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REAL ESTATE BROKERS OWE DUTY TO DISCLOSE TO PROSPECTIVE BUYERS THAT SELLERS MAY NOT BE ABLE TO TRANSFER TITLES FREE FROM LIENS

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The California Court of Appeal recently decided a case having important implications on real estate transactions, especially in light of the economic downturn. The case, *Holmes v. Sumner* (4th Dist. 2010, 2010 WL 3896726), dealt with whether real estate brokers owe a duty to buyers to disclose, prior to entering escrows, property defects potentially impacting the value or desirability of properties.

The facts of the case were undisputed. A real estate broker, acting as a seller's agent, listed a property for sale, advertising a price of 749,000-\$799,000. The buyer agreed to a sale price of \$749,000 and a 30-day escrow period.

Unbeknownst to the buyer at the time the purchase documents were signed, the property was subject to three deeds of trust totaling over \$1.4 million. As this amount clearly exceeds the purchase price, almost doubling it, the property could not be transferred free and clear of all monetary liens and encumbrances.

Having already sold his principal residence in anticipation of the purchase, the buyer sued, asserting causes of action for negligence, negligent misrepresentation, and for deceit based upon both misrepresentation and the failure to disclose.

The court began its analysis by noting the general rule that where the seller or seller's agent knows of facts materially affecting the value or desirability of property, and they are known only to him, there is a duty to disclose those facts to the buyer.

Importantly, the duty to disclose is not limited to physical defects, and has been extended by courts to include neighborhood nuisances, murders occurring on the property, and improvements constructed in violation of building codes or zoning regulations. The court extended this rationale to the facts of the case, ruling that monetary liens and encumbrances on property significant enough to affect its value and desirability constitute defects that must be disclosed.



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The broker claimed there was no duty to disclose the defect because the buyer should have discovered it through a reasonable title inspection. The court found this argument unpersuasive, noting that while a title check would have revealed the deeds of trusts, the current balance of the promissory notes would not have been indicated.

Furthermore, a buyer's obligation to make a reasonable inspection of the property does not require them to perform a title search prior to making an offer on a property. Instead, as the court noted, preliminary title reports are typically provided during escrow. Thus, the failure to conduct a title search prior to making an offer on the property did not prohibit the buyer from asserting his cause of action.

The broker also argued that the absence of a contractual privacy agreement between the parties precluded the finding of a duty owed to the buyer. To determine whether a duty is owed to a third party despite the lack of contractual privacy agreement, California courts apply six factors.

- 1) The extent to which the transaction was intended to affect the plaintiff.
- 2) If harm is foreseeable.
- 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) Is moral blame attached to the defendant's conduct?
- 6) The policy of preventing future harm.

Briefly discussing each factor, the court ruled that the transaction clearly affected the buyer, that foreseeable injury would result from a failed transaction, and injury had in fact occurred. Furthermore, the court found the brokers actions sufficiently related to the buyer's injury because the buyer could have protected himself had he known of the defect.

Finally, the court recognized that a fundamental duty is imposed on realtors to deal honestly and fairly with all parties to a transaction, and that public policy weighed in favor of preventing future harm.

Summarily, the court held that, "When a real estate agent or broker is aware that the amount of existing money liens and encumbrances exceeds the sale price of a residential property...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."

This decision has important implications for those involved in real estate transactions. Sellers of real property and real estate brokers should be aware of their duty to disclose defects in property that may materially impact the desirability or value of real estate. Importantly, this duty arises prior to entering into escrow. Buyers, on the other hand,



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should be comforted by the protections provided by California law, helping to reduce the risk of losing money on failed real estate transactions.

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