A SELLERS' MARKET: ANTICIPATED LEGAL CHALLENGES PART 2: A CASE STUDY

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This article is Part 2 of the author's initial submission which can be found in the North County Lawyer, August 2021, Vol. 38, No. 8, at page 20, et. seq. The housing market has not changed since that publication. The housing bubble, the incredible sellers' market, has not burst. In fact, if anything, the sellers' market has continued to result in ever-increasing prices. Buyers continue to fight against competing bids. Some buyers unwisely make offers in which all contingencies are removed, to gain what they perceive to be a competitive edge. The ongoing sellers' market has resulted in a multitude of legal issues, some of which are discussed, below. The case study, below, is demonstrative of just one example of this market's consequences.

Select Applicable Law:

The current residential sales market is a challenge to buyers who are caught up in a frenzied sellers' market, the likes of which have not been seen by your author in nearly 50 years of experience as a California real estate trial attorney, and now a mediator with West Coast Resolution Group in San Diego, California. As a result of low housing inventory, where demand far outstrips supply, sellers feel empowered to exponentially increase sales prices to numbers far beyond the reach of many buyers. Sellers' disclosures, as well as agents' and buyers' due diligence, are too often inadequate and ignored. Unhappy buyers following close of escrow result in increased litigation and arbitration.

Under both California common law and statutory requirements, sellers have an obligation to disclose known material facts to buyers which facts affect the value or desirability of the subject property for sale. See, for example, California Civil Code Section 1102.3, et seq., and the venerable case of Lingsch v. Savage (1963) 213 Ca. App.2d 729, 740-742, among a plethora of California cases holding the same.

Real estate brokers and agents (both referred to herein as "agents") have a fiduciary duty owed to their principals. See Civil Code Section 2079.2, and Field v. Century 21 (1998)63 Cal. App.4th at p.25 ("a broker's fiduciary duty to his client requires the highest good faith and undivided service and loyalty.") In addition, California Civil Code section 2079 requires the agent to "(a) conduct a reasonably competent and diligent visual inspection of the property" and (b) disclose to the prospective buyer "all facts materially affecting the value or desirability of the property that an inspection would reveal."

Buyers also have duties of reasonable care to themselves in purchasing residential real estate. (See Civil Code Section 2079.5, indicating that nothing in section 2079 relieves a buyer of the duty to exercise reasonable care to protect himself.) This discussion of duties in the context of residential real estate sales is obviously not all-inclusive.

Discussion:

So how are sellers, buyers, and real estate agents coping with this frenzied market? Are sellers disclosing known material facts affecting the value or desirability of the subject property? Are real estate brokers and agents living up to their common law, statutory, fiduciary, and other duties? Are buyers exercising reasonable care and diligence with reference to their purchase?

The answer to these questions, above, in the context of this frenzied seller's market, is too often in the negative. For the record, each case varies. However, sellers, motivated by selling their properties in this market, are often focused on dollar signs only. The house they purchased for five figures, may now be sold for six, or even for seven figures. Never mind the personal and real property tax consequences of this gain, and the challenge in finding replacement property.

Agents may be buried in multiple transactions at once; even their transaction coordinators are confronted with a deluge of paperwork where documents and the volume and content thereof are daunting. Keeping transactions timely and on track represent a challenge to all.

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Buyers, who feel lucky just to have their offer accepted by sellers, often overlook a careful review of the documents they receive during the purchasing process, including but not limited to paying close attention to details of the purchase agreement, escrow instructions, inspection reports, preliminary title reports and their backup documents, as well as to written disclosures submitted by sellers and agents. The phrase "beauty is only skin deep" can apply to a very nice looking home with serious undisclosed issues lurking beneath the surface. Buyers may be "blinded by the light" of the ostensible visual physical condition of the subject property, only to learn post close of escrow (COE) of defects and negative conditions.

A Case Study:

To demonstrate the above, let us review a case study, one based in fact. Or not. The following tale does not necessarily represent actual events. It may be a compilation of several cases.

