

Not so elementary my dear Watson: *Holmes* case revamps disclosure requirement

Most lawyers already know that bad facts often make bad law. Real estate brokers and agents are about to become familiar with this adage too, thanks to the recent case of *Holmes v. Summer*. <http://www.courtinfo.ca.gov/opinions/documents/G041906.PDF> In that case, the California Court of Appeal held that real estate brokers could be liable for failing to disclose adverse facts about a property *prior to* execution of a purchase agreement, even though the adverse facts were then disclosed during the due diligence period.

Phil and Jenille Holmes, the plaintiffs and buyers, entered into a contract to buy residential property owned by a client of Sieglinde Summer, the seller's licensed real estate broker. After routine negotiation over price and escrow period, the parties entered into an agreement that included a \$749,000 purchase price, a standard contingency period, and customary language that required that the property be delivered "free and clear of all monetary liens and encumbrances." During the negotiations, Summer and the seller knew, but did not disclose, that (a) there were three loans, each secured by a separate deed of trust, in the aggregate amount of \$1,141,000, and (b) none of the lenders had approved a short sale. Without knowing these facts, the buyers signed the purchase agreement and sold their existing home. However, the seller could not perform the agreement because the lenders would not approve a short sale. The buyers then sued.

The seller's financial condition rendered the seller judgment proof, leaving Summer as the sole target of the buyers' lawsuit. The absence of the seller as a viable defendant meant that the buyers' focus shifted from a simple breach of contract claim against the seller to a breach of duty to disclose claim against the broker. The buyers argued that prior to their execution of the purchase agreement, Summer should have told them that the outstanding balance of the loans encumbering the property greatly exceeded the purchase price and that the lenders had not approved a short sale. Summer argued that these disclosures were not necessary and that, even if they were required, Summer's duty to disclose was satisfied when the seller provided the buyer with a preliminary title report during the contingency period that disclosed the three deeds of trust. The trial court held that Summer did not have an affirmative duty to disclose the status of the seller's debt against the property and dismissed the case. The buyers appealed.

The appellate court overruled the trial court's ruling and held that Summer was "obligated to disclose to the buyers that there was a substantial risk that the seller could not transfer title free and clear of monetary liens and encumbrances." The appellate court concluded that there was no reasonable way for the buyers to know the current outstanding balance of the loans or whether the seller had short sale approval. The appellate court concluded that "even though a title search may have divulged the existence of recorded deeds of trust against the property, it would not likely have disclosed the current balances of the promissory notes secured by the deeds of trust"

Having found that a title search would most likely not provide adequate disclosure to the buyer, and that most buyers do not order a title search until after signing the contract, the appellate court could have found in favor of the buyers and ended its decision there. However, the bad facts of this case compelled the court to go further. Because the broker failed to disclose these facts, and because the buyers sold their former residence in reliance on the contract, the

appellate court held that Summer should have informed them of the adverse financing conditions **before** the purchase agreement was even signed. In the appellate court's view, a buyer needs such facts to "weigh the risks of entering into an agreement, and preparing their finances and related affairs to facilitate completion of the purchase." The appellate court also noted that "disclosing the liens only after the buyers had entered into the escrow failed to protect them in this context."

The *Holmes* case introduces a new level of complexity to generating broker listings and marketing material. This decision forces brokers to evaluate the overall condition of any property for sale and prepare a disclosure list that each prospective buyer must receive before a contract is signed. The extreme facts in the *Holmes* case, mainly the lack of short sale approval and loans greatly in excess of the purchase price, offer little guidance on how a broker should determine what disclosures are material and when they should be made. This requirement should lead to discussions with sellers about both what should be disclosed and when it should be disclosed (and perhaps necessitate revisions to the standard agreements brokers use when engaged for a listing).

While the *Holmes* case concerned residential property, its reasoning applies to both commercial and residential transactions. In every transaction, brokers need to ask themselves whether (1) there are facts which a buyer can later (in hindsight) assert were so material they should have been disclosed prior to signing the contract, and (2) the buyer can assert that it suffered damages in reliance on the contract itself, even if the transaction never closes. Put another way, if a fact is material enough to disclose during due diligence, consider whether it makes more sense to disclose it before contract execution, not after.