

AVOIDING THE “FAILURE TO DISCLOSE” LAWSUIT



By **Geoffrey M. Gold**

A new owner faces an unexpected problem with the property. It could be a leak or a dispute with a neighbor. It could be that the house is haunted. Whatever the unwelcome surprise, the seller always is to blame. The “auto accident” of any real estate transaction is the “failure to disclose” lawsuit.

A seller should consider the elements a buyer would have to prove to prevail in a failure to disclose lawsuit before completing the sale. The elements of a cause of action for fraud based on non-disclosure are (1) non-disclosure by the seller of material facts affecting the value or desirability of the property; (2) the seller's knowledge of such facts, and of their being unknown to or beyond the reach of the buyer; (3) the seller's intention to induce action by the buyer; (4) inducement of the buyer to act by reason of the non-disclosure; and (5) resulting damages.

First, there is the question of non-disclosure. In certain real estate sales, statutory disclosure requirements apply. Beyond that, common law standards govern. No such thing as *caveat emptor* – let the buyer beware – exists in California real estate transactions. A seller has a common law duty to disclose defects materially affecting the value or desirability of the property when the seller is aware of the defects and knows the buyer is ignorant of the facts and would not discover them in the exercise of reasonable diligence.

While a seller who reasonably and in good faith believes a defect has been corrected has no statutory duty to disclose it, the best way to avoid possible suit is for the seller to disclose anything that is arguably important enough that it would matter to the seller if he were buying. Thus, a seller is well advised to follow the “golden rule” of full disclosure - disclose to others as you would have others do unto you.

Why? Whenever the court is asked to decide who acted “reasonably,” in “good faith” or with “awareness,” or whether some point is “material” or if the buyer acted “reasonably diligently,” a factual issue will predominate. The seller will not exit the case quickly.

Another element of the suit is the intent of the seller to induce reliance. Again, this may pose a question of fact, as in most instances only circumstantial evidence can establish *mens rea*. The more subjectivity there is to the analysis, the greater the chance that the seller may be found to have liability. Hence, even a marginal case may have settlement potential, if pursued by an aggressive buyer claimant.

As to the question of reliance, a sure-fire way to reduce the chances that the buyer can claim that he justifiably relied on some alleged non-disclosure by the seller is to do what the drug companies do when they sell a bottle of medicine. Warn the consumer about what might be prudent for a user to do. Let the buyer know that the roof is old and may need to be replaced and that a professional roofer should be called to give an estimate. State the obvious.

Failure to disclose lawsuits can be terribly expensive for sellers because the factual issues of non-disclosure of material facts, intent, and reliance must be decided. A seller cannot expect to escape unscathed should a serious previously undiscovered problem emerge.

Assuming that the seller may face some liability, the typical real estate form contract unthinkingly used by most brokers provides for attorney's fees to be awarded to the prevailing party on the claim, regardless of the size of the victory.

What can a seller do to limit liability? The seller should calculate the risk of a future failure to disclose lawsuit into the transaction. The seller should remove or amend

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the standard attorney's fee or arbitration/mediation clause, which could promote the pursuit of conflict. The seller should act prudently in disclosing prior events and transactions concerning the property, and consider inserting contract language to insulate against certain known and unknown contingencies arising from the property's past. It is not easy to defeat a failure to disclose claim on summary judgment, considering the variety of factual points of difference. Things will get worse for a seller with even modest exposure when it is realized that the seller may also be required to pay the buyer's legal expenses.

Taking this into account, the seller should dedicate more thought to how to kill the idea at the outset that the seller intended to defraud. The safest solution is deep, straightforward disclosure. The seller should recommend explicitly that the buyer is advised to hire an expert to review the work that was done to fix certain conditions at the property, because the seller cannot warrant perfection. The seller should reveal all that he knows, including any previous specific problems.

In addition, disclosure obligations should be fulfilled early. A recent case ruled that, if a seller fails to timely disclose even immaterial items according to statute, then the seller may be barred from proceeding against the buyer for breach of contract. The buyer can back out of the transaction at any time, even if all contingencies have been removed, where no proper transfer disclosure statement or required hazards report

has been furnished. The seller would be foolish to allow the buyer such an easy way out of the deal, but it happens all of the time.

Finally, the damages recoverable in a typical failure to disclose case consist of the difference between the contract price and the fair market value of the property at the time of sale. The buyer is not entitled to recover the cost of the alleged fix or improvement. This is something that often confuses failure to disclose claimants and counsel. So again, by disclosing that the property is imperfect, the seller may reduce damages exposure. If the property as advertised could not have been sold for a price higher than the buyer paid, no damages will be available in a failure to disclose case.

The bottom line is that a seller will minimize failure to disclose liability by impugning the property during the sale process, warning would-be purchasers of potential issues and the benefit of further expert investigation, and adding clear contract language that the seller is not the guarantor of any future ill.

Geoff is a trial lawyer specializing in business and real estate matters. He has litigated to successful conclusion cases involving a wide variety of corporate and business issues as well as commercial and real estate transactions. Geoff also acts as outside general counsel to many developing businesses and assists his individual and corporate clients with their everyday legal affairs (ggold@rutterhobbs.com).