A couple of months ago, an old law school pal called your author to discuss a transaction for the purchase of a residence in California. This pal is a retired attorney, and his wife is a retired certified public accountant. The call was received after the buyers' offer was accepted.

The agreement utilized was the California Residential Purchase Agreement and Joint Escrow Instructions (RPA-CA), referred to herein as the "RPA." (The RPA is about to go through another metamorphosis in or about December; the ten (10) page RPA will go to a sixteen (16) page format. The author will review and report on the new document in this publication once it becomes effective.)

The residence they were in contract to purchase was in a twenty-floor condominium complex, in a high-end California community. The building consisted of 50 units. The subject unit was located on the eighteenth floor. The view from this unit, 2100 square feet, two bedroom, two bathrooms, was spectacular, consisting of breathtaking views of the ocean, mountains, and city. The purchase price was $2.8 million. The building had a 24-hour concierge service, two parking spaces per each unit, guest parking, even valet parking, all available on a 24/7 basis. The HOA regular monthly assessment was $3800, again, per month. My friend, the attorney, and his CPA wife were both now retired. This purchase of this unit appeared to be a "slam dunk" for this very successful, retired couple, who had no difficulty in making an all-cash offer.

So why in the world did my old law school pal call me, knowing that in nearly five decades, I had represented sellers, agents, and buyers in commercial, land, and residential lawsuits, in the Superior Court and in arbitrations, and now a full-time mediator? (More shameless self-promotion, later.) Here is where it gets interesting.

Under the RPA, specifically paragraph 10 F. (2) therein, the operative document in my friends' purchase, the seller is obligated to request from the HOA the most recent 12 months of HOA board minutes for regular and special meetings. In addition, Mrs. Buyer, the former CPA, asked in an addendum to their offer for the seller to request certain financial documents from the HOA, including balance sheets, reserve studies, budgets, and all records of regular and special assessments. So far so good.

The HOA's management company produced minutes, and financial documents. However, only 11, not 12 months of minutes and financial documents were provided. In addition, the financial documents were incomplete and not up to date. After our discussion, my pals, the buyers, refused to release contingencies and close escrow until all the requested documents were delivered to them

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The seller's and buyers' agents then became involved in the issue and made certain that all requested documents were delivered to the buyers, including all 12 months of HOA meeting minutes. Now the plot thickens. The buyers discovered that the minutes of the HOA board meeting for month one, previously not produced, referenced a debate among the board members and those in attendance at the meeting. The fight between the board and other owners in attendance was over a huge gap in the HOA's reserves, those sums of money required to be set aside to deal with repair and/or replacement of common area components, such as elevators, swimming pools, air conditioning units, parking structures, to name a few. According to the reserve study, conducted the previous year, the HOA's reserves were 95% underfunded. The reserve study was prepared by qualified accounting professionals who reviewed the HOA's books and records. (California Civil Code section 5550 requires a Reserve Study based on a "diligent visual site inspection" at least every third year with annual reviews in between.)

To make matters worse, this year-old set of HOA minutes discussed repayment of a $790,000 loan taken out several years prior by the association's board of directors. The purpose of this loan was to enable the board to pay operating expenses and make needed repairs to common area components. The monthly dues were insufficient and the then board members did not have the desire or will to impose a special assessment for the shortfall. Afterall, those directors wanted to remain popular with their fellow owners.

Mrs. Buyer's assessment was that the HOA was about $2million in the red, after considering repayment of the loan and the inadequate reserves! When the elevator would inevitably fail, or other common area features required repair or replacement, the HOA was faced with only two choices. The HOA was in the unenviable position of having to levy a special assessment on all its owners, and/or increasing the monthly regular assessments, neither of which would be welcomed by the unit owners. This was a building nearly fifty years old, it was tired, and needed substantial repairs and replacements. Who is going to pay the freight? The unit owners, of course.

