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California Real Estate Finance

Fifth Edition

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GOLDEN GATE UNIVERSITY

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DONLEY AND MARJORIE BOLLINGER CHAIR IN
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To Christine, who actually handles all the matters I just talk about.

R.B.

*To Lisa, for her love, and to my colleagues Roger, Steve and Dan,
for permitting me to join this excellent endeavor.*

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To Cindy for her love and support, and to my colleagues for encouraging me to teach.

S.W.D.

To Felice, who holds the senior lien on my heart.

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*And to all of the debtors and creditors and judges whose mistreatment of
one another has kept the bar so fully occupied.*

The Authors

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Preface

“Necessitous men are not, truly speaking, free men, but, to answer a present exigency, will submit to any terms that the crafty may impose upon them.” —Lord Chancellor Northington, 1762.

“By the growth of equity on equity, the heart of the common law is eaten out, and legal settlements are destroyed.” —Chief Justice Hale, 1672.

Why This Course?

At this moment, you may well be wondering whether you really ought to be taking this class or switching over into some field more exciting, or at least less formidable. Like as not, your intentions are to practice in the more glamorous areas of the law, and to turn over all complicated real estate matters to that rather square mortgage specialist down the hall. In lieu of any academic apology for this course, you are invited to read the sad story of Carl Mooslin, a Los Angeles attorney, who received twenty-eight dollars for the services he rendered to his long-time client, and wound up being liable to her for \$42,000.

Starr v. Mooslin

14 Cal. App. 3d 988 (1971)

HERNDON, J. — Defendant and appellant Carl J. Mooslin, an attorney at law, appeals from the judgment awarding plaintiff damages in this action for legal malpractice. Plaintiff Elena Starr charged that as the result of defendant’s negligence in representing her in a transaction involving a sale of real property, she suffered damages in the sum of \$50,000. The judgment against defendant in the amount of \$42,000 was entered upon the verdict of a jury.

Plaintiff, a woman in her eighties, was the owner of real property located at 355 South Alvarado Street, Los Angeles. Defendant, a practicing attorney and engaged in the general practice of law, had handled various legal matters for plaintiff over a period of approximately ten years. Some time in the year 1965 plaintiff decided that she would offer her property for sale. Thereafter she received offers from Lucius Foster and William Cooper. Plaintiff discussed some of these offers with the defendant. On January 4, 1966, plaintiff and defendant met with Foster and Cooper at defendant’s law office. At this meeting the parties negotiated further with respect to the purchase and sale of the property but no agreement was reached. Foster stated that he would not be participating in

the transaction as a principal but that a Mr. Robert Fisher, 'an experienced builder and developer' whom he represented, would offer \$60,000 for the property, \$10,000 to be paid in cash at the close of escrow with the balance to be evidenced by a \$50,000 promissory note secured by a deed of trust. The offer further provided that the purchase money deed of trust would be subordinated at a later date to a \$275,000 construction loan. The money for construction purposes would be borrowed in installments, the first to be in the amount of \$30,000. Foster further stated that Fisher would be willing to provide additional security by way of a deed of trust on other real property he owned.

On the following day, January 5, 1966, Mrs. Starr decided that she would accept the offer as presented by Foster on behalf of Fisher. After calling Foster and informing him of her decision, she called defendant and requested that he appear at the City National Bank in Beverly Hills at the time appointed to represent her in the opening of the escrow for the purpose of effectuating the sale. In response to plaintiff's request, defendant went to the City National Bank and, after verifying the terms of the sale with the parties present, proceeded to dictate escrow instructions to an employee of the bank using a printed form.

