by Robert S. Mann and Bess Blank

True value

Even if the out-of-pocket measure of damages does not apply, victims of real estate fraud may pursue other avenues of recovery

A POTENTIAL CLIENT RELATES that she purchased a 4,850 square-foot home for $6.8 million. She and the seller engaged the same real estate broker. The property included a detached, 1,000 square-foot guest house. The parties used standard forms provided by the California Association of Realtors (CAR),[1] and the forms state that at the time of sale, the sellers were unaware of any violations of the building code, construction defects, or problems with the house.

A few months after the purchase, the first rainstorm arrived, and water poured in everywhere. A forensic investigation disclosed multiple construction defects, and there was evidence of prior damage that had been painted over. When repairs started, a city building inspector arrived and informed the client that her detached guest house was not permitted and had to be demolished. The cost of repair of the water damage was $600,000. The unpermitted guest house was demolished, reducing the useable square footage of the property. The purchase price was approximately $1,400 per square foot, leading to the conclusion that the value of the guest house was $1.4 million (with an adjustment for the value of the land).

Two measures of damages are likely to apply. One is the out-of-pocket rule under Civil Code Section 3343, which may so limit recovery that filing suit may not be worth the effort. The other is the benefit-of-the-bargain measure under Civil Code Section 3333. Knowing which measure to apply is difficult.

The out-of-pocket measure of damages[2] under Section 3343—which provides the measure of damages for fraud involving the purchase, sale, or exchange of property—is "the difference between the actual value of that with which the defrauded person parted

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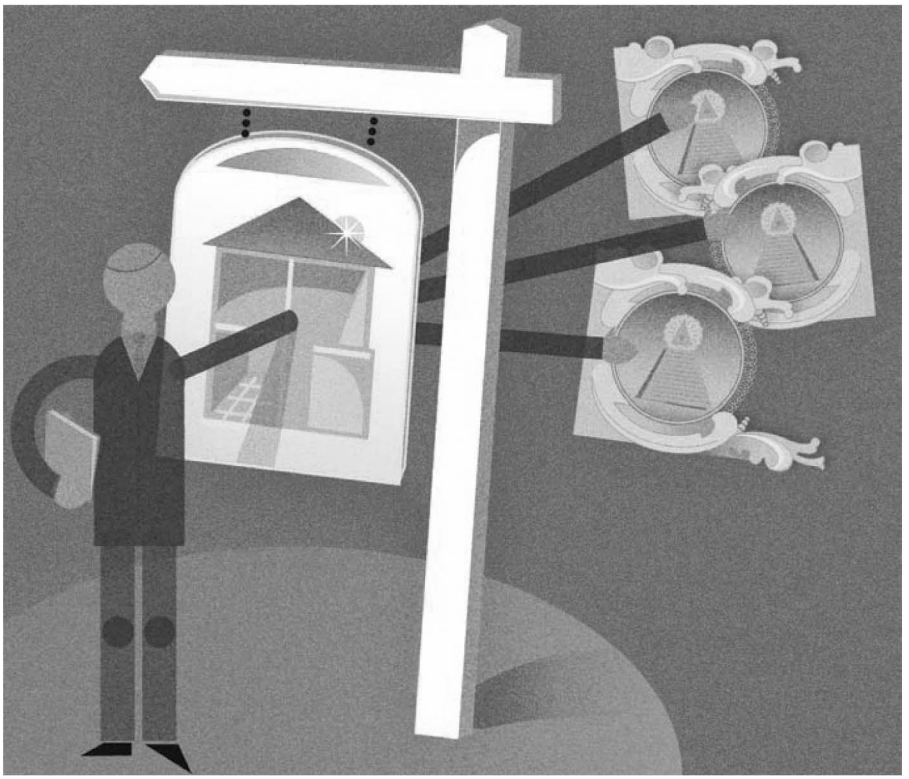
and the actual value of what was received."[3] Section 3343 also specifically disallows recovery of "any amount measured by the difference between the value of property as represented and the actual value thereof."[4] In other words, the section does not permit plaintiffs to recover the benefit-of-the-bargain damages of Section 3333, which states, "[T]he measure of damages…is the amount which will compensate for all the detriment…."



