New Disclosure Duties for Brokers in Short Sales

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

Follow this and additional works at: http://digitalcommons.law.ggu.edu/pubs

Part of the Property Law and Real Estate Commons

Recommended Citation
http://digitalcommons.law.ggu.edu/pubs/337

This Article is brought to you for free and open access by the Faculty Scholarship at GGU Law Digital Commons. It has been accepted for inclusion in Publications by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.
November 2010

Midcourse Corrections:

New Disclosure Duties for Brokers in Short Sales

Roger Bernhardt

Holmes v Summer (2010) 188 CA4th 1510, ___ CR3d ___, reported at p 200, includes an easy set of facts to describe, but a hard analysis to cover straightforwardly; rich issues bump into each other at multiple places.

The facts were that frustrated buyers sued the seller’s broker for not informing them that the property they were shown was overencumbered and that the lender’s consent to a short sale would be required for the deal to close. Since that consent was never obtained, the deal never did close and they filed this action. The trial court sustained the brokers’ demurrers, but the court of appeal reversed.

A Major Decision or a Major Problem?

The opening paragraph of the opinion warns readers that the court believes that its decision is going to be a portentous one in light of the horrible impact that such brokers’ activities can have on our fragile real estate market. “Particularly in these days of rampant foreclosures and short sales,” brokers’ failure to disclose that “the property is so greatly overencumbered that it is almost certain clear title cannot be conveyed for the agreed-upon price” means that “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.”

Now, while overencumbering property and not disclosing important information to buyers is always serious, I do not think that the situation described here is that common or dangerous. As a general matter, brokers do not care to waste time working on deals that are unlikely to close, and they are unlikely to see much profit in keeping potential buyers uninformed about the likelihood of completion. Indeed, the California Association of Realtors has a standard form for their members to give to sellers who want to list overencumbered properties and another one to give to buyers interested in purchasing them. Both are filled with warnings about the uncertainty of these deals. In fact, new and probably more elaborate forms are about to be released. While the Department of Real Estate has recently expressed its concern about fraud in short sales, its worry has been over misinforming lenders about the values involved, not misinforming buyers about the need for lenders to consent. (Last year’s statute requiring prompt lender response to a short pay demand—CC §2943—has probably caused lenders generally to say “no” more quickly rather than incur sanctions for thinking too long. This year’s new law prohibiting deficiency recoveries after short sales—CCP §580e—will likely discourage lender consent even more.)

1. Is Shortness Material?

The first major issue in the opinion was whether the seller’s brokers had any duty to inform the buyers that the property was currently underwater. While California law requires a seller and his broker to disclose all facts “materially affecting the value or desirability of the property,” the brokers claimed that the amount of debt on a property does not affect its value or desirability
because the buyer’s right to a clear title means that the debt always will be paid off—or else the deal will not close. Debt is not like a physical defect that can outlast the closing of escrow.

The court, however, saw the situation more globally. There is harm from both kinds of defects, just in different ways.

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. [188 CA4th at 1519; emphasis added.]

We are so accustomed to thinking about buyers aggrieved because they were defrauded into completing a purchase of problematic property that we tend to assume that those who were lucky enough to discover the fraud in time to get out of the deal before it closed do not have a similarly actionable fraud claim. They were victims only of attempted fraud, lacking the necessary reliance feature to entitle them to recover damages.

This assumption gains support from the statutory measure of damages for fraud in real estate sales and purchases—the difference between what the buyer paid and the value of what he got (CC §3343)—a measure that cannot possibly work in a transaction that never closed, when the buyer paid nothing and received nothing.