The escrow instructions thus prepared provided for a total purchase price of \$63,000 of which \$10,000 was to be paid in cash and the balance to be evidenced by a \$50,000 promissory note payable to plaintiff secured by a purchase money deed of trust. Further provision was made for the delivery to Foster of a note in the amount of \$3,000 to cover his broker's commission. Fisher and Cooper and/or their nominee were named as purchasers. By a subsequent amendment to these instructions the purchase price was reduced to \$60,000 and the provision for the promissory note in payment of Foster's commission was eliminated. The instructions further provided that the buyer would execute and place in escrow a deed of trust as additional security in favor of the seller on real property located at Rose-land and LaBrea. Beneath the foregoing provisions the following language as dictated by defendant was typewritten into the instructions: "The following is stated as a matter of record only with which the escrow holder is not to be concerned: (1) Seller agrees to subordinate on demand, to a 1st trust deed, not to exceed \$275,000.00, bearing interest at not more than 7.5% per annum, for not more than 30 years. Seller agrees to subordinate forthwith to \$30,000.00, the same being a portion of the above referred to \$275,000.00 loan, and will execute upon demand any additional subordination agreement in order to enable Buyer to refinance or to increase the encumbrance to be placed upon the land provided the same shall not exceed in total \$275,000.00 represented by a single 1st trust deed."

Within a few days thereafter Fisher made arrangements to borrow \$30,000 from Irving and Matilda Scham and Ben and Eva Solomon. This loan was to be evidenced by a promissory note secured by a first deed of trust on the property which plaintiff had agreed to sell to Fisher. On January 18, 1966, Fisher and the parties from whom he was borrowing the \$30,000 opened an escrow at LaCienega Escrow Company for the purpose of effectuating that loan. Fisher deposited therein his promissory note and the lenders deposited the \$30,000.

On the following day, January 19, 1966, Fisher deposited in the original escrow at City National Bank his promissory note in the amount of \$50,000 payable to plaintiff and the two deeds of trust on the subject property, one of which was security for the \$30,000 loan and the other was to secure plaintiff's \$50,000 note. Plaintiff's deed of trust contained on its face the following provision: 'This deed of trust is second and subject to a first deed of trust to record concurrently.'

On January 24, 1966, the LaCienega Escrow Company paid out \$10,150 to the City National Bank for plaintiff's account, \$18,265 to Robert Fisher, \$300 to Lucius Foster, and \$1,285 to other persons not involved in this case.

According to the testimony of the employee of City National Bank who handled the escrow for that institution, the instruments deposited therein were recorded pursuant to the oral direction of defendant and the escrow was thereupon closed. As a result of these procedures plaintiff's \$50,000 purchase money deed of trust and the \$30,000 deed of trust held by the Schams and Solomons were recorded concurrently. Plaintiff's deed of trust was thereby subordinated.

Subsequently, Fisher failed to make the payments on the Scham-Solomon note. Fisher's default resulted in foreclosure proceedings instituted by the Schams and the Solomons. At the trustee's sale the property was purchased by the beneficiaries. Plaintiff was unable to bid at the sale because of her lack of sufficient funds. The purchasers at the foreclosure sale thereafter brought an unlawful detainer action against Mrs. Starr to obtain possession. Mrs. Starr filed an answer and cross-complaint naming as cross-defendants Fisher, Cooper, Foster, the Schams, the Solomons, and others, and charging said cross-defendants with fraud and conspiracy to deprive her of her property. This litigation was terminated by a settlement whereby Mrs. Starr repurchased her property for \$32,500.

Immediately thereafter plaintiff resold the property for \$57,500 of which \$32,500 was paid to the buyers at the foreclosure sale. Plaintiff received \$1,500 in cash and a promissory note in the amount of \$14,035 secured by a deed of trust on the subject property. Approximately \$800 was expended in escrow expenses and \$8,167 was paid over to Mr. J.J. Brandlin as compensation for his legal services.

Thereafter the instant action against defendant was filed by Mrs. Starr. Her complaint alleges that defendant, as an attorney, undertook to represent her and to act as her attorney in consummating the sale of her property. It is further alleged in substance that defendant negligently performed his duties in that he failed to use that degree of learning, skill and judgment ordinarily used by lawyers of good standing and practicing in the same locality under similar circumstances and as a proximate result of such negligence plaintiff was damaged in the sum of \$50,000.

