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Roger Bernhardt

Recorded notice that residence was “substandard” was neither defect in, nor lien or encumbrance on, the title under title insurance policy.

Elysian Inv. Group, LLC v Stewart Title Guar. Co. (2002) 105 CA4th 315, 129 CR2d 372

In 1998, Elysian purchased a residence from Countrywide Home Loans that had been previously acquired in foreclosure and was sold “as is.” In connection with the purchase, Elysian obtained a standard California Land Title Association policy of title insurance insuring against “any defect in or lien or encumbrance on title.” After the purchase, Elysian discovered that a “notice of premises classified as substandard” (Notice) had been recorded by the county against the property in 1996. The Notice was not listed by the title insurer as an exception to coverage. After the title insurer denied Elysian’s claim for coverage, Elysian sued for breach of contract and tortious breach of the implied covenant of good faith and fair dealing, alleging that the insurer had breached the policy by failing to inform it of the Notice. The trial court granted the insurer summary judgment, holding that the recording of the Notice was not a “defect in or lien or encumbrance on the title” and did not result in “unmarketability of the title” within the meaning of those terms in the policy.

The court of appeal affirmed. The court pointed out that title insurance does not cover physical conditions of property that merely affect land value, nor does it cover future events. The Notice merely warned that there were physical defects at the property. It was not enough that later events might result in enforcement ultimately affecting title.

Also, as a matter of law, the Notice did not affect marketability of title. The Notice concerned the physical condition of the property, for which there was no coverage, and did not raise any doubts about title. Although Elysian may have incurred unexpected expenses to bring the property up to code, that did not cast doubt on who owned the property.

THE EDITOR’S TAKE: In many other jurisdictions, the outcome of this case would be different (see, *e.g.*, *New England Fed. Credit Union v Stewart Title Guarantee Co.* (Vt 2000) 765 A2d 450). However, California makes a rather peculiar distinction between the ability of a document to be recorded and its (legal) ability to give constructive notice to others. That makes it possible for many writings to be inserted into the records for others to see, but not to charge others who did not actually see the writings with notice of their existence. (And, as an inevitable aftermath, to generate litigation between title insurers and their customers over the consequence of the insurer not reporting the writings to the customers.)

Given that disjunction between “recordability” and “notifiability,” it is hardly surprising that the title insurer would not be liable for failing to disclose the county’s recorded notice. Thus, if Elysian, the non-notified purchaser, has no recourse against Stewart Title, can it instead recover from its vendor, Countrywide? The grant deed’s implied covenant against encumbrances will not help it because (1) the notice has now been defined to be not an

encumbrance, and (2) the encumbrance was “done, made or suffered” by the grantor’s borrower, not the grantor itself—who was merely the lender in the prior deal. So there is only a claimed pre-deed disclosure duty, which is muddled by the conflicting facts that Countrywide sold the property “as is” on the one hand, but knew of the notice on the other (also knowing that the recorded notice would not be difficult for a prudent purchaser to find on its own). There may be some special provision in the sales contract calling for particular disclosure of such notices (although, for example, the California Association of Realtors Residential Purchase Agreement (and Joint Escrow Instructions), Area Edition (AEPA-11, dated 10/2000), appears to me to cover only notices received by the seller after the contract was signed, not preexisting notices!). This should help in such litigation, but it is not as effective as knowing in advance about the notice so that you can elect to purchase the property anyway or to just walk away from the deal. (Or does that too easily assume that a buyer can back out of the contract on discovery of the notice, claiming unmarketability of title, if the notice does not affect title as this case holds?)

The opinion says the purpose of county recordation is to inform the owner of the duty to bring the property up to code, but I doubt that, since the ordinance requires the building department to have already issued an “order” to the owner before it records the “notice.” It is not the owner that the county probably wants to notify so much as the potential purchaser, because, while it is true that the county can make any owner bring her property up to code whether or not she knew about the violation, she will be more likely to insist that her seller do so before transferring title if she has learned of the violation through the public records. That will happen only if she personally looks at the records, since the document does not give constructive notice and need not be reported by the title company (unless a true abstract has been requested, and even then the omission may not be actionable under this holding).

If I were advising the county, I would suggest that it amend its ordinance to declare that the notice gives constructive notice of its contents once it is recorded. That may be preempted by state law, but it doesn’t hurt to try. That should lead a court to hold that it therefore does affect title, although a further new judicial distinction between giving constructive notice and affecting title is always possible. As a backup, I would also suggest the county attempt to impose a lien on the property now for corrective work it may have to do later—like a future advance mortgage does—because a lien is generally deemed to affect title (and thereby give constructive notice). Why corrective liens encumber title whereas orders to correct do not will always remain a mystery, but one might as well get on the good side of the distinction. —*Roger Bernhardt*