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LITIGATION

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- Assisted in the resolution of a partnership dispute over an entertainment event, resulting in the client taking control of the business.
- Assisted an investment-banking client in obtaining a settlement recovery in Federal Court from a Nevada hotel operator/developer who had failed to pay a fee owed.
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Tenants: Looking for Space and Negotiating Clout?



By **David Y. Joe**

The use of a request for proposal and a letter of intent can save a tenant time, money and effort in property identification and lease negotiations. By focusing on material issues and identifying any major problems at an early stage, negotiations can be expedited and uncertainties eliminated. Employing a request for proposal and a letter of intent minimizes a tenant's risk of walking away in the midst of lease negotiations because the landlord did not concede a particular point, only to find that it cannot obtain such concession from any landlord of a comparable property.

A request for proposal benefits a tenant by creating a "market" for its business among landlords. First, the tenant should meet with its attorney and real estate broker to determine what issues are most important with respect to a property to lease and what, if any, issues would cause the tenant to walk away from a deal. Once these issues are determined, the real estate broker should prepare and send a comprehensive request for proposal to various landlords.

The tenant's negotiating leverage is maximized at the request for proposal stage because the tenant has not settled on any particular location or landlord. Prospective landlords recognize that the tenant can go elsewhere if they fail to agree on a critical issue. Once a tenant has selected a particular location, the tenant's negotiating leverage diminishes significantly. After reviewing responses from different landlords, a tenant can then select the landlord it wishes to engage in negotiating a detailed letter of intent.

A letter of intent outlines preliminary agreements

between parties to a transaction that are meant to be memorialized by a more definitive future document, such as a commercial lease. Which entities will be bound by the lease agreement? Where are the leased premises located, how big are the premises and how will the same be used? How much rent will be charged and how will it be increased? What will the commencement date of the lease be and how long is the term? Who will be responsible for building out the space? Who will pay for the build out? Will the tenant be allowed the right to assign or sublease the space? If so, on what terms and conditions? Will the tenant receive non-disturbance protection? These and many other issues can and should be addressed in a letter of intent.

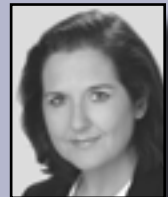
Be aware that, under California law, a letter of intent may constitute a binding contract for the parties involved to negotiate in good faith. It is important to pay close attention to what a letter of intent does or does not say. If the letter of intent is not meant to be the final agreement between the parties, make sure clear and unambiguous language is included to that effect. Likewise, if the letter of intent is not meant to constitute a binding contract to negotiate in good faith, make sure language is included specifically negating such duty.

Once the letter of intent has been fully negotiated, the parties can move forward with the lease agreement, confident that the first draft will be close to the final, executable version.

David specializes in real estate transactions, with particular emphasis on purchase and sale, leasing and financing of industrial, office and retail properties. His legal expertise is complemented by business acumen gained as the co-founder of a full-service residential and commercial real estate brokerage and property management firm (djoe@rutterhobbs.com).

RHD ATTORNEY UPDATE


We are pleased to welcome Elizabeth Botsford to the firm. Elizabeth specializes in tax, estate planning and contentious probate matters. She also has experience advising entrepreneurs in both transactional and litigation matters. Elizabeth graduated with Honors from the London School of Economics receiving her J.D. in 1987. She is currently attending Loyola Law School to complete her LL.M in tax.



We are also excited that Natasha Shabani has joined the firm's Intellectual Property practice. Natasha has expertise in drafting agreements of all types including licenses, contracts, sweepstakes and contest rules for promotions, and website privacy policies. She also represents clients on copyright, trademark and other legal issues related to intellectual property. Natasha earned her J.D. from Columbia Law School where she was a Harlan Fiske Stone scholar, and a Bachelor of Arts in Political Science from Yale University.

R H D I N T H E N E W S

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| January 31, 2007: | RHD was a proud sponsor of Bet Tzedek's 19th Annual The House of Justice Dinner Gala. |
| January 30, 2007: | Andrew Apfelberg was the panel facilitator for "Create a Referral Based Business," an educational workshop for members of the Professionals Network Group. |
| January 25, 2007: | Frank Melton presented "Employment Law Developments and Tips for Nonprofits" at the 2007 Nonprofit Forum. |
| December 26, 2006: | The Los Angeles Daily Journal featured Greg Sater in a front-page photo and article about beach volleyball entitled "Keeping His Sand Legs: No Bar Card Required." |
| December 10, 2006: | Frank Melton was quoted in the New York Times' article "Financial Side Effects of On-The-Job Injuries." |
| November 16, 2006: | Rutter Hobbs & Davidoff was a sponsor of the 5th Annual Attorney-Banker-CPA Networking Breakfast. |
| November 13, 2006: | Brian Davidoff presented "Asbestos Bankruptcies: A New Wave In Southern California" at the Los Angeles Bankruptcy Forum. |
| November 9, 2006: | The Los Angeles Daily Journal and The San Francisco Daily Journal published Olivia Goodkin and William Kampf's article "As State Minimum Wage Goes Up, Increases for Other Earners Will Ripple Through Payrolls." |
| November 2006: | Frank Hobbs was named a Fellow of the American Academy of Trial Counsel. |
| October 27, 2006: | Brian Davidoff presented "Law Firm Marketing: One Firm's Perspective" at the 2006 Primerus Conference. |
| October 2006: | Brian Davioff was named Vice-Chair of the Primerus Business Corporate International (BCI) Group. |

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