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Lessons Not to Learn About Merger

Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

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Ram's Gate Winery v Roche

Ram's Gate Winery, LLC v Roche (2015) 235 CA4th 1071 teaches lessons that both transactional and litigation attorneys should not particularly want to learn. These lessons suggest that the old common law doctrine of merger can be safely ignored, whereas clients could suffer unpleasant consequences if those issues are not securely covered in the contract.

The decision is more fully reported on p 107, but its basic facts are that the plaintiff purchasers signed a contract with defendant vendors to acquire their winery, closed escrow on the deal, and a year later claimed that the winery's location on an earthquake fault had not been disclosed to them as the contract required. The vendors responded that the fault had been disclosed, and—more importantly—that their contractual disclosure obligation had been "merged" into the deed they had accepted at the closing, thereby extinguishing that previous obligation in the contract.

Any seller's liability for nondisclosure that sounds in tort rather than contract is probably not subject to a merger defense. Buyers who have not discovered a "hidden" defect until later (usually when they have taken possession) are able to sue for fraud or negligent misrepresentation for as long after close of escrow as the statute of limitations permits (usually 3 years after discovery; see CCP §338(d)). But *Ram's Gate* involved a contractual disclosure obligation comparable to the tort obligation to disclose all facts materially affecting value (which I'll call the "disclosure clause").

The inclusion of that disclosure clause in the contract induced the purchasers to add a cause of action for breach of contract to their complaint (and, later, to abandon their nondisclosure tort causes of action entirely). The vendors' motion for summary judgment asserted that the disclosure provision had merged into the deed and that the noninclusion of any similar disclosure language in that document meant the purchasers no longer had any supportable basis for claiming that a contractual duty to disclose still existed. Worse, while the contract did provide for the postclosing continuation of some of its obligations, the disclosure provision was not in that list of surviving provisions. The trial court granted the summary judgment motion. The purchasers responded by dismissing their tort causes of action, standing on their contract claim, and appealing the adverse ruling on it and the dismissal of their case. The court of appeal validated their strategy

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Merger of Contract Provisions Into Deeds

A major drawback of basing a lawsuit on a provision in a real estate sales contract is that if the purchase has already been consummated, the provision may be deemed merged out of existence. Real estate sales contracts are generally executory, intended by both vendor and purchaser to govern their relationship only until their respective performances have been completed and escrow has closed. Purchasers use their generally allotted 30 to 90 days to accomplish their due diligence investigations of the condition of the property (and to assemble the funds necessary to pay for their purchase), while vendors take the steps necessary to make their titles marketable or otherwise satisfactory to their purchasers. At the end of this period, their escrow agent swaps what it has been given, handing the vendor's deed to the purchaser and the money paid by the purchasers to the vendor. (The parties might now be also called grantor and grantee, and the former purchaser is now not merely the equitable owner of the land but also its legal owner. The executory contract has accomplished its purposes, has been executed, and is generally gone, once escrow closes.)

One aspect of the executory feature of such an arrangement is that either party could have refused to close the deal if the performance tendered by the other was not what the contract required. A purchaser may refuse to pay the price if the title or physical condition of the property is not what the contract called for. The right way to object to inadequate performance of an executory real estate sales contract is to refuse to close when the critical moment has arrived; indeed, objecting sooner than that may be an anticipatory breach.

The flip side of that proposition is that once a purchaser has accepted his vendor's performance, the time for objecting or complaining about its inadequacies has probably passed. Since a party's basic contractual right is to refuse to close, engaging in a close ends that right to decline to close. It is this feature that is generally described in legal shorthand by saying that a purchaser's contract rights have merged into his deed. From then on, whatever rights he has must derive from his deed, rather than from his old contract.

This version of the merger doctrine works sensibly for some features of a real estate sales contract, but it is a silly doctrine when applied categorically. The Uniform Land Transactions Act, approved by the National Conference on Uniform State Laws in 1975, proposed to eliminate the doctrine of merger entirely, but no jurisdiction ever adopted it. See Brown, *Symposium Article: What Ever Happened to the Uniform Land Transactions Act?*, 20 Nova L Rev 1017 (Spring 1996). A purchaser often wants greater protection than abrupt merger and termination afford after close of escrow.

Our legal system allows a party to obtain more security by acting appropriately. For example, the purchaser can (in the contract) call for a grant deed rather than a quitclaim deed, thereby gaining the protection of some statutorily implied covenants (*i.e.*, that his grantor has not previously conveyed the property to anyone else, and that she has not personally permitted any encumbrances to burden her title). CC §1113. But nondisclosure of an existing earthquake fault would hardly amount to a breach of either one of those "special" covenants—she did not cause any tremors.

The contract may also require other explicit warranties from the grantor to be included in the deed, often done when the land purchased will include a new structure on it, which the seller warrants will be—for some time thereafter—free of defects or of merchantable quality. That device effectively guarantees the continuation of some contract provision, either by converting it into a longer-lasting deed provision or by providing in the contract for its continuation after close of escrow.

