

Comparing the Foreclosing Beneficiary's Duty of Disclosure with the Prospective Purchaser's Obligation to Investigate the Property? The 9th Circuit Sheds Some Light on the Issue

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In *DM Residential Fund II, LLC v. First Tennessee Bank National Association*, 2015 U.S. App. Lexis 22816, the 9th Circuit Court of Appeals held that a third-party purchaser has a duty to investigate possible defects to a property prior to a foreclosure sale and, upon discovery of any defect, is required to act promptly to rescind the sale.

First Tennessee Bank ("FTB") initiated a non-judicial foreclosure on a residential real property owned by Cynthia Huerta and sold the Property at public auction to DM Residential Fund II, LLC ("DM"). Shortly after purchasing the Property, DM discovered that the Property lacked a utilities easement which was required to provide electrical services to the Property. The defect was not disclosed at the foreclosure sale. Rather than trying to rescind the sale immediately upon discovering the defect, DM waited two years to sue FTB for failing to disclose the defect. During that time, DM built improvements on the Property and even attempted to sell it. The Central District Court of California granted FTB's Motion for Summary Judgment. DM appealed the Order. The Court of Appeals for the Ninth Circuit upheld the District Court's ruling.

California law requires that the foreclosing beneficiary or its trustee disclose any known defects in the property being foreclosed upon that may materially affect the value of the property or the buyer's decision to purchase it. *Karoutas v. HomeFedBank*, 232 Cal.App. 3d 767, 771. In *DM Residential Fund*, FTB was on notice of the lack of the utility easement and the Court noted that FTB had a duty to disclose the defect to the purchaser of the Property prior to the foreclosure sale. However, because DM waited two years before suing FTB, the 9th Circuit ruled that DM affirmed the transaction and deprived itself of the equitable remedy of rescission.

The 9th Circuit determined that, because DM did not act promptly after discovering the defect, it is barred from later challenging the foreclosure sale. Specifically, the Court held that upon discovering that the Property did not have electricity, and that none could be obtained without the easement, DM was put on notice that, perhaps, FTB acted improperly during the foreclosure sale by not disclosing the defect. Once on notice, however, it was DM's duty to investigate whether FTB had notice and knowingly failed to disclose the defect prior to the foreclosure sale. Since DM did not investigate FTB's knowledge of the defect, and did not file an action against FTB when it first learned of the defect, but rather proceeded to develop the Property (actions which, according to the Court of Appeals, were inconsistent with unwinding a contract), DM lost its right to rescind the sale.

In a dissenting opinion, Judge Kozinski, argues that the majority has misread California law and ignored important facts in upholding the District Court's ruling. According to Judge Kozinski, DM did not have a duty to investigate whether FTB was aware of the defect but even if such a duty exists, what could DM have done to learn of the defect sooner – before developing the

Property. According to Judge Kozinski, it is not reasonable for DM to have assumed that FTB was aware of the defect, since as, the foreclosing lender, FTB did not occupy the Property or have any other physical dealings with the Property. Judge Kozinski also explains that, although DM learned from Ms. Huerta (approximately a year after the sale) that FTB was in fact aware of the defect at the time of the sale, this does not mean that DM could have made contact with Ms. Huerta prior to the foreclosure sale to learn this information or had any reason to think that Ms. Huerta made the disclosure to FTB.

Based on this Court of Appeals ruling, a third party purchaser has a duty to investigate possible defects to a property prior to a foreclosure sale and, upon discovery of any defect, is required to act promptly to rescind the sale. However, the investigation cannot be a superficial glance at the property. Instead, the investigation must be thorough and diligent and may even include reaching out to the party being foreclosed on in order to learn as much information about the property as possible. Furthermore, even if a lawsuit to rescind is brought within the statute of limitations for rescission, the rescission may be denied for being untimely if it was not sought promptly upon the discovery of the defects.

For FTB, they got lucky. Foreclosing beneficiaries and their trustees must remember to disclose any known fact that could negatively affect the value of the property or a prospective purchaser's decision to purchase the property.

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