Defending Buyer Nondisclosure and Misrepresentation Claims in Real Property Transactions

Paul P. DeAngelis

Paul P. DeAngelis

Paul DeAngelis, www.ppdlaw.com, has his own firm in San Francisco. Paul concentrates on real estate matters, including litigating buyer and seller disputes arising from purchase and sale transactions, neighbor and HOA disputes, and broker defense issues. He also provides transaction and counseling services to buyers and sellers in transactions, to property owners to resolve neighbor and HOA disputes, and to brokers and agents regarding risk management and BRE compliance issues.

I. INTRODUCTION

This article discusses the law and arguments to consider when defending buyer claims of nondisclosure and misrepresentation arising from the purchase and sale of residential real property with a focused analysis on the element of buyer's reliance.[1] This article addresses developing defenses, whether considered by sellers or real estate brokers,[2] for common sources of these claims: repairs, improvements, permits, legal use, or deed restrictions. It also offers suggestions for how sellers could mitigate the risks of such claims, including how to disclose material facts to buyers without making conclusions about their effect on value.

Nondisclosure and misrepresentation cases generally have good arguments on both sides. The law imposes independent duties on sellers and buyers in purchase and sale transactions. A seller has a duty to disclose known material facts affecting the value or desirability of his or her real property to buyers when a seller knows such facts are not known to or within a buyer's diligent attention or observation. Sellers must tell and believe the truth, and at least have a reasonable basis for believing their statements. A buyer, on the other hand, has a duty to investigate and make informed decisions about disclosed matters or those matters within a buyer's diligent attention or observation. Close cases often turn on a buyer's reliance (whether a buyer reasonably relied on a seller's alleged misrepresentation or nondisclosure) or a buyer's ability to have discovered the undisclosed fact.

The fair market value of real property is based on what a willing buyer may offer and a willing seller may accept at the same point in time. Sellers generally possess the best information about facts affecting the value or desirability of their properties. Their complete and accurate disclosures provide information to give fairness and certainty to buyers in transactions. Nothing in this article should be read to downplay the importance of a seller's complete and accurate disclosures.

II. SELLER'S DISCLOSURE DUTIES

A. Affirmative Duties to Disclose Material Facts

Sellers of real property have affirmative common law and statutory duties of disclosure.[3] At common law, if "the seller knows of facts materially affecting the value or desirability of the property . . . and also knows such facts are not known to, or within the reach of the diligent attention and observation of the buyer, the seller is under a duty to disclose them to the buyer."[4]

As to the meaning of material facts, "facts are material if they would have a significant and measurable effect on market value."[5] For example, material facts include repairs done without necessary permits or in violation of building codes.[6] The law, however, limits a seller's disclosure duty to material facts: "once the essential facts

are disclosed a seller is not under a duty to provide details that would merely serve to elaborate on the disclosed facts."[7]

By statutory law, unless an exception applies, sellers of residential property (one to four dwelling units) must provide a form specified by statute, known as the Real Estate Transfer Disclosure Statement ("TDS"), to a buyer.[8] Civil Code section 1102.6 requires its use and sets forth the content of the TDS form. A TDS requires sellers to answer many questions about the condition of the property and other matters affecting its value or desirability, including permits, use restrictions, and nonconforming uses.[9] The Legislature also requires a seller to make each disclosure on the TDS form in good faith, which means "honesty in fact in the conduct of the transaction."[10]

B. No Duty to Explain or Make Conclusions

Sellers have a duty to disclose the actual facts, not a duty to explain the legal or practical ramifications of disclosed facts, or to make conclusions about their effect on value.[11] "What must be disclosed by a property seller is the fact or facts affecting value. The seller is not required also to explain to the buyer why that fact affects the property's value."[12] *Alfaro v. Community Housing Improvement System & Planning Assoc., Inc.*[13] cited the following instructive examples as to how the rule applies in practice: "once seller disclosed that residence was in flood plain, seller was not required to disclose effect of local ordinance on rebuilding or improving it;"[14] "[t]he material fact that had to be disclosed was the fact that there was a lawsuit for defects, not each and every allegation contained within the court file;"[15] and "once seller disclosed that mobile home park was subject to recorded easements, seller was not required to disclose the location of an oil pipeline easement or how he had accommodated it."[16]

C. The "As Is" Clause Does Not Change Disclosure Duties

Some purchase and sale contracts include an "as is" clause, affirming that the buyer is purchasing the property in its present condition. However, an "as is" clause does not excuse the seller's duty to disclose known material facts:

> A provision that in effect requires the buyer to accept the property "as is" merely means that the buyer accepts the property in the condition that is visible or observable by him. An "as is" clause does not protect the seller from liability for his or her own negligent failure to disclose a material fact.[17]

Nor do exculpatory provisions in a residential real property contract change a seller's disclosure duties. For example, one court confirmed a party could not escape liability by arguing the following exculpatory provision: "No representations, guaranties or warranties of any kind or character have been made by any party hereto, or their representatives which are not herein expressed."[18] The court found a principal, who had a positive duty to disclose, could not rely on such clause to escape liability for nondisclosure because parties cannot contract around fraud.[19]

III. BUYER'S DUTIES TO INVESTIGATE AND OBTAIN INFORMATION

A. Affirmative Duty to Use Reasonable Care and Investigate

A buyer has an affirmative "duty to exercise reasonable care to protect himself or herself, including those facts which are known to or within the diligent attention and observation of the buyer or prospective buyer."[20] A buyer must investigate and make informed decisions about disclosed matters or matters that are within a buyer's diligent attention or observation.[21]

Miller & Starr explains the effect of a buyer's investigation on the reliance issue:

> When the conditions of the property are visible and could be discovered readily by a visual inspection by the buyer, the buyer who inspects the property relies on his or her own investigation regarding those matters that are discovered, or should have been discovered, by the inspection. A buyer is deemed to have knowledge of those conditions that are patent, obvious, and apparent by visual observation by an inspection conducted with ordinary diligence in the context of the buyer's knowledge, intelligence, and experience. A buyer cannot claim reliance on the seller's concealment or representations regarding conditions that are obvious and apparent by a visual inspection.[22]

The duty of a buyer to protect himself or herself in a transaction is so significant that the law may treat a buyer who elects to not inspect the property the same as one who inspects it. "A buyer who does not inspect the property may be deemed to have knowledge of those conditions that are patent, obvious, and apparent by visual inspection during an inspection conducted with ordinary diligence in the context of a buyer's knowledge, intelligence, and experience."[23]

B. A Buyer's Duties to Read Disclosures and Advisories

The preprinted forms used in residential transactions often provide recommendations and warnings to buyers. The preprinted forms are sometimes referred to as "boilerplate." But a court may charge a buyer of being aware of the information provided in disclosures and advisories, regardless of whether or not the buyer actually read them.[24] Further, courts may hold buyers to the legal effect of advisories and disclosures, regardless of whether or not they read them.[25]

In deciding what effect to give advisories to investigate and exculpatory and disclaimer clauses found in the preprinted forms, courts apply reasonable reliance principles to evaluate the effectiveness of them.[26] "[T]he efficacy of disclaimers is assessed by reference to their context and specificity."[27] The more specific the advisory or recommendation applies to the alleged undisclosed or misrepresented fact, or the greater the visibility of such advisory or recommendation, the greater weight a court may give it. For example, a court may consider the purpose and use of an advisory, or the conspicuousness, size, and font of the disclaiming language, or its use and location in the forms.

IV. NONDISCLOSURE AND MISREPRESENTATION CLAIMS

A. A Nondisclosure Claim

This article addresses a seller's nondisclosure liability resting on fraud. While California courts have recognized claims against sellers for negligent nondisclosure liability arising from the purchase and sale of property, these cases appear relatively infrequently.[28] "Generally, the decisions involving a seller's liability for failure to disclose a material defect have been based on a fraud theory of liability. However, the failure to disclose a material fact may breach the standard of care for a seller of real property and lead to liability based on negligence."[29]

A discrepancy appears to exist between the jury instruction used for a real estate seller's nondisclosure of material facts and the cases discussing a seller's nondisclosure liability. Case law focuses on the analysis of whether a buyer can prove reasonable reliance on the seller's nondisclosure.[30] The jury instruction for a seller's nondisclosure of material facts, California Civil Jury Instructions ("CACI") No. 1910, instead focuses on whether a buyer can prove he or she did not know, and could not reasonably have discovered, the undisclosed information and prove that the seller knew the same. This article does not attempt to resolve the apparent discrepancy between the case law and jury instruction, but merely raises the issue.[31] Practically speaking, the facts developed to try to negate reasonable reliance (as required by case law) may equally serve in negating an argument that a buyer could not have reasonably discovered the undisclosed fact (as required by the jury instruction).[32]

1. Case Law

A seller's mere nondisclosure of a material fact may create fraud liability. "Where a seller fails to disclose a material fact, he may be subject to liability 'for mere nondisclosure since his conduct in the transaction *amounts to a representation of the nonexistence of the facts which he has failed to disclose*.'"[33] A seller's failure "to fulfill such duty of disclosure constitutes actual fraud" based on the statutory definition of fraud in Civil Code section 1572, subdivision 3.[34] Section 1572, subdivision 3 defines actual fraud, amongst other things, as "[t]he suppression of that which is true, by one having knowledge or belief of the fact."[35] As to the nature of the fraud, the *Lingsch* court noted the allegations were a kind of fraud or deceit "based on concealment or nondisclosure" and distinguished it from active concealment.[36]

The court in *Lingsch* cited the elements for fraud based on mere nondisclosure as the following: "(1) Nondisclosure by the defendant of facts materially affecting the value or desirability of the property; (2) Defendant's knowledge of such facts and of their being unknown to or beyond the reach of the plaintiff; (3) Defendant's intention to induce action by the plaintiff; (4) Inducement of the plaintiff to act by reason of the nondisclosure; and (5) Resulting damages."[37]

The court found the plaintiffs substantially pled the defendant's intention to induce action by alleging their "reliance" as opposed to "inducement." The plaintiffs alleged they relied on the defendant's nondisclosure.[38] More than forty five years later, the *Alfaro* court cited the *Lingsch* case as the law establishing reasonable reliance as an element of a nondisclosure claim: "Reasonable or justifiable reliance on the nondisclosure is an element of such fraud."[39]

2. Jury Instruction

CACI No. 1910 requires that a buyer of real property prove the following elements to establish a claim for nondisclosure against a seller: (1) buyer purchased real property from seller; (2) seller knew the information was not disclosed; (3) seller did not disclose the information; (4) buyer did not know and could not reasonably have discovered this information; (5) seller knew the buyer did

not know and could not reasonably have discovered this information; (6) the information significantly affected the value or desirability of the property; (7) buyer was harmed; and (8) seller's failure to disclose the information was a substantial factor in causing buyer's harm.[40]

CACI No. 1910 uses the language "could not reasonably have discovered" rather than "reasonably relied" on the seller's nondisclosure. The directions for use to CACI 1910 state the "instruction sets forth the common law duty of disclosure that a real estate seller owes to his or her buyer. Nondisclosure is tantamount to a misrepresentation."[41] The Sources and Authority to CACI 1910 include the *Lingsch* case and its declarative statement that a seller's failure to meet his or her disclosure duty "constitutes actual fraud."[42]

Because of the language used in the CACI instruction, attorneys defending nondisclosure claims should consider proving that a buyer could have reasonably discovered the undisclosed fact (as well as proving that the buyer did not reasonably rely on the alleged nondisclosure). This suggestion offers a pragmatic way to address that no published case specifically provides guidance as to what, if any, significance to give the apparent discrepancy between the jury instruction and case law.