A court may do the same by treating the covenant as "collateral" whose termination at close of escrow is either deemed inconsistent or incompatible with the intent of the parties, like a seller's promise in January to make an improvement to the property as soon as the snow melts or when the necessary materials or permits arrive. The covenant in this case, however (to disclose within the first 10 days of the contract), hardly seems to fit within that "collateral" category, but the court finessed this point by redefining the word in terms of relationship to the deed rather than to the sales contract, enabling it to not even get to the question of inconsistency (although, personally, I think such a characterization more removed the provision away from the collateral covenant exception rather than bringing it within it). The "intent to survive" requirement was held satisfied by the purchasers' statement that it was their intention to have that provision "continue after close of escrow," somewhat ignoring the integration clause in the contract and its parol evidence consequences. (The court also got around merger by saying that the provision had already been breached—when the 10-day period ended—and that merger did not apply to already existing causes of action, a more acceptable explanation.)

Finally, the executory sales contract can expressly provide that some of its provisions are intended to "survive" the closing of escrow. Utilization of a survival clause should not only ensure the continuation of a provision important to one of the parties, but also reduces the need for litigation in order to prove it. It is probably the cheapest as well as the most effective way to deal with this issue.

Another, different version of the merger doctrine operates to consolidate smaller interests and estates in land into larger ones, but with sometimes more dangerous consequences. If a neighbor had an easement across Blackacre and then acquired the fee to that parcel, his continued walking along the old road is no longer explained as exercise of his (former) easement, but instead as one of the activities an owner of the fee (in the newly acquired Blackacre) may engage in as part of his right of possession as owner of a possessory estate, his smaller easement having merged into his larger fee. This doctrine was mainly created to eliminate the clutter of having too many interests in land fragmenting titles, but it can generate undesirable consequences for incautious parties. For instance, the foreclosure of a senior mortgage is generally intended to wipe out all of the interests of both the mortgagor and any junior mortgagee in the same property, thereby allowing the foreclosing mortgagee to sell a complete title to the high bidder at his foreclosure. But if the junior mortgage interest was not properly included in that foreclosure, it was not then eliminated, and the bidder acquired the former interests of the senior and the mortgagor, which then may be held to have merged into a title that is subject to the old junior mortgage—now elevated into senior position. Most courts have found ways to avoid such an absurd application of merger law; the Restatement of Mortgages proposes its complete abolition in the mortgage field. But some courts still employ the doctrine; the possibility that it could arise to cause mischief means that it probably takes a lawsuit to get past it. That sort of merger trap requires entirely different avoidance strategies not covered in this column, but see my article *Mortgages and Merger* in ABA Probate and Property, Vol. 26, No. 6 (2012) (also reproduced on my website at http://rogerbernhardt.com/index.php/ceb-columns).

This Contract

The provision in this case obligated the sellers to disclose all information they had materially affecting the value of their property. The question for the court was whether it survived the close of escrow. One would normally expect buyers to use such a disclosure provision before rather than after closing, during the 10-day period that the contract gave them to do their due diligence; it also then permitted them to withdraw in their "sole discretion." Thus, its apparent role was probably to assist the purchasers in deciding whether to back out—within that first 10 days—rather than to belatedly generate or eliminate their remorse if they had already closed without backing out. I would therefore expect the provision to operate pre-close, but I would also expect it *not* to operate post-close. I would not expect a court to hold that such a clause ordinarily survived past the close of escrow. When a covenanting seller had affirmatively refused to disclose a material fact, I would expect her buyer to be entitled to refuse to close, and perhaps to sue for breach, but I would not think that her buyer instead could close escrow, take title, and then bring his damage or rescission action. When the seller has not disclosed but the buyer has not realized it, the suit is inevitably post-close, and probably subject to a 4-year statute of limitations starting either on the expiration of the 10-day period or the close of escrow. (The court seemed to think the end of the 10 days was the trigger.)

What Should You Do if You Don't Want a Provision to Survive?

Since none of the covenants implied in a California grant deed covers disclosures, and since disclosure provision survival seems generally unlikely, it is hard for me to understand a conclusion that it could survive, and even harder to assume that the purchasers can prove that it did survive. But I do not make the rules, and now we all must operate under a rule that a disclosure provision can survive the close of escrow and allow a purchaser to complete the purchase and thereafter sue for breach of a disclosure provision in the contract. Counsel should not have the confidence to advise their clients that they can always count on being able to enforce the disclosure provisions in their contracts even though they have already closed escrow, just because Ram's Gate was able to do so.

I was also somewhat dubious of the value of insisting on (and paying extra for) a contractual disclosure provision, since the duty to disclose all facts materially affecting the value of the property being sold is already imposed on vendors as a matter of tort law (*Lingsch v Savage* (1963) 213 CA2d 729), which does not need to be paid for. But to whatever degree a buyer believes that such a clause adds value to his purchase, then it obviously adds even more value if it lasts longer by virtue of surviving the close of escrow and endures even longer than liability for tortious nondisclosure does.