The rules seem simple, but the case law shows that their application is anything but. While courts have held that Section 3343 provides the exclusive measure of damages for a party that has been defrauded in the purchase, sale, or exchange of property,[5] some courts have carved out exceptions in cases in which the fraud has been committed by a fiduciary.[6]

When considering an action, therefore, a threshold issue is whether the broker acted as a fiduciary. A listing agent represents the seller and is a fiduciary to the seller but not to the buyer. The person representing the buyer is called (confusingly) a seller's agent and is a fiduciary to the buyer but not the seller. A dual agent represents the buyer and seller and is a fiduciary to the buyer and seller, as in the example involving the potential client and her guest house.[7]

The distinctions are critical for an evaluation. First, if the broker or agent is a fiduciary, a breach of fiduciary duty has been held to be a species of constructive fraud.[8] Second, if the cause of action seeks recovery of damages for fraud, whether constructive or actual, some inconsistencies exist in the case law about whether Section 3343 or 3333 applies. In *Salahutdin v. Valley of California, Inc.,* the court found that the plaintiff is entitled to recover damages against the fiduciary under Civil Code Sections 1709 and 3333, arguing that the "faithless fiduciary…makes[s] good the full amount of the loss of which his breach of faith is a cause."[9]

Section 3333 allows for the recovery of general tort damages: "all the detriment proximately caused" by the breach of an obligation not arising from contract. Similarly, Section 1709 provides that "one who willfully deceived another with the intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers." Civil Code Sections 3333 and 1709 provide the benefit-of-the-bargain measure for damage, which is substantially broader than the damages recoverable under Section 3343.[10] In addition, when applying this measure of damages, many courts have not limited recovery to the benefit of the bargain and have fashioned remedies that provide even more compensation to aggrieved plaintiffs.[11] In the example, the client who lost the guest house and had to make repairs may be able to sue the sellers and the broker for fraud. However, the client's recovery against the sellers will be governed by the out-of-pocket measure of recovery set forth in Section 3343. Recovery against the broker, however, may be governed by the broader measure of damages provided by Sections 1709 and 3333.

Another threshold issue in evaluating damages is the value of the property. In applying the out-of-pocket measure of damages, a plaintiff must prove that he or she paid more for the property than it was worth.[12] This means that the plaintiff must present evidence of the market value of the property on the date of purchase.[13] This evidence should take the form of expert testimony. For example, in *Fragale v. Faulkner,* the plaintiff failed to present any evidence of the actual value of the property he purchased. Therefore, a nonsuit was upheld with respect to the plaintiff's claim for fraud against the sellers, since the plaintiff failed to establish damages under Section 3343.[14] It might be possible for a homeowner, without a third-party expert, to testify about the value of his or her property, but the homeowner would have to establish a foundation for the testimony. For example, the homeowner could establish that he or she was aware of comparable values for adjacent homes at the time of purchase.[15] Ordinarily, it is necessary to retain a qualified expert to determine value at the time of purchase. The defense can be expected to retain its own experts in property valuation.

In the example, one consideration for case evaluation is that the property (without the guest house and with the defects) may have been worth the $6.8 million that the buyer paid for it. If so, the buyer did not suffer out-of-pocket damages under Section 3343.[16] If there is no difference between the sale price of the property and its market value, the buyer may establish all of the elements of fraud and yet recover nothing from the seller. The only remedy is to rescind the sale and get the money back in exchange for releasing the property.

Section 3343 also may leave the plaintiff uncompensated for the $600,000 in repairs, although those damages could be recoverable under different theories of liability. For example, in *Central Mutual Insurance Company v. Schmidt,*[17] the court held that the cost of repair is not a measure of damages under Section 3343. Indeed, while Section 3343(a)(1) permits the recovery of amounts reasonably and necessarily expended as a result of the fraud, recovery of costs of repair is not included. Instead, the recoverable damages are "expenditures which were reasonable under the circumstances…insofar as they have been lost or rendered fruitless because of the deceit."[18]

For example, in *Garrett v. Perry,* the plaintiff purchased a ranch and filed suit against the seller for fraud. In addition to awarding the plaintiff damages for the difference between the amount paid for the ranch and its actual value, the court held that the plain-

tiff was also entitled to the costs of operating and improving the ranch that were incurred prior to the plaintiff losing the ranch to foreclosure. The court held that since these expenditures were not offset by any income from the ranch (the condition of which made it impossible for the plaintiff to earn a profit), they were reasonable expenditures that were "lost or rendered fruitless because of the deceit."[19] In the example, however, the repairs undertaken by the client to fix the water damage are not expenditures that have been lost or rendered fruitless because of the deceit. Therefore, the repairs in the example are not recoverable under Section 3343.

