found on the GCA Law Partners website at www.gcalaw.com.
- R.E.A.C.H. is a publication of general applicability and not specific to any set of facts. Thus, it should not be relied upon for any specific case or matter without further discussion. No attorney-client relationship is formed as a result of your reading or replying to this newsletter, which is not intended to provide legal advice on any specific matter, but rather to provide insight into current developments and issues.

KEN VAN VLECK
kvanvleck@gcalaw.com

1891 LANDINGS DRIVE
MOUNTAIN VIEW, CA 94043
TEL 650.428.3900
FAX 650.428.3901
www.gcalaw.com

GCA LAW PARTNERS LLP