Section 3343 adds reliance damages to this general measure, which makes it appropriate for buyers also to recover whatever they actually spent in preparing to go through with a deal. But how does that work when—as here—the major harm claimed by the buyers was the sale of their old house (done to get the cash necessary to buy the new one)? If the buyers sold their old house at its market value, what can they recover from the seller or his broker for that transaction? Their closing costs and the commission they paid to their broker in that sale should qualify, but is that all? Must the buyers say that they sold their old house for a loss or are now homeless to get real damages? General tort damages under CC §3333 for deceit sometimes make more sense in unusual real estate situations (see Bernhardt, On Making & Breaking Contracts, at http://www.rogerbernhardt.com/jan_2004.html), but even when that is so, are there general damages in such a case? Or are actual damages being sought primarily as a foundation for recovery of punitive damages?

What Other Information Is Material Under a “Disclosure at the Outset” Standard?

The court defends its conclusion by saying imposition of a duty on the brokers “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.” 188 CA4th at 1520. From that I surmise that this obligation is not limited to overoptimistic short-sale situations. The obligation to inform the other side of the “high risk of failure” of one’s own client should worry sellers’ brokers not only about getting lenders’ consents to discount their loans but also about getting the consents of any other parties holding interests in the title, or clearing away burdens, or obtaining the other entitlements necessary to the transfer. Likewise, buyers’ brokers should worry about the need to warn sellers about the risks of their clients’ ability to fi nd sufficient funds to close, or being able to sell their own house first (even when it is not a stated condition), or perhaps even the possibility of the buyers using the backout rights that the contract gives them as an intended cover for changing their minds because a better deal somewhere else may show up, or even
because of generalized remorse about the deal (see Bernhardt, *Midcourse Corrections: The Cost of Free Looks—Ruminations on Steiner v Thexton*, 33 CEB RPLR 61 (May 2010), also available at http://www.rogerbernhardt.com/may_2010.html).

It may not be that likely that courts will actually hold brokers responsible to the other side in these situations, but it certainly is likely that plaintiffs’ lawyers will heavily rely on the language of this opinion to fight off brokers’ demurrers and motions for summary judgment to get their cases to juries.

2. The Timing of Disclosures

The brokers had also argued that they were not liable because “the liens were disclosed during escrow” (emphasis added), but they lost because the court held that they “had a duty to disclose the liens before the buyers signed the agreement” (emphasis in original), because “[o]nly 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.” 188 CA4th at 1520. This makes it important to think about not only what must be disclosed, but when it must be disclosed. While there are many cases offering guidance on the former (what matters should be disclosed), there is not much out there as to the latter (when those disclosures should be made).

It is clear that when a matter is disclosed before the first offer is solicited, that is always early enough; it is just as equally clear that a matter not disclosed until after escrow has closed (and the checks have cleared and title has passed) is too late. But the period in between those two events lacks similar certainty. Consider the following:

- A defect is first disclosed in a transfer disclosure statement that was not given to the buyers until after the contract had been signed. Is that disclosure timely enough to eliminate any accusation of fraud, if the buyers have a 3-day right of rescission thereafter?
- A disclosure is not made until 2 weeks after the contract was signed. Is that untimely, if it was still within the 17-day backout period that many real estate form contracts include?
- A disclosure is not made until after all of the contingency periods have expired. Is it too late, even if it was accompanied by an offer to let the buyers withdraw? What if this happened—as occurred in *Jue v Smiser* (1994) 23 CA4th 312, 28 CR2d 242—in last 2 or 3 days before close of escrow?

In each of these situations, what if the buyers had (by the date of disclosure) already listed their own house for sale (becoming potentially liable for a broker’s commission if they remove it from the market) or taken some other similarly detrimental action?

I suspect that as we go down this road, we will discover that there will be no single rule or clock to apply to all problems, and that we will come to live with dozens of contextual rules about the dating and completeness of post-opening-day foreclosures.