But if I wanted such enduring protection, I would not stop with just including a contractual obligation to disclose, simply hoping that it will last. (The trial judge did not think the clause survived; it required an appeal by the purchasers to get the outcome they wanted.) More careful drafting—including an explicit survival characterization in the provision itself, as well as including the provision in any overall list of surviving obligations found elsewhere in the contract—would have been a good deal cheaper and surer. Indeed, really good drafting might even convert an otherwise short-lived provision into a long-lasting one.

Some Puzzling Questions

Two other features of this case intrigued me and might affect outcomes in related situations
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Why Did the Purchasers Abandon Their Tort Claims?

I wonder why the purchasers abandoned the tort causes of action that they had originally pleaded, electing to stand solely on their contract theory. Their fraud and negligent misrepresentation claims pretty much depended on the same facts as did their breach of contract claim, so what led them to do so? Three possible reasons occurred to me, and there may be some lessons to learn from that.

First, perhaps the purchasers were concerned that the statute of limitations for tort claims had already run. The limitations period for fraud (and probably also for negligent misrepresentation) is 3 years from discovery (CCP §338(d); see also CC §1572(2)). These purchasers had waited more than 3 years after the end of the 10-day period and the close of escrow (although less than 3 years from the date of their claimed discovery) to file suit. The claimed late discovery might stretch those time periods, but there was evidence that they had been advised about the fault line at the time of purchase. On the other hand, a breach of contract cause of action would give them 4 years after their purchase to commence their litigation, thus making all those dates obsolete. A litigator analyzing the nondisclosure claims of a somewhat stale purchaser might breathe a sigh of relief in finding a good disclosure clause in the contract and amend the complaint accordingly.

Or perhaps the purchasers thought that it would be too difficult to prove all of the elements required in a tort cause of action. Fraud needs an intent to defraud, whereas breach of contract does not. What if the sellers had merely forgotten to mention the old earthquake fault? Negligent representation may require some affirmative misstatement, a case harder to make if there was merely a failure to say anything about the old fault. These might not be considerations to worry about in a contact claim, where nonperformance of the provision should be enough without more, regardless of whether intentional or inadvertent, or whether by silence or affirmative statement. It's a much easier case when there is a contractual provision than when there isn't.

Finally, perhaps the purchasers feared that the "economic loss" rule would prevent them from recovering sufficient damages in a purely tort action, even if they could prove the rest of their case. That rule could confine their recovery to physical or personal injuries and exclude simple loss of value, which is recoverable only in a contract rather than a tort case. Nothing in the opinion indicates that any physical damage to persons or property was caused by concealment or nondisclosure of the earthquake fault, so their claim that the land was worth less because of its proximity to the fault line could arguably be rejected as only an economic loss, not recoverable in a tort action. I think it is pretty clear that that rule has been displaced by the provision of our fraudulent sales statute, CC §3343, which measures liability by "the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received" regardless of whether there were personal or physical injuries. Conversely, however, I do not see any significant evidence that it has also been displaced in California in a negligent misrepresentation case—a position that seems to have been adopted only in Texas. See *D.S.A., Inc. v Hillsboro Indep. Sch. Dist.* (Tex 1998) 973 SW2d 662.

Time in Tort

Another area of uncertainty is how the time of discovery can affect the rights of the purchaser. I regard that topic as uncertain because we do not have all the rules we need to give solid advice to clients. Moving somewhat jerkily along a calendar from the beginning to the end of a deal will illustrate my concerns.

If the purchaser observes the defect before he has even made an offer, no issue is likely to arise: Either he does not then make an offer, or his offer requires the vendor to correct the problem, or the offered price is reduced. There is probably no chance that a purchaser who has already observed a defect can fail to mention it in his offer and then later demand that it be remedied.

If the purchaser observes the defect after his offer has been made and accepted, the due diligence rights in his contract probably cover the situation and describe his courses of action. Many contracts have provisions giving purchasers a certain number of days to satisfy themselves about the property's condition and allowing them a complete right to back out if they so choose. (See my column *The Cost of Free Looks—Ruminations on* Steiner v Thexton, 33 CEB RPLR 61 (May 2010), available on my website at http://rogerbernhardt.com/index.php/ceb-columns.) Or they can choose to bargain further, threatening to withdraw—in their "sole and absolute discretion"—with considerably more strength than otherwise.

The discovery of defects after the close of escrow is probably the most common of all the situations. Everyone understands that that is generally when tort actions begin rather than end. *Ram's Gate* adds that even a contract action can still lie. Just beware of the statute of limitations.

What to do about a defect discovered when there is no backout provision or its time period is over, but *before* escrow has closed, is where we are somewhat in the dark. Does the ending of the inspection period mean that the contract has become truly and unconditionally binding on a purchaser, regardless of what he has learned? Or does his permitting escrow to close thereafter mean that he has thereby waived all his previous rights to say or do something about the defect? I would expect litigators to be very cautious in advising their clients about prospects of success when this is the case. (One decision—*Jue v Smiser* (1994) 23 CA4th 312, reported at 17 CEB RPLR 233 (July 1994)—did allow a purchaser who discovered a key defect just one day before closing to complete his purchase and thereafter file suit, but the facts may be too specific to support a broad sounding rule.)

Overall, the *Ram's Gate* decision gives buyers and sellers of land much to chew on.