B. A Negligent Misrepresentation Claim

Negligent misrepresentation arises upon "the assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true."[43] Or, it may arise upon "[t]he positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true."[44]

Such claims require a buyer to prove the following elements: (1) a seller represented an important fact; (2) the represented fact was untrue; (3) though the seller honestly believed it to be true, seller had no reasonable grounds to believe it was true when made; (4) the seller intended the buyer to rely on it; (5) the buyer reasonably relied on it; (6) the buyer was harmed; and (7) the buyer's reliance was a substantial factor in causing the harm.[45]

C. An Intentional Misrepresentation Claim

Intentional misrepresentation is "the suggestion, as a fact, of that which is not true, by one who does not believe it to be true."[46] Except for the third element, the elements are the same for intentional and negligent misrepresentation claims. In contrast to a claim for negligent misrepresentation, the third element of an intentional misrepresentation claim requires that a buyer at least prove that a seller "knew that the representation was false when he/she made it, or that he/she made the representation recklessly and without regard for its truth."[47]

D. Difference Between Intentional and Negligent Misrepresentation Claims

The proof needed for the third element of a negligent misrepresentation claim is more lenient than the proof needed for the third element of an intentional misrepresentation claim.

> [W]hen a person makes a false statement with an honest belief that it is true, but without reasonable grounds to believe that it is true, that constitutes a negligent misrepresentation. When a person makes a positive statement of a fact and he or she does not have sufficient information to justify the assertion, good faith is no defense to a charge of fraud. A person may have acted "fraudulently" toward another merely because he or she was careless or negligent.[48]

As between the two types of misrepresentation claims, a negligent misrepresentation claim may often present a buyer's easiest path to prove liability because it does not require proof of scienter or intent to defraud. The law recognizes a claim for negligent misrepresentation even though a seller may honestly have believed the representation to be true, but finds such honesty is without a reasonable basis.

As between the two claims, courts also apply a more lenient standard of reasonable reliance to intentional fraud claims.[49] The California Supreme Court explained the rule:

> Negligence on the part of the plaintiff in failing to discover the falsity of a statement is no defense when the misrepresentation was intentional rather than negligent. Nor is a plaintiff held to the standard of precaution or of minimum knowledge of a hypothetical, reasonable man. If the conduct of the plaintiff in the light of his own intelligence and information was manifestly unreasonable, however, he will be denied a recovery.[50]

However, a buyer must still prove justifiable reliance as an element in an intentional fraud case, but "mere negligence in failing to investigate or verify to determine the truth of a representation is not a defense to fraud."[51]

V. REASONABLE RELIANCE PRESENTS A CRITICAL DEFENSE ISSUE

A. Applying Reliance to Nondisclosure and Misrepresentation Claims

A buyer must reasonably rely upon a seller's representation or alleged failure to disclose material facts.[52] "Reliance exists when the misrepresentation or nondisclosure was an immediate cause of the plaintiff's conduct which altered his or her legal relations, and when without such misrepresentation or nondisclosure he or she would not, in all reasonable probability, have entered into the contract or other transaction."[53] Actual reliance is an element of both fraud by omission and misrepresentation.[54] A buyer may readily prove his or her actual reliance on the TDS because the TDS expressly states that a buyer may rely on the information contained in it.[55]

B. Reasonable Reliance

Reasonable reliance offers fertile ground to create defense arguments because the fact finder must find a buyer reasonably relied on a seller's representation or nondisclosure. A buyer's "mental capacity, knowledge, and experience" bear on the reasonableness of a buyer's reliance.[56] Unless undisputed facts leave no room for reasonable minds to differ, a plaintiff's reasonable reliance presents a question of fact.[57]

> Besides actual reliance, [a] plaintiff must also show "justifiable" reliance, i.e., circumstances were such to make it *reasonable* for [the] plaintiff to accept [the] defendant's statements without an independent inquiry or investigation. The reasonableness of the plaintiff's reliance is judged by reference to the plaintiff's knowledge and experience.[58]

Buyers typically conduct their own visual inspection and hire professionals to conduct a contractor's inspection and a termite inspection. As to the effect on reliance from his or her own inspection, Miller & Starr explains that a buyer "relies upon his or her own observations and not the representations by the seller or the seller's agent. To overcome this inference, the buyer must establish that he or she did not in fact inspect the property, or that he or she was justified in not making an inspection or in relying on the other party, in spite of the inspection."[59] If a buyer hires an expert to do inspections, he or she will be regarded as knowing the facts the expert could have discovered during such inspections, including the falsity of a seller's representations.[60]

Reliance issues rest on a fact intensive analysis. Buyers and sellers have litigated real property transactions for decades in California, and the body of law developed and fact patterns within the cases both present opportunities to develop creative arguments. The following are some considerations which steer the reliance analysis: (1) the nature of the material fact, (2) what the seller knew, (3) what the seller represented, (4) what the seller did or did not do about disclosing the fact, (5) a buyer's background, and (6) what a buyer did or could have done to learn of the material fact.