3. When It Is the Seller’s Broker Who Did Not Inform the Buyers

This would have been a considerably easier case had the defendant—who was apparently the only broker in the picture—designated herself as a dual agent rather than solely agent for the sellers. That way, she would have had fiduciary duties to the buyers and made it much easier to impose disclosure duties on her. Instead, her status made the court of appeal feel compelled to go through the classic six-factor privity analysis before imposing such duties on her.
In general, I think those six factors always get to the result a court wants to reach, which makes serious analysis of them feel like a waste of time. While that may describe the “intended to affect plaintiff,” “foreseeability of harm,” “certainty of injury,” “close connection,” and “prevention of future harm” factors (all of which led, I thought, to completely predictable results), the court’s analysis of the “moral blame” factor was worth noting.

**Moral Blame and Confidentiality**

The judges and the brokers had strongly differing views on this issue. For the judges, it was a case of “rudimentary fairness” that the buyers be informed before they opened escrow. But for the brokers, it was a question of being forced to “violate their duty of confidentiality to the seller” in light of the provision in CC §2079.16 that “an agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.”

That sentence is no model of legislative clarity. Does “not obligated to reveal” mean “obligated not to reveal”? (See Bernhardt, *Midcourse Correction: Nondisclosures by Sellers, Brokers, and Home Inspectors*, 24 CEB RPLR 114 (Apr. 2001), also available at http://www.rogerbernhardt.com/april_2001.html.) If the language does not impose a duty of keeping information confidential, then what does it do? Brokers believe that they are duty-bound not to relay to the buyer what the seller has told them about his personal financial problems, just as they must keep silent about the seller’s health issues when they relate to AIDS (CC §1710.2—although it is similarly hard to translate the circuitous language of a section that says nondisclosure is not actionable but is then silent on the effect of disclosure).

The court gave two significant responses to the brokers’ confidentiality contention. The first response was that the statutory reference applies only to matters that do not materially affect the property. If that means that brokers are entitled to not disclose only what does not matter, it makes one wonder why the legislature would ever bother to create that silly a law.

The second response was more substantive and political. Any obligation of confidentiality a broker owes to her own client is trumped by the obligation of fairness she owes to the other party, even if that is not her client (188 CA4th at 1526):

The solution to the conflict between the duty to disclose and the duty to maintain client confidentiality is clear. When the duty of fairness to all parties requires the disclosure to the buyer of confidential information reflecting a substantial risk that the escrow will not close, then the seller’s real estate agent or broker must obtain the seller’s permission to disclose such confidential information to the buyer, before the buyer enters into a contract to purchase the property. In a case such as the one before us, where the seller’s financial situation is so precarious, if the seller is unwilling to consent to the disclosure of confidential information, and the real estate agent or broker nonetheless chooses to undertake representation of the seller, he or she does so at the peril of liability in the event the transaction goes awry due to the undisclosed risks involved.

In light of such a “balancing,” can a broker ever agree to keep a matter secret for her client? “Don’t ask if you don’t want to have to tell” becomes the principle guiding behavior. Because real estate brokers seem content to live within the contradictions of dual agency law, this disclosure rule may impose no new great danger, but we should hope that this kind of weighing is never also similarly applied to attorneys.
The court summed up its position by saying that it was not converting a seller’s broker into a buyer’s fiduciary. “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.” 188 CA4th at 1528. Think about how to explain to your broker client that she may not be a fiduciary to one party, but nevertheless she has duties of fairness to that same party that may take away whatever safety net her nonfiduciary status had given her.

Any attorney representing brokers should advise them to communicate the fact that the seller’s property is underwater (i.e., the debts against the property exceed its fair market value) to potential buyers right at the start—along with any and all other possibly relevant facts. That is common sense as well as good conduct. On the other hand, I am not sure that many attorneys representing buyers would have agreed to bring damages actions on their behalf because they had not been so informed at the beginning of the deal, if they nevertheless learned before close. Now, after the *Holmes* decision, that case looks somewhat more promising.