The two most prominent disclosure forms used in residential sales transactions in California are the Transfer Disclosure Statement, or TDS, (see Civil Code section 1102.3, et seq., a creature of legislation), and the Seller Property Questionnaire, or SPQ, a form created by CAR which is contractually required by the RPA for the seller to fill out and provide to the buyer. Both forms require detailed disclosures and explanations by sellers.

In my law school chum's case, the seller made no disclosures about the HOA's dire financial condition in either the TDS or SPQ, or elsewhere. Well, one might say, perhaps the seller had no knowledge of the HOA's poor financial condition. After all, a seller must disclose all ***known*** material facts affecting the value or desirability of the property. As it turns out, the seller had been on the HOA's board at the time of the HOA's board of directors meeting when the financial issues were hotly contested, discussed and recorded in those minutes not originally produced. A motion was made at the HOA board meeting to impose a special assessment of $40,000 upon each of the condo unit owners. The motion failed to be approved by the directors, who were concerned with their inevitable loss of popularity among the unit owners.

Upon learning of the dire financial situation, my buyer friends immediately cancelled their purchase. Under the RPA-CA, a buyer may cancel and receive back his or her entire deposit if cancellation occurs before removal of contingencies. In the pending case study, the buyers had not removed contingencies and the seller eventually instructed escrow to return the deposit to the buyers, in full.

No disclosure of the HOA's dire financial straits was made to these buyers by the seller or the agents. Had the buyers not insisted upon the delivery to them of all 12 months of minutes, along with all HOA financial documents, they would have most likely closed escrow. Eventually, after close of escrow, the financial issues would have come to light. The HOA could not have ignored these issues forever, and the owners would have been slammed with a five-figure special assessment. In addition, or in the alternative, the HOA may have increased the monthly dues/assessments, which were already substantial. Many of the owners in the complex had lived in the building for decades, had purchased their units when the prices were substantially less, and did not have the resources or willingness to pay a five-figure special assessment and/or an increase in regular, monthly assessments.

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Is the new trend resulting from this sellers' market, a movement trending back to caveat emptor, buyer beware?

As one pundit put it, when one buys a unit in a condominium, or the unit is in a planned development or other common interest subdivision, the buyer is going into business with the other owners. There is no practical mechanism to research the creditworthiness or financial strength of each of the individual owners. Hence, the importance of reviewing the minutes and the financial records of a homeowner's association becomes so important.

It would be interesting to know if the seller in our case study, above, will disclose the now known negative financial condition of the HOA to future, prospective buyers, or whether the listing agent would do the same. The unit was gorgeous, according to photos shown by the buyers. The view was "to die for." Interesting to note also is that it was the buyers, not the agents or seller, who discovered the non-disclosed financial situation of the HOA. Whether the agents had an obligation to research and review the association's financial records is a matter for debate. Do the agents even have a duty to advise their buyers to carefully review HOA minutes and financial documents? After all, we have briefly touched upon the buyer's duty to exercise due diligence in their purchase of residential real property. See Civil Code section 2079.5. But it is doubtful that most buyers and agents recognize the potential importance of the HOA's minutes and financial documents, as well as CC&Rs, by-laws, budgets, reserve studies, rules and regulations, to name a few. No position regarding standard of care issues for agents is made in this article.

As another question, do buyers of units governed by CC&Rs, or do their agents pre-close of escrow, before removal of contingencies, have an obligation to review the preliminary title report to determine if the unit's parking spaces are part of the legal description, i.e., the fee, or are the parking spaces simply assigned by the HOA to the unit owners, with no ownership rights? My friends never got to the point of reviewing the preliminary title report, they cancelled before having to do so. End of the case study.

General Discussion:

Returning to the seller's market issues, as the inventory of residential property becomes even more scarce, and the competition among buyers intensifies, it is not difficult to imagine buyers ignoring or not even being aware of, their duties of due diligence, and/or agents ignoring their statutory and common law duties. It is predictable that sellers feeling their oats will tell buyers to take it or leave it and being less diligent in their disclosures.