C. Negating A Buyer's Reasonable Reliance to Defend Intentional Torts

Justice Traynor explained reasonable reliance in *Seeger v. Odell* and established the law to use when challenging a buyer's reliance in intentional tort cases:

> As a general rule negligence of the plaintiff is no defense to an intentional tort. The fact that an investigation would have revealed the falsity of the misrepresentation will not alone bar his recovery. . . . Nor is a plaintiff held to the standard of precaution or of minimum knowledge of a hypothetical, reasonable man. Exceptionally gullible or ignorant people have been permitted to recover from defendants who took advantage of them in circumstances where persons of normal intelligence would not have been misled. "No rogue should enjoy his ill-gotten plunder for the simple reason that his victim is by chance a fool." If the conduct of the plaintiff in the light of his own intelligence and information was manifestly unreasonable, however, he will be denied a recovery. He may not put faith in representations which are preposterous, or which are shown by facts within his observation to be so patently and obviously false that he must have closed his eyes to avoid discovery of the truth.[61]

Seeger provides the basis to challenge a buyer's reasonable reliance in intentional tort cases when the buyer acts "manifestly unreasonable," "preposterous," or "closes his eyes to avoid discovery of the truth" to obvious and patent falsity.[62] More recently, the California Supreme Court cited the *Seeger* case to confirm it has "required that a plaintiff's reliance on a defendant's fraudulent misrepresentations not be 'manifestly unreasonable' for over [fifty] years."[63]

The "preposterous" challenge to a buyer's reasonable reliance also applies to negligent misrepresentation claims: "[e]ven in [a] case of a mere negligent misrepresentation, a plaintiff is not barred unless his conduct, in the light of his own information and intelligence, is preposterous

and irrational."[64] The "preposterous" rule applies to, and offers a potential defense to, both negligent and intentional misrepresentation claims.

Miller & Starr explains the rule in the context of misrepresentation and nondisclosure claims in the purchase and sale of real property:

> **A buyer may rely on seller's representations without an inspection.** Depending on the facts and circumstances, unless the party's reliance is irrational or "preposterous," a party is entitled to rely on the representations of the other party and on the representations of the other party's agent without making an independent investigation or verification to discover the falsity of the representation. A buyer of real property has a right to rely on the seller's representations concerning matters of fact that are unknown without making an independent investigation as to their truth, even though such an investigation would have disclosed the falsity of the representation and the buyer had the opportunity to make such an investigation. Unless the buyer is made aware of facts that would reasonably create a suspicion that there had been a misrepresentation or concealment by the seller, there is no duty to investigate the truth of the seller's statements or to discover the facts concealed.[65]

A buyer's awareness of facts creating a reasonable suspicion of a false representation may trigger a buyer's duty to investigate. It also seems irrational to rely on a representation when one knows of facts calling into question the truth of the representation. Because buyers cannot close their "eyes to avoid discovery of the truth," they must investigate conflicting facts.[66]

D. *Alfaro v. Community Housing Improvement System & Planning Assoc., Inc*: Constructive Notice, Inquiry Notice, and Actual Knowledge

Relying on *Alfaro*, attorneys for the seller may argue a court should charge a buyer with knowledge of the contents of anything referred to in the documents and reports a buyer receives in a transaction.[67] A buyer has actual knowledge of the existence of matters identified in such records and is on inquiry notice as to the nature and extent of those matters.[68] For example, if a so-called 3R Report, providing the permit history for a property, identifies an incomplete permit, the buyer receiving it has actual knowledge of an incomplete permit and is on inquiry notice as to the nature of it.[69]

In *Alfaro*, the appellate court found that the buyers had inquiry notice of the nature of a deed restriction recorded on the properties and referenced in the preliminary title reports they received.[70] The buyers learned those deed restrictions related to affordable housing and restricted their ability to sell and finance the properties. The buyers argued those reports did not describe the nature of the restrictions.[71] The appellate court described one of the main issues as "whether the plaintiffs are chargeable with notice of the deed restriction.…"[72]

In analyzing that issue, the court confirmed, "a purchaser who receives and reads a preliminary title report revealing the existence of a deed restriction has actual notice of its existence [internal citation omitted] and is on inquiry notice of the nature of that restriction."[73] The court reasoned that "[a] seller's nondisclosure of the state of a property's title, unaccompanied by affirmative misstatements about that title, should not blind a reasonably prudent buyer from reading a document that purports to describe the state of title of the property he or she is about to acquire."[74]

Alfaro explained the law regarding notice issues. "'Every person who has actual notice of circumstances sufficient to put a prudent man upon inquiry as to a particular fact, has constructive notice of the fact itself in all cases in which, by prosecuting such inquiry, he might have learned such fact.'"[75] As an example, in *Alfaro*, the court confirmed "the recording of a deed restriction is ordinarily regarded as imparting constructive notice of its contents to subsequent purchasers."[76] "Constructive notice is 'the equivalent of *actual knowledge*, i.e., knowledge of its content is conclusively presumed.'"[77]

Alfaro confirmed, however, that constructive notice does not apply to public records in defrauded buyer cases. "[T]hough defrauded buyers will not be deemed to have constructive notice of public records, this does not insulate them from evidence of their actual knowledge of the contents of documents presented to them or from being charged with inquiry notice based on those documents."[78] Nondisclosure and misrepresentation are fraud-based claims. Therefore, in defense of those claims, a court may not charge a buyer with constructive notice of public records. But, a court may consider applying actual knowledge and inquiry notice to these claims.

VI. *JUE V. SMISER*: A CAVEAT TO RELIANCE ARGUMENTS

Jue v. Smiser[79] seemingly dispenses with a buyer's reliance in misrepresentation cases because in *Jue*, buyers learned

of a potential misrepresentation after contracting but prior to escrow close and still elected to close the deal. Despite their awareness of a potential misrepresentation prior to the close of escrow, plaintiff buyers were still allowed to pursue damages for the misrepresentation.