*Holmes v Summer* (2010) 188 CA4th 1510, ___ CR3d ___

Summer, a licensed real estate broker who represented the seller of residential real property, listed the property at $749,000 to $799,000, stating that the seller was motivated and that the broker would receive a 3-percent commission. Phil and Jenille Holmes (Buyers) saw the listing and were shown the property by Summer, who did not mention any encumbrances on the property that might affect the seller’s ability to sell at the advertised price. Buyers offered to purchase the property for $700,000, free and clear of all monetary liens and encumbrances. The seller counteroffered $749,000 with a 30-day escrow; Buyers accepted. The counteroffer did not mention that the property was subject to three deeds of trust totaling $1,141,000, making it extremely difficult to transfer the property free and clear of all monetary liens. Buyers were unaware of the liens when they signed the purchase documents. Buyers then sold their existing home in order to purchase the seller’s property. Seller failed to convince the lienholders to accept a short sale, and thus was unable to close escrow.

Buyers filed suit against Summer and her employer (collectively, Brokers) alleging negligence, negligent misrepresentation, and deceit based on misrepresentation and failure to disclose. Brokers demurred, stating that they were not required to guarantee the seller’s performance and if the seller could not come up with cash to close the transaction, that was a business decision for which the brokers were not liable. Buyers replied that Brokers knew about the excess debt when listing the property and were unsuccessfully attempting to arrange a short sale during escrow. The trial court sustained the demurrer; the court of appeal reversed.

The court of appeal noted that if a seller knows of facts materially affecting the value or desirability of the property that are known or accessible only to it and also knows that those facts are not known to the buyer, then the seller has a duty to disclose them to the buyer. *Lingsch v Savage* (1961) 213 CA2d 729, 29 CR 201. If the seller’s real estate agent is also aware of such facts, then that agent also has a duty to disclose. 213 CA2d at 736. The purpose of the rule is to ensure that the buyer has sufficient information to make an informed decision whether to purchase. The buyer may be harmed by entering into an escrow to purchase property when it is highly likely that the escrow will never close. The real estate agent is under a duty to exercise
reasonable care to protect those whom the agent is inducing into a transaction for the purpose of earning a commission. *Easton v Strassburger* (1984) 152 CA3d 90, 98 n2, 199 CR 383. Brokers had a duty to disclose, before Buyers signed the purchase agreement, information alerting Buyers that the sale was at high risk of failure.

The court noted that Buyers were not in a position to protect themselves because it is not typical in a residential purchase for the buyer to perform a title search before making an offer. The California Association of Realtors standard form purchase contract states that the buyer will receive a preliminary title report after escrow is opened. Even if a title search would have divulged deeds of trust, it would not have disclosed the balance owing on the promissory notes. Further, when a seller agrees to sell a property free and clear of all liens and encumbrances, the seller impliedly represents that he will be in a position to deliver title free and clear. The court also noted that even if Buyers had been on constructive notice of the liens, the seller still would have had a duty to disclose.

Brokers argued that the court’s ruling would require them to divine when a seller may have breached agreements and to disclose that to the buyer. However, the court noted that the seller’s financial situation was clear to Brokers at the time the purchase agreement was signed. When an agent or broker is aware that either a short sale requiring the cooperation of a lender or the deposit of cash by the seller will be required to release monetary liens, the agent has a duty to disclose those facts to the buyer so that the buyer can investigate further regarding the risk that the transaction will fail.

Brokers also argued that imposing this duty to disclose would require them to breach their duty of confidentiality to the seller. The court noted, however, that brokers have a duty, under CC §2079.16, to disclose confidential matters if they materially affect the desirability of entering into the transaction. Brokers also have a duty of honest and fair dealing and good faith. CC §2079.16(b). The representation that the property could be purchased for $749,000 was less than honest because Brokers knew that the sale was a highly risky proposition. Brokers also relied on duties of confidentiality imposed by the Code of Ethics and Standards of Practice of the National Association of Realtors. The court noted, however, that the Code of Ethics establishes that when it conflicts with the law, the obligations of the law must take precedence.