Brokers

The attorney considering the example, however, should remember that the potential client has a claim against the broker for fraud. If the court applies the tort measure of damages against a fiduciary under Sections 1709 and 3333, the buyer is not limited to recovering just the difference between the actual value of the property and the price she paid. Rather, she can recover "all detriment proximately caused" by the fraud. Whether this detriment is measured as the benefit of the bargain or by some other measure, the buyer has the potential to reap a much greater recovery against the broker.[20] A finding of fraud will, however, vitiate the broker's insurance coverage, making the collection on the judgment difficult.

In fact, many courts have departed from a strict benefit-of-the-bargain approach and fashioned remedies that award plaintiffs the damages proximately caused by the deceit. In *Fragale*, the court held that with respect to the plaintiffs' claims against the sellers, there was no evidence of out-of-pocket damages. However, the court did permit recovery against the broker, who acted as a dual agent. That recovery was measured by the cost of repair, since such an "award effectively places the [plaintiffs] in the position they would have enjoyed if [the broker's] false representation had been true; it enables them to place the property in the condition which they believed existed at the time of purchase."[21]

Similarly, in *Pepitone v. Russo*,[22] the plaintiff had been defrauded by her broker into a purchase of a motel that was encumbered by undisclosed loans and deeds of trust. As a result, the plaintiff lost the motel to foreclosure. The court held that the plaintiff was entitled to not only the difference between the purchase price of the motel and the undisclosed loans but also the additional expenses that the plaintiff incurred in trying to prevent the foreclosure. The court noted that although the plaintiff had not sought future profits, those losses are recoverable under Sections 3333 and 1709 in an appropriate case.[23]

In *Strebel v. Brenlar Inc.*, the plaintiff was living in a home in San Bruno and entered into a transaction to purchase a new home in Sonoma. However, neither the sellers nor the dual agent broker initially disclosed to the plaintiff that there were tax liens on the Sonoma property that prevented the sale. After the contract was signed, the plaintiff learned of the liens, but the broker assured him that the sellers were taking care of them. Expecting the Sonoma deal to close, the plaintiff sold his home in San Bruno. The liens were not removed on the Sonoma house, and the plaintiff's purchase could not proceed. The plaintiff looked for alternative housing in Sonoma, but property values had increased, and the plaintiff could no longer afford to purchase another home. The court awarded damages against the broker measured as the lost appreciation on the plaintiff's home.[24] The court measured the appreciation damages not by the date of the fraud but by the date of trial.[25]

In *Strebel,* the plaintiff asserted claims for negligence and for fraud, but an unhappy buyer can assert additional causes of action, including negligent misrepresentation and breach of contract. A claim of negligent misrepresentation, however, will not broaden the scope of the potential damages, because

recovery for negligent misrepresentation is limited to the out-of-pocket measure of damages.[26] On the other hand, the standard CAR forms obligate the seller to disclose "all known material facts and defects affecting the property," so the seller's failure to disclose known defects is a breach of contract.

Breach of Contract

Civil Code Section 3300 provides that the damages for breach of contract are "all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom." The potential recovery under Section 3300 would arguably include the cost of repair of the undisclosed defects, since those are the damages that were proximately caused by the dual agent's breach and are reasonably foreseeable.[27]

None of the leading cases that involve undisclosed defects in connection with the sale of real property discuss the remedy of breach of contract except to the extent that a buyer seeks to rescind the purchase. There are a number of reasons why. The first is that a claim for breach of contract can only be asserted against the seller; it cannot be asserted against the listing agent because there is no privity of contract between a buyer and the agent representing the seller. In many instances, the seller probably does not have the financial resources to pay a judgment, and therefore an aggrieved buyer will be more motivated to pursue an action against a broker, who may have adequate financial resources or insurance.