As land for construction of single-family residences becomes more scarce and astronomically expensive, vertical construction of high-rise condominiums and townhouses is becoming more common. Homeowners' associations, along with their governing documents and financial records are often quite prevalent in the housing market. Review of documents associated with the governance and operation of HOAs, along with records reflecting the financial condition, maintenance, reserves, replacement and ever-growing functional obsolescence of critical systems, contain information often critical to a prospective buyers' decision whether to go forward with their purchase.

The age of the complex is also critical; older multi-family buildings and even SFRs require repairs and replacement of systems which suffer from age-related degradation. But here again, buyers in this market may be desperate and potentially reckless in their search for housing; after all, single family residences built in the 1920s through at least the 1950s are often marketed as "architecturally unique," or "mid-century masterpieces." Is the new trend resulting from this sellers' market, a movement trending back to *caveat emptor*, buyer beware?

Sellers must understand the critical importance of making robust disclosures, for their buyers' sake as well as for their own risk and litigation avoidance. Once sued, the challenge for sellers is that, generally, there is no insurance which covers a seller who is sued by the buyer. Regardless, when a claim is made against sellers, their counsel should immediately tender the claim for defense and indemnity to all seller policies of insurance. (With the exception, perhaps, of life insurance policies.) From the author's experience representing sellers, a tender is typically met with a negative response from the carrier. Finding and utilizing the legal services of experienced insurance coverage counsel is critical to any area of law practiced by the reader. Sellers who are sued by buyers of residential or other kinds of real estate are faced with the ominous task of incurring substantial attorneys' fees and costs, as are buyers who are paying counsel on a per hour, rather than a contingency fee basis.

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Please permit a prediction, of sorts. Buyers in this market will close escrows, paying prices beyond anyone's experience, imagination, or expectations. They will close escrow and settle into their newly purchased SFR homes, town homes, or condo units. After several months in these homes or units, after paying a fortune to purchase the property, a fortune for down payments, paying thousands of dollars per month in loan payments, real property taxes, HOA dues, both regular and special assessments, these buyers will awaken from their slumber, following their frenzied purchases in which they let their guard down. And now the buyers will face reality. They will question their purchases; they will find defects/material issues/neighborhood issues, previously undisclosed. The lawsuits will hit the proverbial fan. Agents will be accused of failing to protect their buyers or sellers. Sellers will be accused of failing to disclose known material facts. Buyers will be accused of failing to protect themselves.

One caveat:
If attorneys are going to represent a buyer or seller in an action arising out of the RPA, the prevailing buyer or seller is entitled to an award of attorney's fees. See paragraph 25 of the RPA.

However, the parties must first demand mediation or agree to mediation in response to a demand therefor to preserve the prevailing party's rights to recover attorney's fees. See Paragraphs 25 and 22.A., **Dispute Resolution**, of the RPA.

This is a big deal, to coin the vernacular. Recovery of attorney's fees by the prevailing buyer or seller cannot be understated. It would be a bad day for a practitioner to give the buyer or seller the good news: "We won the case," and then the bad news: "Oops. "We" failed to demand mediation, or "we" failed to agree to mediate in response to a demand for mediation, thanks for paying your attorney's fees, but unfortunately, we cannot recover them from the losing side. But, hey, we won!" The phrase "Pyrrhic victory" comes to mind.

Shameless Self-Promotion:
In my decades of practice, my modus operandi was to absorb the law and facts for each case, so that the case became part of my DNA. Now, in my mediation practice, that same approach is applied to each case that I mediate. Prior to attending law school, I studied, taught, and performed classical piano. The discipline applied to learning, teaching and performing, was applied to law school, the Bar exam, the practice of law, and now, to my mediation practice. That is my commitment to counsel who select the author to mediate your cases.

Please contact West Coast Mediation Group, to schedule your mediation. We have a terrific panel of real estate and non-real estate mediators, including your author, who are extremely experienced. My mediation practice includes business and real estate disputes as well as other types of matters. Contact Kathy Purcell, our incredible and user-friendly case administrator, at West Coast, 619-238-7282, to schedule your mediation.

Thanks to all. Enjoy the holidays!

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