In *Jue*, buyers learned about the sellers' representation that a famous architect named Julia Morgan designed the house from sellers' marketing materials prior to contracting on April 27.[80] On June 8, the sellers disclosed their uncertainty about Ms. Morgan's involvement, days before the June 11 escrow close. Buyers decided to close escrow anyway on June 11.[81] Buyers then filed an action against the sellers for damages based on the alleged misrepresentation.

Defendants filed a motion for summary judgment, arguing the buyers had no justifiable reliance because the undisputed facts show they had knowledge of all material facts prior to escrow close and elected to close the deal. The trial court granted summary judgment.[82] The appellate court reversed, holding that a fact finder considers a buyer's reliance prior to and at the time of entering the purchase contract.[83] The court found "reliance must be established at the time the initial contract is struck" and "[i]t is not necessary that a claimant establish *continuing* reliance . . . ."[84]

The *Jue* court did not mention any buyer's property inspection contingency or how the court's reasoning would apply when that contingency exists. Normally, a buyer has seventeen days (or less in a seller's market) to inspect the property and then elect to proceed with or walk away from the deal. If the seller delivers disclosures or materially amends a disclosure required in section Civil Code section 1102.6, after the offer to purchase, a buyer receives a similar three or five day contingency upon receiving the materials in section 1102.3.[85] The *Jue* court left open how section 1102.3 would apply to last minute disclosures.

While courts and attorneys must respect the *Jue* case as good law, no published opinion has followed it for the point that a buyer may learn of a misrepresentation prior to close, elect to proceed with the purchase, and then sue the seller for damages based on the misrepresentation.

VII. COMMON TRANSACTION ISSUES GIVING RISE TO BUYER CLAIMS

Sellers have affirmative duties to disclose all known material facts affecting the value or desirability of their real property when a seller knows such facts are not known to or within a buyer's diligent attention or observation. While "disclose everything you know" sounds easiest enough for sellers to do in theory, disclosure obligations present challenges in practice. Particularly challenging are disclosures about repairs or improvements, the scope or legality of permits, reports about past, current, or future problems, deed restrictions, or legal use.

Building practices and laws are complex as evidenced by expert witnesses having divergent opinions about whether improvements or repairs are properly constructed, permitted, or performed up to code. This complexity increases risks for sellers. The following are some examples of scenarios which could open the door for a misrepresentation claim from a buyer: work to a seller's home may have been done outside the scope of a permit; a contractor may have misdiagnosed a problem or not actually repaired it; a certificate of completion or occupancy or an inspector's sign off does not mean all work has been performed up to code, has no defects, or that a contractor did it within the scope of the permits or plans; [86] building and planning laws change such that improvements are no longer practical;[87] construction permits may not necessarily authorize intended use; or a seller may rely upon the escrow company to disclose deed restrictions to a buyer.

Buyers sometimes first learn of these issues when they apply for permits or hire professionals to do repairs or improvements. When that happens, a buyer understandably forms negative perceptions that a seller misrepresented or failed to disclose material facts to the buyer.

VIII. A ROAD MAP TO DEVELOPING DEFENSES BASED ON BUYER'S NON-RELIANCE

A. The Mediation Demand Letter and Factual Basis for Claims

Buyer-seller litigation typically starts with a mediation demand letter to the seller to try to perfect the buyer's right to attorney's fees if he or she is the prevailing party under the purchase and sale contract.[88] Standard residential contracts require compliance with the mediation clause as a prerequisite to an award of attorney's fees should that party prevail in the dispute.

A typical mediation clause states:

> Buyer and Seller agree to mediate any dispute or claim arising between them out of this Agreement, or any resulting transaction, before resorting to arbitration or court action. . . . If, for any dispute or claim to which this paragraph applies, any party commences an action without first attempting to

> resolve the matter through mediation, or refuses to mediate after a request has been made, then that party shall not be entitled to recover attorney fees, even if they would otherwise be available to that party in any such action.[89]

Unless an exception applies, a buyer must make a mediation demand to a seller before initiating litigation. And, a seller must respond to the demand by agreeing to mediate. Courts strictly construe mediation clauses and, unless an exception applies, will deny a prevailing party attorney's fees for failing to first mediate or for refusing to mediate after receiving a demand.[90]

Apart from doing a pragmatic analysis on alleged damages and weighing any demand amount against the initial and continuing costs of litigation, one of the most important first steps is for a seller to identify the facts the buyer claims the seller did not disclose or mispresented. If the buyer's demand letter was light on the facts, a seller should ask for more detail to make the mediation more meaningful. It is not uncommon to exchange informally the most relevant documents before mediation.

B. Investigating the Claim

After receiving a buyer's mediation demand letter, a seller's attorney should review the transaction file, including all emails, and drill down on: (1) what the seller (and his or her listing broker and agent) knew and represented, in writing and orally, about the alleged misrepresented or undisclosed facts; (2) whether the buyer received any information about the alleged nondisclosure or misrepresented fact or whether the buyer's diligent inquiry or investigation may have led to the discovery of the alleged fact; and (3) whether the buyer received any advisories or recommendation to investigate the alleged nondisclosure or misrepresented fact.

The disclosure forms are often where to find any relevant representations and disclosures, including any red flag conclusions about repairs, improvements or permits. For instance, the TDS, Section C, Questions 4 and 5, ask about a seller's awareness of work done without necessary permits or in non-compliance with building codes. The Seller's Supplement to the Real Estate Transfer Disclosure Statement ("STDS") also asks a seller about his or her awareness of reports, inspections, or repair estimates, and if aware, the STDS asks a seller to describe such awareness and whether copies of the documents are available. Further, a buyer's property inspection or termite reports sometimes call out work that does not appear to meet code or appears done without necessary permits.