In most instances, however, a claim for breach of contract is not covered by insurance. While a claim for fraud is also not covered by insurance, a claim for negligent misrepresentation will most likely trigger insurance coverage. Therefore, the buyer can best maximize the potential recovery by asserting claims for negligent misrepresentation and fraud against the seller and the broker. In addition, the buyer can also recover punitive damages on a fraud claim, whereas fraud damages are not recoverable in an action for breach of contract. On the other hand, as a practical matter, a claim for breach of contract is relatively easy to prove compared to a claim for fraud. To prove a claim for breach of contract, a buyer need only prove that a seller breached the warranty and representation that all known defects had been disclosed. In the example, this would address the undisclosed construction defects.

Finally, the attorney in the example will need to determine whether contract provisions in the purchase and sale agreement preclude a claim for breach of contract. Those provisions most likely do not bar a defrauded purchaser from bringing suit for fraud. The standard CAR form provides for the right of inspection but also mandates certain disclosures by the seller. Further, the forms also contain provisions that discuss the buyer's inspection and state that the buyer is not relying on any representations by the seller or its agent.

CAR forms also provide that the property is being sold as-is, without any representations or warranties. Sellers and agents often mistakenly believe that as-is provisions protect the seller from liability for any conditions at the subject property. In fact, in commercial practice and in case law,[28] as-is clauses merely relieve the seller from making an investigation of potential problems and from making repairs for problems that the buyer identifies. The CAR form as-is provision does not relieve the seller from the duty to disclose known defects or problems with the property and does not ordinarily bar a claim for fraud.

In *Manderville v. PCG&S Group, Inc.*,[29] the parties used a CAR form that included a provision that the agreement was integrated, that all understandings between the parties were incorporated into the agreement, and that the buyer was advised to investigate the laws limiting development of the property, including zoning. The seller's broker argued that this exculpatory language precluded, as a matter of law, the buyers' showing of justifiable reliance as an element of the buyers' claim for fraud in the inducement.[30] The

court concluded that the exculpatory clauses did not automatically preclude a fraud claim.[31] In so holding, the court relied in part on Civil Code Section 1668, which holds that a contract that purports to exempt a party from responsibility for that party's own fraud is against public policy.[32] Whether an exculpatory provision in the CAR form and the buyer's investigation will bar a claim for fraud depends on the nature of the investigation and whether the buyer, in the exercise of reasonable diligence, would have been able to discover the falsity of the representations.[33]

Another CAR form provision requires the buyer and the seller to first mediate any dispute and to submit the dispute to arbitration if mediation does not work. The arbitration provision is only binding, however, if the parties initial it. If the buyer in the example wants to sue the seller and the broker, there could be a venue conflict. The buyer may face two separate proceedings—one in arbitration against the seller and the other against the broker in court. The buyer, however, can request that the court stay one of the proceedings until the other is completed.[34] The attorney reviewing the potential lawsuit in the example must therefore consider not only how damages may be measured but also which CAR form provisions apply (depending on which provisions were initialed by whom).

A unhappy buyer who has been defrauded in connection with the purchase of residential real property has a number of factors to consider in asserting a claim. Under Sections 3333 and 1709, the potential client in the example can recover against the broker all damages that were proximately caused by the deception. Since the courts have tailored many types of remedies to fully compensate a party defrauded by a fiduciary, the client may recover not only the cost of repair but also the difference between the value of the residence as represented and its actual value. Regardless of whether the recovery is limited by the out-of-pocket measure of damages under Section 3343 or permitted by the more expansive measure available under Sections 3333 and 1709, the attorney representing the defrauded client should be prepared to offer evidence and experts to testify as to value and damages. ■

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[1] *See* http://www.car.org/legal/standard-forms.

[2] *See, e.g.,* Alliance Mortgage Co. v. Rothwell, 10 Cal. 4th 1226, 1250 (1995).

[3] Civ. Code §3343(a). Additional recovery is available under the section for amounts that were actually and reasonably expended in reliance on the fraud, for loss of use of the property if the loss of use was proximately caused by the fraud, and, in some circumstances, for lost earnings.

