Short Sales: Let the Agent Beware

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If a transaction is a short sale, the real estate agent handling the sale might be liable to the buyer if that fact is not disclosed up front. This week a California Court of Appeal issued a decision which imposes a duty upon a seller's agent to disclose that the seller's existing loans far exceed the contract purchase price. *Holmes v. Summer*, __ Cal.App.4th. ___ (2010 Daily Journal D.A.R. 15614) (filed October 6, 2010).

In this case the seller's agent listed for sale a residential property for $749,000. The property was subject to three deeds of trust totaling debts of $1,140,000, thus the sale would have to be a "short sale." No disclosure of the existing loan amounts were made in the MLS listing or to the buyer prior to executing the purchase contract.

The purchase contract provided that the buyer would purchase the property free and clear of any liens. After entering into the contract the buyer sold the buyer's existing home in order to purchase the property. The seller was not able to get the three lenders to agree to a 35% reduction in the existing loans, and then defaulted on the obligation to sell the property free and clear of liens. Instead of suing the seller for a breach of the contract and failure to disclose the problem with the loans up front, the buyer sued the seller's agent. The trial court surmised that the seller was broke and thus the buyer went after the agent's "deep pockets."

The trial court dismissed the buyer's case, holding that the agent had no duty to disclose the loan information. The Court of Appeal reversed that decision. It held that in this instance the listing agent had a duty to disclose to the buyer the existence of deeds of trust of record and the extent to which the property was "underwater." Furthermore, the disclosure had to be made before the buyer signed the purchase contract. The Court of Appeal indicated that where there was such a substantial over encumbrance of the property "there is a duty on that agent or broker to disclose the state of affairs to the buyer, so the buyer can make an informed choice whether or not to enter into the transaction that has a considerable risk of failure."

This conflicts with another duty of real estate agents, i.e., the duty not to disclose clients' confidential information. The court stated that both the "duty to disclose and the duty to maintain client confidentiality is clearly involved [in this case]." The court opined that deeds of trust, being in the public record, are not "confidential information" and that the basic duty of an agent to treat each party to the transaction "honestly and fairly" trumps the agent's duty of confidentiality to the seller. To avoid the conflict, the court suggested the agent must obtain the seller's permission to disclose such confidential information to a buyer before the buyer enters into a contract to purchase the property. Otherwise, the agent would be proceeding at his or her own "peril of liability in the event the transaction goes awry due to the undisclosed risks involved."

This case involved facts about existing loans that made a short sale extremely unlikely to succeed. What if the loans were smaller? What if there were fewer lenders? What if the seller has a pending divorce or bankruptcy? Is a listing agent required to disclose such confidential information to the buyer? This decision might open the floodgates to other claims against listing agents for failure to disclose confidential information about a seller's financial situation or other relevant circumstances that might make it difficult for the seller to consummate the sale. It is going to be important for agents to carefully assess the risks and rewards when selling distressed properties, and to beware of this disclosure obligation.