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INTRODUCTION

The Smiths bought a historic property in Ashland Creek from the Greens. The Greens had made several improvements while living there, building a patio, and later enclosing part of it to make a dining room. But they failed to determine the location of the septic tank, and the dining room is now above the septic tank, which is illegal.

The Greens failed to disclose several defects, including the improperly constructed dining room, other improvements made without permits, and the defectively constructed and maintained septic system. Since they made the improvements and made some changes to the septic system, the Greens must have known of the defects.

During escrow, the Smiths discovered that part of the property encroached on another lot. The parties negotiated an addendum to the sales contract under which the price for the property was reduced by $200,000, and the Greens contracted to resolve the encroachment within two years from the close of escrow. If the encroachment issue was resolved in that time, the Smiths agreed to pay an additional amount. Now, more than three years since the close of escrow, the encroachment issue is not yet resolved but is expected to be soon.

ISSUES

1. Are the Greens liable for the cost of repairing the defect under a negligence or strict liability theory?

2. Can the Smiths recover the cost of repairing the defective construction under a fraud theory?

3. Can the Smiths contend that the Greens' failure to resolve the encroachment issue within the time specified in the contract is a failure of a condition, thus excusing them from paying the additional money?

SUMMARY

1. Most likely not. Under California law, plaintiffs cannot recover economic damages in tort for defective construction, only for personal injury and for damage to other property caused by the defect. The California Supreme Court has held that economic damages such as cost of repairing the defect are not available in tort.

2. No. California follows the so-called out-of-pocket damages rule for misrepresentation in the sale of real property, unless the parties had a fiduciary relationship. (There is no evidence of such a relationship in this case.) Civil Code § 3343(a) provides that the only damage available for misrepresentation in the sale of real property is the difference between the property's actual value and the purchase price. Costs of repairing defects are not recoverable.

3. Possibly, but failure of a condition is basically a defense to a suit for specific performance or damages by the Greens, and does not entitle the Smiths to damages. Additionally, to plead failure of a condition, the Smiths would have to relinquish their right to have the Greens resolve the encroachment issue.

FACTS

The Greens listed their Ashland Creek property for sale through a broker in mid-2___. The property is on a hillside overlooking Ashland Creek, and is unique. It has been featured in BETTER HOMES AND GARDENS and on television. A long private driveway starting at a private gate near the street leads up to three residences. Since there is no sewer connection, the property is served by a septic tank system.

The Smiths and the Greens were social acquaintances, and the Smiths had visited the property several times. In December 2___, after the listing agreement expired, the Smiths agreed to buy the property for $1.5 million, which included approximately $200,000 for certain unique personal property in the house. The deal was financed by a note to the sellers secured by the property. The purchase included a lease-back agreement, under which the Greens would be allowed to live in the house for a time, with "rental" to be deducted from the balance due on the note.

During escrow, the Smiths discovered that part of the property—which included a gazebo—actually encroached on another property. On March 26, 2___, the parties executed an addendum to the purchase contract under which the purchase

price was adjusted to $1.3 million, with approximately $1.1 million allocated to the price of the real property and $200,000 to the personal property. The addendum also provided that the Greens would attempt to resolve the encroachment issue as follows:

> SELLERS [Greens] have represented to BUYERS [Smiths] and BUYERS are relying on SELLERS' representation [that] SELLERS have contacted the adjoining property owner and obtained oral indication that the encroachment issue is capable of resolution by way of a lot split. The proposed resolution would result in a lot split such that the portion of the adjoining property being encroached upon by SELLERS will be split or separated from the adjoining property and become a record part of the property which is being purchased by BUYERS. Such lot split is anticipated to be agreed upon by the owner of the adjoining property and which lot split will be acceptable to the city and/or any other regulatory authorities. *Alternatively, that is, if the adjoining owner and/or the city or other regulatory authority does not agree to a lot split* then, and in such event as an alternative thereto, SELLERS will negotiate with the adjoining property owner for a perpetual easement as to the current use of the property being encroached upon and which easement shall be for the benefit of the PROPERTY being purchased by BUYERS herein. [¶] SELLERS shall have two years from the date of close of escrow [March 31, 1999] in which to complete either of the above, that is, a lot split or perpetual easement. Any and all legal expenses on account thereof shall be borne solely by SELLERS. [Emphasis added.]