[4] Civ. Code §3343(b)(1).

[5] Fragale v. Faulkner, 110 Cal. App. 4th 229, 236-39 (2003).

[6] California courts are divided on this issue. *See, e.g.,* Fragale, 110 Cal. App. 4th at 236 (departing from the Section 3343 measure of damages when the fraud is committed by a fiduciary); *but see* Hensley v. McSweeney, 90 Cal. App. 4th 1081, 1086-87 (2001) (applying Section 3343 measure of damages when the fraud is committed by a fiduciary). The California Supreme Court has not decided the issue. *See* Alliance, 10 Cal. 4th at 1250.

[7] *See* Civ. Code §§2079 *et seq.*

[8] Salahutdin v. Valley of Cal., Inc., 24 Cal. App. 4th 555, 562 (1994). *Salahutdin* may be a factually limited case. Most subsequent cases measure value as of the date of sale.

[9] *Id.* at 567.

[10] *Id.* at 565-66.

[11] Fragale, 110 Cal. App. 4th at 236.

[12] *See* Alliance Mortgage Co. v. Rothwell, 10 Cal. 4th 1226, 1250 (1995).

[13] Nece v. Bennett, 212 Cal. App. 2d 494, 497-98 (1963); *but see* Garrett v. Perry, 53 Cal. 2d 178, 186 (1959) (While values must ordinarily be considered at the time of the fraudulent transaction, the court can consider circumstances occurring after the transaction that operate to increase or decrease the damages.).

[14] Fragale, 110 Cal. App. 4th at 237.

[15] Evid. Code §813(a) (The owner of real property can offer his or her opinion as to the value of the property. However, that opinion is still subject to challenge pursuant to Evidence Code §814, and if the owner does not have a sufficient foundation for his or her opinion, then the opinion might be considered worthless.). Fragale, 110 Cal. App. 4th at 241.

[16] Section 3343 does not bar a plaintiff from seeking to rescind the transaction. *See* Ford v. Cournale, 36 Cal. App. 3d 172, 184 (1973).

[17] Central Mut. Ins. Co. v. Schmidt, 152 Cal. App. 2d 671, 676-77 (1957).

[18] Garrett v. Perry, 53 Cal. 2d 178, 186 (1959).

[19] *Id.* at 186.

[20] CACI 1924.

[21] Fragale v. Faulkner, 110 Cal. App. 4th 229, 239 (2003).

[22] Pepitone v. Russo, 64 Cal. App. 3d 685 (1976).

[23] *Id.* at 690 n.3.

[24] Strebel v. Brenlar Inc., 135 Cal. App. 4th 740 (2006). The plaintiff had an expert testify as to the appreciation damages.

[25] *Id.* at 749. *See also, e.g.,* Walsh v. Hooker & Fay, 212 Cal. App. 2d 450 (1963) (The plaintiff was not limited to recovering only the secret profit realized by his stockbroker.); Salahutdin v. Valley of Cal., Inc., 24 Cal. App. 4th 555, 568 (1994) (The court measured the benefit-of-the-bargain damages against the broker not from the date of the transaction but from the date of discovery of the fraud.).

[26] Alliance Mortgage Co. v. Rothwell, 10 Cal. 4th 1226, 1249-50 (1995).

[27] The standard CAR form includes an attorney's fees provision. However, even assuming the buyer does not pursue a claim for breach of contract and only pursues claims for fraud and negligent misrepresentation, the prevailing party would still be entitled to an award of attorney's fees, since the claim arose out of the transaction.

[28] *See, e.g.,* Manderville v. PCG&S Group, Inc., 146 Cal. App. 4th 1486 (2007); Loughrin v. Superior Court, 15 Cal. App. 4th 1188 (1993).

[29] Manderville, 146 Cal. App. 4th 1486.

[30] *Id.* at 1489.

[31] *Id.* at 1501-04.

[32] *Id.* at 1500-01. Civ. Code §1668.

[33] Manderville, 146 Cal. App. 4th at 1500-01.

[34] Code Civ. Proc. §§1281.2 *et seq.*