C. Walking Through the Evidence to Develop Defense Arguments

1. Did the Seller Correctly Disclose Any Facts About the Claim?

The TDS and STDS forms comprehensively ask about the condition of the property and other facts affecting its value or desirability. These forms likely ask about the material facts at issue. If disclosures show the seller omitted facts, incorrectly disclosed or made incorrect conclusions about the facts, or provided information only about the tip of the iceberg, the next level of inquiry begins as to what the seller knew and reasonably believed to be true. If evidence shows the seller correctly disclosed the material fact, he or she stands on solid ground to mount a defense.

2. Did the Seller Have Actual Knowledge of the Material Fact or a Reasonable Basis for Believing Any Representation About It?

Actionable nondisclosure requires the seller to have actual knowledge of the undisclosed fact. And, an actionable negligent misrepresentation claim requires a buyer to prove the seller had no reasonable basis to believe the represented fact was true. The seller controls information about his or her knowledge or beliefs unless a buyer's investigation shows otherwise. In practice, to resolve the dispute, the seller may confirm the absence of knowledge or provide evidence to show the reasonable basis for the representation. The evidence there often rests on the seller's word. But sometimes the buyer learned of the material fact through circumstances that support reasonable inferences that the seller lacked knowledge or had a reasonable basis for representing the fact.

The seller should prepare to address any evidence the buyer presents or offers to show a seller's knowledge. Sometimes the offer rests on reasonable inferences. A seller's investigation should cast a wide-enough net to gather evidence to rebut any inferences the buyer relies upon.

3. Could the Buyer Have Learned About the Facts Giving Rise to the Claim or Did the Buyer Reasonably Rely on the Seller's Representation About Facts?

The disclosures and advisories usually provide facts to support a seller's defense that a buyer failed to investigate and did not reasonably rely on a seller's representation or non-disclosure. Specific disclosures, whether in the TDS or reports provided to a buyer, often provide the most useful

evidence to argue the seller disclosed the alleged issue and/or the buyer failed to investigate or did not reasonably rely upon a seller's representation or undisclosed fact.

A transaction file typically contains many advisories and disclosures warning buyers to investigate permits and use issues. Sellers' attorneys should closely scrutinize the transaction file, including the purchase and sale contract and any inspection or buyer advisories. If in electronic form, search for the following key words, or variations of such, in preprinted forms: "condition of property," "inspections," "illegal units," "permits," and "nonconforming uses." But keep in mind, electronic text recognition software typically does not recognize handwritten words and the TDS and STDS forms usually contain handwritten words.

Depending on the nature of a buyer's allegations and the facts disclosed or represented, a seller may argue the buyer could have reasonably discovered facts related to repairs, improvements, permits, legal use, or deed restrictions. The buyer may have received advisories and written recommendations to investigate those issues and the public records. A buyer usually has ready access to online records from counties or cities related to permits.[91] A preliminary title report may identify the documents recorded on title to a property. A buyer can also readily go to an assessor-recorder's office or contact the escrow company to obtain the recorded documents.

4. Any Actual Knowledge or Inquiry Notice?

An attorney should also review the transaction file to see if the records identify the existence of the material fact at issue and whether further inquiry in public records would have revealed the nature of such facts. *Alfaro* would support that argument.[92] An attorney may consider a more extended use of the case by arguing the buyer had inquiry notice of any fact in the transaction file, regardless of whether public records or another source may provide further details.

IX. MITIGATING THE RISKS OF BUYER CLAIMS

A. The Disclosing Seller Mentality

Workable guiding principles are honesty, accuracy, and completeness. Sellers should adopt an inclusive rather than exclusive mentality when completing disclosure forms and in providing other material information and documents to buyers. Sellers should not read questions as limiting information nor should they adopt the thinking that "it's not asked for." If known material facts are not asked for, sellers owe affirmative duties to disclose them to buyers. Nor should a seller assume a buyer knows about a material fact or that a buyer's diligent attention or observation will lead to the discovery of the material fact. Disclose everything, and when a seller has doubt about whether to disclose something, the answer to any doubt is to disclose it.

B. Disclose Reports, Permits, and Construction Records Without Conclusions

Sellers should disclose all records related to repairs, estimates, permits, reports, and related documents they have or control, and identify documents they do not possess but know about. Sellers are wise to avoid explaining their ramifications or potential effect on the value of the property.[93] Examples of problematic conclusions include using language like "legal" in-law, work "meets code," "all work completed with permits," or "expansion potential." "Legal" requires a conclusion whereas the issuance of permits, scope of work stated in the permits, and issuance of certificate of completion reflect facts. Similarly, "all work completed with permits" or all repairs "meet building code" represent conclusions, often requiring expert opinions. In contrast, disclosing the seller's source of the information to a buyer communicates factual information that helps the seller mitigate risks. For example, the seller may disclose that his or her contractor advised the work did not require permits or advised the work was done with necessary permits. That way, a buyer knows the seller's source of information for making the disclosure and has more information upon which to decide whether to independently verify it.

C. Disclose Past Repairs and Water Leaks

Sellers may mitigate their risks by disclosing past problems and water leaks, even when a seller believes they are "fixed." Concluding they are fixed and resolved may create risks. Making factual disclosures about the problem and efforts to repair may mitigate the seller's risks. For example, state "observed water stains on wall" or otherwise describe the condition observed. Disclose seller's complaints about water leaks or damage and efforts to investigate, diagnose, and repair it by providing names and contact information of the professionals involved, dates and all estimates, invoices, reports, photographs, or related documents. Provide the time since the repair efforts and what the seller has observed since the date of repair work. Depending on the facts, there are further steps to use to mitigate risks through disclaimers and advisories.

