



The Professional Lines **ALERT**

California Court Holds That Sellers Agents Must Disclose When Their Clients' Property Is Overencumbered by Debt

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Reacting to “rampant foreclosures and short sales,” a California court of appeal held that a sellers’ agent was liable to buyers for not disclosing to them before they signed the purchase agreement that the sellers’ debt on the property substantially exceeded the sales price of the property. *Holmes v. Summer*, No. G041906 (Cal. Ct. App. Oct. 6, 2010). More specifically, the court announced the following new rule, expanding the duty of disclosure that sellers’ agents owe to buyers:

[W]hen a real estate agent or broker is aware that the amount of existing monetary liens and encumbrances exceeds the sales price of a residential property, so as to require either the cooperation of the lender in a short sale or the ability of the seller to put a substantial amount of cash into the escrow in order to obtain the release of the monetary liens and encumbrances affecting title, 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.

The case arose from the listing of a residential property for \$749,000 to \$799,000. After the buyers saw the MLS listing and visited the property, they submitted an offer for \$700,000 free and clear of all monetary liens and encumbrances, and a 60-day escrow. The sellers countered with \$749,000 and a 30-day escrow. The buyers accepted the counteroffer.

When the sellers’ broker showed the property, she never mentioned that the sellers had three deeds of trust against the property, with a total debt of \$1,141,000. Nor did the counteroffer prepared by the sellers’ broker mention that the only way that title could be transferred free and clear of liens and encumbrances was if the lenders agreed to a short sale (discounting the debts on the property by at least \$392,000) or the sellers deposited \$392,000 into escrow.

In reliance on the counteroffer, which failed to mention the sellers’ debts against the property, and in preparation for closing escrow, the buyers sold the home that they then resided in to finance their purchase of the property. The lenders refused to agree to a short sale by discounting the sellers’ debts and the sellers lacked the funds to deposit \$392,000 into escrow. Thus, escrow never closed.



After the sale fell through, the buyers sued the sellers' broker for (1) deceit based on misrepresentation, (2) deceit based on failure to disclose, (3) negligent misrepresentation, and (4) negligence.

The sellers' broker argued that imposing a duty on sellers' brokers to disclose the excess debt on their clients' property would violate their duty of confidentiality under California law and the National Association of REALTORS® (NAR) Code of Ethics.

The court agreed that California law prohibits the disclosure of confidential information that does not involve the duties listed in California Civil Code Section 2079.16. The duties articulated in Section 2079.16 are:

- (a) Diligent exercise of reasonable skill and care in performance of the agent's duties.
- (b) A duty of honest and fair dealing and good faith.
- (c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties.

However, the court found that the circumstances involved did involve the “duty of honest and fair dealing and good faith”— that is, the duty to treat each party to the transaction honestly and fairly — and perhaps even the duty to disclose known matters affecting the desirability of entering into the transaction. The court explained that the sellers' broker violated the duty of fairness when signing the buyers up for a real estate purchase that the broker had reason to know was a “highly risky proposition.” “[F]airness under the circumstances dictated disclosing that either lender approval or a substantial seller payment was required to close escrow.”

As for the NAR Code of Ethics, the court noted that the preamble to it stated: “While the Code of Ethics establishes obligation that may be higher than those mandated by law, in any instance where the Code of Ethics and the law conflict, the obligations of the law must take precedence.” The court reasoned that the circumstances of the case presented a situation where California law and the NAR Code of Ethics conflicted. Therefore, California's duty of fairness, which required disclosure of the sellers' excess debt, trumped any duty of confidentiality in the NAR Code of Ethics.

Providing guidance to sellers' brokers faced with clients with substantial debt exceeding the sales price, the court stated that such brokers should obtain the sellers' permission to disclose their confidential financial information to prospective buyers. Sellers' brokers should withdraw from representation if the sellers refuse to grant permission to disclose.

The court's decision does not create a fiduciary duty between sellers' brokers and prospective buyers. But it does expand in scope the disclosure duty under California law by requiring sellers' brokers to disclose that a property's debts significantly exceed the advertised sales price. It also expands the disclosure duty in time by requiring that disclosure before the buyers sign the purchase agreement.



For further information, please contact **Christina A. Lee**, **Joseph J. De Hope**, [Marissa I. Delinks](#) or your regular [Hinshaw attorney](#).

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