The addendum provided that "In the event that" the Greens had the lot split, the Smiths would pay an additional $200,000; if the easement, "the terms and conditions of [which] are subject to the reasonable approval of BUYERS," the Smiths would pay an additional $100,000. There is no "time is of the essence" language in the addendum itself, although the addendum does "ratif[y] and affirm[]" "all other terms and conditions" of the previous agreements, including the Residential Purchase Agreement and Receipt for Deposit, which does provide that "time is of the essence." See Residential Purchase Agreement, ¶ 27.

The Greens and later their daughter remained on the property until April 13, 2___, when the Greens' trustee succeeded in evicting the daughter. On that date, the Smiths took possession of the property, and then became aware of a very serious problem with the septic tank and dining room. Briefly, the tank must be replaced, at least partially because of faulty construction or repair while the Greens owned the property. There are indications that the Greens must have known of the problems, which they never disclosed. (The Smiths have found the Real Estate Disclosure Statement they were given when they bought the property. It does disclose the septic tank, but not the defects.) Additionally, the Greens added on a patio and a dining room in 19__, both by permit, over a portion of the septic tank. Replacing the septic tank is expected to cost about $150,000 to $200,000.

Now, more than three years since the close of escrow, the encroachment issue has not been resolved, at least to the Smiths' satisfaction. After the close of escrow the Greens obtained an easement, but the Smiths rejected it because the addendum called for the Greens to try to obtain a lot split—which they had not attempted—before resolving the problem by an easement. The Greens then worked on the lot split, and persuaded the owner to agree, but the process is still not complete. In the meantime, the Greens recorded the easement, but more than two years after the close of escrow and without obtaining the Smiths' approval as the addendum required.

DISCUSSION

1. The Smiths cannot recover the costs of repairing the defective construction under negligence or strict liability.

The Greens constructed their dining room without determining the septic system's location, and as a result the dining room was illegally built on top of the septic system. Moreover, it seems that the Greens also at one time constructed or repaired the system in such a way that it does not drain, and will need to be replaced. There is no evidence that these defects have caused damage to other parts of the property or personal injury. Under these circumstances, the Greens are not liable in tort for the costs of repairing the defect or for diminution in property value. *Aas v. Superior Court* (2000) 24 Cal.4th 627, 632.

In *Aas v. Superior Court*, the plaintiff buyers of single-family homes sued the builders for construction defects that had not yet caused property damage. They advanced causes of action for negligence, strict liability, breach of implied warranty, and—in the case of one group of homeowners—breach of contract and breach of express warranty. The trial court granted the defendants' motions in limine and excluded evidence of those construction defects that had not yet caused property damage from the negligence causes of action, on the ground that the plaintiffs could not recover in tort for those defects. *Id*. at 633. (The court did not exclude evidence

of those defects in the breach-of-warranty and breach-of-contract causes of action.) On review, the California Supreme Court agreed with the trial court.

The Court first defined the question as:

> May plaintiffs recover in negligence from the entities that built their homes a money judgment representing the cost to repair, or the diminished value attributable to, construction defects [defined as "deviations from the applicable building codes or industry standards"] that have not caused property damage?
> *Id*. at 635.

The Court explicitly noted that the plaintiffs could introduce evidence of such defects that *had* caused property damage, and could introduce that evidence in their breach-of-warranty and -contract claims, if they survived to trial. *Ibid.*

After reviewing the law of tort and contract damages for defectively made property—real and personal—the Court concluded that California law had long denied recovery in negligence for defects that did not cause damage to other property or personal injury, and found no public policy that mandated changing that result. Rather, the court held that any change in the law should be left to the legislature:

> Home buyers in California already enjoy protection under contract and warranty law for enforcement of builders' and sellers' obligations; under the law of negligence and strict liability for acts and omissions *that cause property damage or personal injury*; under the law of fraud for misrepresentations about the property's condition; and an exceptionally long 10-year statute of limitations for latent construction defects. While the Legislature may add whatever additional protections it deems appropriate, the facts of this case do not present a sufficiently compelling reason to preempt the legislative process with a judicially created rule of tort liability.
> *Id*. at 652-53 (italics added; citations omitted).