X. CONCLUSION

Nondisclosure and misrepresentation claims present fact intensive issues, often decided on a buyer's reliance. The facts and issues of each case dictate the defenses and strategies to consider. Mitigating risks to try to avoid such claims also turn on the facts of each transaction.

Endnotes

1 This article is for informational purposes only and does not create an attorney-client relationship, nor should it be relied upon as legal advice. Readers seeking legal advice should consult with a qualified attorney about the facts or issues of their particular case or transaction.

2 Attorneys representing real estate brokers and agents may consider the arguments when they apply to their case and defenses, appreciating that the fiduciary duties a broker and agent owe to their client buyer may change the analysis. *See e.g.*, *Field v. Century 21 Klowden-Forness Realty,* 63 Cal. App. 4th 18, 25–27 (1998); s*ee also, Michel v. Palos Verdes Network Group, Inc.*, 156 Cal. App. 4th 756, 762 (2007) (constructive fraud arises upon fiduciary's failure to share material information with its principal regardless of actual fraudulent intent); *Salahutdin v. Valley of California, Inc.*, 24 Cal. App. 4th 555, 562–63 (1994) (same).

3 *See Calemine* v. *Samuelson*, 171 Cal. App. 4th 153, 161 (2009).

4 *Id. quoting Shapiro v. Sutherland*, 64 Cal. App. 4th 1534, 1544 (1998) (internal citations omitted).

5 *Calemine*, 171 Cal. App. 4th at 161.

6 *Lingsch v. Savage*, 213 Cal. App. 2d 729, 737 (1963); *Milmoe v. Dixon*, 101 Cal. App. 2d 257, 260–61 (1950).

7 *Calemine*, 171 Cal. App. 4th at 161, *citing Pagano v. Krohn*, 60 Cal. App. 4th 1, 8–9 (1997).

8 Cal. Civ. Code §§ 1102(a), 1102.2, and 1102.6.

9 *Id.* at TDS, Sec. C, Questions 4, 10, 12.

10 Cal Civ. Code § 1102.7.

11 *Sweat v. Hollister*, 37 Cal. App. 4th 603, 608–09 (1995) *disapproved on other grounds by Santisas v. Goodin*, 17 Cal. 4th 599, 609, n.5 (1998).

12 *See Alfaro v. Cmty. Housing Improvement Sys. & Planning Assoc., Inc.*, 171 Cal. App. 4th 1356, 1383 (2009), *citing Sweat*, 37 Cal. App. 4th at 608–09 *disapproved on other grounds in Santisas*, 17 Cal. 4th at 609, n.5.

13 *Alfaro*, 171 Cal. App. 4th at 1383.

14 *Sweat*, 37 Cal. App. 4th at 608–09, *disapproved on other grounds in Santisas*, 17 Cal. 4th at 609, n.5.

15 *Assilzadeh v. Cal. Fed. Bank*, 82 Cal. App. 4th 399, 416 (2000) (internal citation omitted).

16 *Stevenson v. Baum*, 65 Cal. App. 4th 159, 165–66 (1998).

17 *See* 1 Miller & Starr, *California Real Estate* § 1:173 (4th ed. 2015), *citing Shapiro v. Hu*, 188 Cal. App. 3d 324, 332–33 (1986) and *Loughrin v. Sup. Ct.*, 15 Cal. App. 4th 1188, 1192 (1993).

18 *Lingsch v. Savage*, 213 Cal. App. 2d 729, 743 (1963).

19 *Id.*

20 Cal. Civ. Code § 2079.5.

21 *Assilzadeh,* 82 Cal. App. 4th at 413.

22 Miller & Starr, *supra* note 17, § 1:169.

23 Miller & Starr, *supra* note 17, § 1:168.

24 *See Carleton v. Tortosa*, 14 Cal. App. 4th 745, 755 (1993).

25 *Id.* at 755–57.

26 *OCM Principal Opportunities Fund v. CIBC World Mkts. Corp.*, 157 Cal. App. 4th 835, 864–65 (2007); *see also*, *Manderville v. PCG & S Group, Inc.*, 146 Cal. App. 4th 1486, 1497–99 (2007) (analyzes reasonable reliance by discussing inspection advisories and exculpatory clauses).

27 *OCM Principal Opportunities Fund,* 157 Cal. App. 4th at 858.

28 Miller & Starr, *supra* note 17, § 1:158, *citing Newhall Land & Farming Co.* v. *Sup. Ct.*, 19 Cal. App. 4th 334, 350–51 (1993); *see also*, *Karoutas v. HomeFed Bank*, 232 Cal. App. 3d 767, 770–71 (1991) (reverses trial court demurrer to negligent nondisclosure claim).

29 Miller & Starr, *supra* note 17, § 1:158.

30 *See Alliance Mortg. Co. v. Rothwell*, 10 Cal. 4th 1226, 1239 (1995); *see also*, *Alfaro v. Cmty. Hous. Improvement Sys. & Planning Assoc., Inc.*, 171 Cal. App. 4th 1356, 1383 (2009), *citing Lingsch v. Savage*, 213 Cal. App. 2d 729, 739 (1963) ("[r]easonable or justifiable reliance on the nondisclosure is an element of such fraud").

31 CACI No. 1910.

32 *Cf.* Miller & Starr, *supra* note 17, § 1:168 (explaining when buyer may rely on seller's representation without duty to investigate truth of representation or to discover facts concealed).

33 *Calemine*, 171 Cal. App. 4th at 161 *quoting Lingsch*, 213 Cal. App. 2d at 736 (emphasis in original).

34 *Lingsch*, 213 Cal. App. 2d at 736.

35 Cal. Civ. Code § 1572, subd. 3.

36 *Lingsch*, 213 Cal. App. 2d at 734–35.

