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Broker Has Duty to Disclose to Buyer that Proceeds of Sale May Not Be Sufficient to Pay Off Encumbrances

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On October 6, 2010, the California Court of Appeal for the Fourth Appellate District, reversed the Superior Court of Orange County's judgment in *Holmes v. Summer*. In *Holmes*, the Superior Court granted brokers' motion to dismiss buyers' lawsuit on the grounds that the brokers did not owe buyers a duty of disclosure.

In its decision, the Court of Appeal reversed the Superior Court and held that brokers do have a duty to disclose to a buyer that there was a "substantial risk" that the loans on the property could not be paid with the proceeds from the sale of the property, without the lenders agreeing to a lesser payoff or the seller paying off the remaining debt even though the broker does not represent the buyer.

In *Holmes*, the broker was a licensed real estate broker who represented a seller in the sale of a home in Huntington Beach, California. The buyers were a couple who sold their home to fund the purchase of the home at issue. Buyers were not represented by broker. At the time broker listed the property, the broker was aware that the property was encumbered by three deeds of trust totaling \$1,141,000. To purchase the property, seller and buyers executed a standard California Association of Realtors form purchase agreement and counter offer. The purchase price of the property was \$749,000. One of the conditions of buyers' offer was that the property be conveyed to buyers without any liens or encumbrances on title. During escrow, buyers learned that the property was subject to three deeds of trust. With the purchase price insufficient to cover the encumbrances on the property, the lenders were asked to accept less payment than that owing under the deeds of trust, but refused. When seller did not provide funds to cover the shortfall, the escrow did not close and buyers pursued this action against the broker and broker's employer, instead of seller.

Under California law, a seller's real estate agent or broker has the duty to disclose to a buyer "facts materially affecting the value or desirability of the property which are known or accessible only to him" if he "knows that such facts are not known to, or within the reach of the diligent

attention and observation of the buyer". In *Holmes*, the Court of Appeal found that financing on the property did affect the value or desirability of the property, where the amount of the deeds of trust on the property made it "highly unlikely" that the escrow would close. The Court of Appeal also found that the broker's duty to disclose the deeds of trust existed prior to buyers entering into the purchase agreement, as "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." Further, the Court of Appeal found that the deeds of trust were outside the "attention and observation" of the buyers, even though they could have been discovered through a title search. In doing so, the Court of Appeal reasoned that a title report was insufficient to give buyers notice of the existing deeds of trust because: (i) a title report would not likely disclose the amounts owing on the loans; (ii) a title report is not typically provided to a residential buyer until the agreement has been signed; (iii) seller had agreed to language in buyers' offer that the property would be conveyed without any deeds of trust; and (iv) constructive notice of the deeds of trust did not eliminate a broker's duty of disclosure to a buyer.

Determining that the brokers did have a duty to disclose to buyers, the Court of Appeal applied a six-pronged analysis to determine if the duty to disclose to a buyer extended to a situation, where as in *Holmes*, the brokers did not have a contractual relationship with the buyers.

The six-prong test applied by the Court of Appeal consisted of the following: (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to him; (3) the degree of certainty that the plaintiff suffered injury; (4) the closeness of the connection between the defendant's conduct and the injury suffered; (5) the moral blame attached to the defendant's conduct; and (6) the policy of preventing future harm.

First, the Court of Appeal found the first prong – extent to which the transaction was intended to affect the plaintiff – satisfied because the purchase and sale affected buyers.

Second, the Court of Appeal found that the second prong regarding foreseeability of harm to buyers was met because "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 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."

Third, the Court of Appeal found that the buyers suffered sufficient injury

to meet the third prong, and the fourth prong was met because there was a close connection between brokers' actions and the injury suffered by buyers.

For the fifth prong, regarding moral conduct, the Court of Appeal held that California cases recognize "a fundamental duty on the part of a realtor to deal honestly and fairly with all parties in the sale transaction". The Court of Appeal refuted brokers' argument that the duty to disclose the financial situation of seller was in conflict with the brokers' duty of confidentiality to seller, as the deeds of trust were part of the public record and disclosing such deeds of trust to buyers would not have resulted in a breach of brokers' duty of confidentiality to seller.

Finally, for the sixth prong, the court found that to prevent future harm to the buyers, brokers needed to disclose the risk to buyers under the circumstances of the *Holmes* case. Therefore, the "policy of preventing harm to an uninformed buyer weighs in favor of imposing a duty of disclosure on a seller's agent or broker in circumstances such as those before us."

The Court of Appeal held that "although the seller's agent does not generally owe a fiduciary duty to the buyer, he or she nonetheless owes the buyer the affirmative duties of care, honesty, good faith, fair dealing and disclosure, as reflected in Civil Code section 2079.16, as well as such other nonfiduciary duties as are otherwise imposed by law."

The *Holmes* ruling is a reflection of the current view of the California appellate courts that the state of the economy has created a need for judicial intervention to clearly define the duties and obligations of licensed real estate brokers and real estate agents to help protect the public interest and concern.

It is not known at this point whether there will be a challenge to the opinion of the Court of Appeal. Nonetheless, the holding of the Court of Appeal is unsettling, as it redefines the scope of a real estate agent's and broker's duty of disclosure to non-represented parties. This unexpected holding may result in an onslaught of litigation until the implications of the holding become well known. It is important to note that even though the Court of Appeal has limited its ruling to the facts of the *Holmes* case, the ruling of the *Holmes* case may still prove instructive, and even controlling, in the commercial context, as the Court of Appeal borrowed from case law involving residential and commercial properties to reach its holding. In light of this, attorneys, real estate agents, brokers, sellers and buyers should continue to maneuver with caution when dealing with the purchase and sale of any property, especially if it is distressed or has the potential of being distressed.

To discuss the ramifications of this recent case, please contact the undersigned.

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