But plaintiffs can recover the cost of repairing any property damage caused by the defect, including damage to other parts of the same property. For example, courts have allowed tort recovery where poorly prepared lots subsided, damaging the houses built on those lots (*Stearman v. Centex Homes* (2000) 78 Cal.App.4th 611, 615, 616-23); where defective bottle caps ruined the wine in the bottles (*International Knights of Wine, Inc. v. Ball Corp.* (1980) 110 Cal.App.3d 1001, 1003-05); and where an unknown defect in an engine compartment caused a fire that destroyed the entire car (*Gherna v. Ford Motor Co.* (1966) 246 Cal.App.2d 639, 644, 649-51). Thus, if the Smiths can show that the defects caused damage to other parts of the property, they can recover for that damage; they just can't recover the economic loss of repairing the defect itself, or the diminution in value caused by the defect (*Aas v. Superior Court*, 24 Cal.4th at 635).

That is, they can if the statute of limitations has not run. As the *Aas* Court noted, the statute of limitations on a latent construction defect is 10 years, which runs from the project's completion. Code Civ. Proc., § 337.15. Since the dining room here was built about 23 years ago, it would appear that the statute has run, since there is no provision for delayed discovery. Nor should it matter that the Greens owned the property for most of the time the defect existed. The statute provides:

> [t]he limitation prescribed by this section shall not be asserted by way of defense by any person in actual possession or the control . . . of such an improvement, *at the time any deficiency in the improvement constitutes the proximate cause for which it is proposed to bring an action.*
> *Id.*, § 337.15(e) (emphasis added).

But the Smiths are in possession, not the Greens.

2. The Smiths cannot recover the cost of repairing the defects based on the Greens' misrepresentations.

In one sense, the *Aas* court was being disingenuous when it suggested that plaintiffs could recover economic damages for misrepresentation in the sale of real property. See *Aas v. Superior Court, supra*, 24 Cal.4th at 652-53. Although strictly speaking that is true, those damages are limited by the out-of-pocket damages rule of Civil Code § 3343, and do not include the cost of repairing any defect not disclosed or misrepresented.

The exclusive measure of damages for fraud in the sale of real or personal property, except when the fraud is committed by a fiduciary, is stated in § 3343. *Alliance Mortgage Co. v. Rockwell* (1995) 10 Cal.4th 1226, 1241. (There is no claim here that the Greens owed the Smiths any fiduciary duties.) Section 3343 provides for an out-of-pocket measure of damages, rather than a benefit-of-the-bargain measure. *Garrett v. Parry* (1959) 53 Cal.2d 178, 184; *Michelson v. Camp* (1999) 72 Cal.App.4th 955, 973. Under the out-of-pocket rule, the standard measure of damages is "the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received." § 3343(a). In this case, that would be the difference between the $1.5 million (or $1.3 million) the Smiths paid for the property and its actual value at the time of the transaction. The

statute specifically forbids a plaintiff from receiving "any amount measured by the difference between the value of the property as represented and the actual value thereof." § 3343(b). And although the Smiths may recover other specified damages—including loss of use and lost profits (see § 3343(a)(1)-(4))—the cases hold that they cannot recover the amount necessary for repairs that were represented to have been made but were not, as long as the lack of those repairs did not make the property worth less than the plaintiff paid for it.

For example, in *Saunders v. Taylor* (1996) 42 Cal.App.4th 1538, Saunders bought a house from Taylor for $87,500. In the disclosure statement, Taylor represented that all repairs had been done with the necessary permits and were up to code. In fact, a family room, constructed without the permits, was not up to code. The cost of bringing the repairs up to code—in other words, of making the property as it was represented—was $25,000. The court of appeal upheld the lower court's grant of a nonsuit on the ground that Saunders had not proved any damages because he had not introduced evidence that the house was worth less than the $87,500 he had paid for it.

Of course, if the misrepresentations were intentional, the Smiths may also recover punitive damages under § 3294. *Alliance Mortgage Co. v. Rockwell* (1995) 10 Cal.4th 1226, 1241.

3. The Smiths probably cannot use the Greens' failure to clear title in the time provided for in the contract to avoid paying for receiving a clear title.