37 *Id.* at 738.

38 *Id.*

39 *Alfaro v. Cmty. Hous. Improvement Sys. & Planning Assoc., Inc.*, 171 Cal. App. 4th 1356, 1383 (2009).

40 CACI No. 1910.

41 *Id.*, Directions for Use (Dec. 2009), *citing Calamine*, 171 Cal. App. 4th at 161.

42 CACI No. 1910, Sources and Authority, *citing Lingsch*, 213 Cal. App. 2d at 736.

43 Cal. Civ. Code § 1710, subd. 2.
44 *Id.* § 1572, subd. 2.
45 *See* CACI No. 1903.
46 Cal. Civ. Code § 1710, subd. 1.
47 CACI No. 1900.
48 *See* Miller & Starr, *supra* note 17, § 1:144.
49 *Alliance Mortg. Co. v. Rothwell*, 10 Cal. 4th 1226, 1239–40 (1995).
50 *Id.* (internal citations omitted); *see also*, Miller & Starr, *supra* note 17, § 1:169.
51 Miller & Starr, *supra* note 17, § 1:167.
52 *See Alliance Mortg. Co.*, 10 Cal. 4th at 1239; *see also*, *Alfaro v. Cmty. Hous. Improvement Sys. & Planning Assoc., Inc.*, 171 Cal. App. 4th 1356, 1383 (2009), *citing Lingsch v. Savage*, 213 Cal. App. 2d 729, 739 (1963).
53 *Alliance Mortg. Co.*, 10 Cal. 4th at 1239.
54 *OCM Principal Opportunities Fund*, 157 Cal. App. 4th at 864.
55 In the TDS, Section II states: "The Seller discloses the following information with knowledge . . . prospective Buyers may rely on the information in deciding whether and on what terms to purchase the subject property." *See* Cal. Civ. Code § 1102.6.
56 *See* CACI No. 1908.
57 *Alliance Mortg. Co.*, 10 Cal. 4th at 1239.
58 *OCM Principal Opportunities Fund*, 157 Cal. App. 4th at 864 (italics in original, internal citations omitted).
59 Miller & Starr, *supra* note 17, § 1:169.
60 *Id.*
61 *Seeger v. Odell*, 18 Cal. 2d 409, 415 (1941).
62 *Id.*
63 *See Alliance Mort. Co.*, 10 Cal. 4th at 1247–48, n.9.
64 *Hartong v. Partake, Inc.*, 266 Cal. App. 2d 942, 964–65 (1968), *citing Van Meter v. Bent Constr. Co.,* 46 Cal. 2d 588 (1956) (internal citations omitted); *see also*, *OCM Principal Opportunities Fund*, 157 Cal. App. 4th at 865 (quoting *Hartong* for same).
65 Miller & Starr, *supra* note 17, § 1:168.
66 *Seeger*, 18 Cal. 2d at 415.
67 *See Alfaro v. Cmty. Hous. Improvement Sys. & Planning Assoc., Inc.*, 171 Cal. App. 4th 1356, 1385–87 (2009); *see also*, Miller & Starr, *supra* note 17, § 1:167 (citing the *Alfaro* case for same).
68 *See Alfaro*, 171 Cal. App. 4th at 1389–90.
69 San Francisco Housing Code § 351(A) requires that a seller provide a 3R Report to a buyer, unless an exception applies. *See* http://sfdbi.org/application-report-residential-building-record.
70 *Alfaro*, 171 Cal. App. 4th at 1389–93.
71 *Id.* at 1389.
72 *Id.* at 1385.
73 *Id.* at 1389–90.
74 *Id.* at 1390.
75 *Id.* at 1389 (*quoting* Cal. Civ. Code § 19).
76 *Id.* at 1385.
77 *Id.* at 1385, n.21, *quoting* 4 *Witkin, Summary of Cal. Law*, Real Property, § 203, p. 408 (9th ed. 1987) (italics in original, citations omitted).
78 *Alfaro*, 171 Cal. App. 4th at 1389.
79 *Jue v. Smiser*, 23 Cal. App. 4th 312 (1994).
80 *Id.* at 314.
81 *Id.*
82 *Id.* at 314–15.
83 *Id.* at 315–18.
84 *Id.* at 317 (italics in original).
85 *See* Cal. Civ. Code § 1102.3a(2)(c).
86 7 *Miller & Starr*, *California Real Estate* § 25:37 (4th ed. 2015) ("the performance of an inspection and the approval of the inspection or work completed is not to be construed as an approval of a violation of the applicable building code or any other ordinance or requirement; any inspection that purports to give approval to a violation or cancellation of applicable code requirements is invalid.").
87 *See e.g.*, *Saffie v. Schmeling*, 224 Cal. App. 4th 563, 566–67 (2014) (1994 earthquake resulted in county no longer accepting fault hazard reports done under earlier standards and current standards made it impractical for a 2006 buyer to build the commercial parcel).
88 *Lange v. Schilling*, 163 Cal. App. 4th 1412 (2008).
89 *Id.* at 1414.
90 *Id.* at 1416–18.
91 *See* Permit/Complaint Tracking System, San Francisco Department of Building Inspection, http://dbiweb.sfgov.org/dbipts/ (last visited May 11, 2016).
92 *See Alfaro*, 171 Cal. App. 4th at 1383.
93 *Accord Saffie,* 224 Cal. App. 4th at 569–72 (seller's broker, who made accurate factual statements about an old fault hazard report calling parcel buildable in the MLS, had no duty to explain to buyer that county building laws had since changed and parcel was no longer buildable).

*First published in the California Real Property Journal, a quarterly publication of the Real Property Law Section of the State Bar of California.