Shortly after signing the purchase contract, the Smiths discovered that some of the improvements on the property actually encroached on the adjoining property. The parties adjusted the price, and the Greens agreed to attempt to negotiate either a lot split or an easement with the owners of the adjoining property. The contract explicitly stated that "SELLERS shall have two years from the date of the close of escrow" to complete the lot-line adjustment. Escrow closed on March 31, 2___, so the Greens had until March 31, 2___, to obtain either the lot split or the easement. By the deadline, they had obtained neither, but now they have recorded an easement and are in the process of finalizing the paperwork for a lot split. Under these circumstances, the Smiths would be hard pressed to argue that they are excused from paying the extra money because the Greens' timely performance was a condition precedent.

A condition is an act or event that gives a party the right to modify or terminate performance under a contract. See 1 Miller & Starr, CAL. REAL ESTATE (3d ed. 2000) § 1:156, p. 599. Civil Code § 1434 provides that "[a]n obligation is conditional, when the rights or duties of any party thereto depend on the occurrence of a certain event." "A condition precedent is one which is to be performed before some right dependent thereon accrues, or some act dependent thereon is performed." Civ. Code § 1436. A condition must be distinguished from a covenant, which is a

promise to do an act or bring about an event. 1 Miller & Starr, *supra*, § 1:157, p. 601. A covenant is a promise to perform. Thus if the promissor fails to act, the promissee can sue for damages. On the other hand, if a condition does not occur, then the party whose performance depends on that occurrence is excused from performance, but is not entitled to damages for breach of contract. *Ibid.* In other words, failure of a condition precedent is a defense to a later suit for breach of contract; when the condition fails, either party may terminate the contract without further performance or tender of performance. *Consolidated World Investments, Inc. v. Lido Preferred Ltd.* (1992) 9 Cal.App.4th 373, 380-81. Thus, had the Smiths simply said that they would no longer accept a lot-line adjustment, the Greens probably could not have forced them to accept one, just as the Smiths probably could not have forced the Greens to continue to try to obtain the adjustment if it took longer than two years. And even if the failure to obtain the adjustment is considered a breach of contract, it is difficult to figure out what damages the Smiths have suffered: either they will still get the adjustment, albeit later than they were promised; or they will not get it, in which case they have already agreed to an adjusted price with the Greens.

Several cases involving sellers' failure to remove clouds on title show the difficulty here. In *Britschgi v. McCall* (1953) 41 Cal.2d 138, sellers and buyers agreed to a sale of property conditioned on the sellers' being able to buy out a tenant's option on it. The sellers were unable to buy out the option, and the buyers refused to perform. The sellers sued for specific performance; the buyers

counterclaimed for damages. The court held that the buyout was a condition, not a covenant; thus the sellers had not breached the contract in failing to buy out the option. *Id*. at 143-144. But the court also held that, because the condition precedent failed to occur, the buyers were excused from completing the deal. Thus specific performance was denied. *Id*. at 144. Likewise, in *Edwards v. Billow* (1948) 31 Cal.2d 350, the sale of property was conditioned on the sellers' being able to subordinate a senior lien on the property to the one securing the present sale. Again, the court held that failure to secure the agreement was not a breach of contract, but was a failure of a condition precedent, and refused to order specific performance. *Id.* at 360-62.

And in any case, if the Smiths accept the lot adjustment or the easement (as they want and need to do), a court would probably find that they had waived the condition. A waiver is the intentional relinquishment of the condition by the party that benefits from it—here the Smiths. *Britschgi v. McCall* (1953) 41 Cal.2d 138, 143. A waiver may be express or implied from conduct, as when a party permits the other party to perform contrary to the contract's terms and accepts the benefits of the performance, while knowing of the default. *Noel v. Dumont Builders, Inc.* (1960) 178 Cal.App.2d 691, 696-697. Here, the Smiths obviously know of the default—failure to obtain the adjustment within two years of close of escrow—and are still prepared to accept performance. (They would be hard pressed not to, since they want the improvements that are on the encroachment.) Thus, if they accept the adjustment

or the easement they will probably be deemed to have waived the condition of timely performance.

CONCLUSION

Under the circumstances here, the Greens seem fortunate. They are not liable for any negligent construction of the septic tank or the dining room unless the Smiths can show that the defective construction caused damage to some other part of the property, or can show personal injury. The Greens committed fraud, but under California's very restrictive damages rules, they are liable only if the property was worth less than the Smiths paid for it. And they failed to timely resolve an encroachment on a neighbor's lot, but since it will soon be resolved, the referee will probably decide "no harm, no foul."