Except for the opinions of the expert witnesses hereinafter summarized, the evidence was virtually uncontradicted. On cross-examination by counsel for plaintiff, defendant testified that he was acquainted with subordination agreements and recognized that such agreements ordinarily provided that the proceeds from secured loans would be used to improve the real property. Defendant did not research the applicable law prior to preparing the escrow instructions in this case. At the time of this transaction it was defendant's understanding that it was probably the law that if plaintiff and the buyer entered into a subordination agreement which provided that the buyer was to use the \$30,000 to improve the property and if the lenders of the \$30,000 had notice thereof and plaintiff did not waive her rights under the subordination agreement and if the \$30,000 was not so used, the subordination would not be effective and plaintiff's trust deed would retain its priority. Notwithstanding his uncertainty on the subject, however, defendant did not research the law and the escrow instructions as prepared by him did not contain such provisions.

Plaintiff called Dennis G. Harkavy, an attorney at law, as an expert witness. The qualifications of this witness as indicated by his testimony are unquestioned. Over defendant's objection made solely on the ground that expert testimony is inadmissible to prove neg-

ligence in a legal malpractice suit, the witness was permitted to state his opinion in response to a hypothetical question whether or not, on the basis of the facts assumed, defendant had exercised that degree of learning, care and skill ordinarily possessed by attorneys in good standing practicing in the Los Angeles area at about this time and under similar circumstances. The witness answered: 'In my opinion the requisite skill of a general practitioner was not employed in drawing these instructions.' The witness thereafter stated at length the reasons for his opinion and pointed out in detail the several respects in which he considered the escrow instructions deficient.

Defense counsel called two expert witnesses, attorney David Sefman and the Honorable Alfred Gitelson, a judge of the Superior Court. The rulings of the trial court permitted each of these witnesses to testify to his extensive experience in relation to the handling of escrows in similar transactions. Each of these witnesses was permitted over plaintiff's objections to testify to his opinion that in conformity with prevailing custom and practice among escrow agencies, a reasonably careful escrow holder would not have recorded the deeds of trust as was done in the instant case but would have required something more in the way of authorization than was required by the City National Bank in this case. Each of defendant's expert witnesses was permitted to testify to his opinion that an attorney engaged in the general practice of law in the community exercising reasonable care could properly rely upon the custom and usage prevailing among escrow holders concerning which the witnesses previously had testified. The witness thereafter testified at some length in giving his reasons for that opinion. The essence of his testimony was that in recording the deeds of trust, the City National Bank had transgressed against the established custom and practice of escrow holders upon which defendant had reasonably relied. On the basis of the testimony of the two experts called by him, defense counsel argued in the trial court that the conceded deficiencies in the escrow instructions were not the proximate cause of plaintiff's damages.

The inadequacy of the escrow instructions to afford plaintiff the protection which the circumstances involved in this case obviously required is undeniable and virtually conceded. No lawyer with knowledge of the most elementary rules of law governing such transactions would have failed to insist upon more adequate provisions to insure that all of the proceeds of the \$30,000 loan, which was to be given security prior to that of his client's purchase money lien, would be used to improve the property.

The teachings of hindsight were not necessary to prove that it was negligent and hazardous to fail to provide such protection. This truth is emphasized by the fact that there was no requirement that the construction loan would be obtained from an institutional lender which could be relied upon to see that the proceeds of the loan were properly used to improve the real property. Moreover, it is an apparent fact that defendant made no inquiry or investigation for the purpose of ascertaining the reliability, financial or otherwise, of the purchaser or the value of the other property which he had promised to encumber as additional security.

In these circumstances it is understandable that defendant and his trial counsel based their defense entirely upon the contention that it was not the conceded deficiencies in the escrow instructions prepared by defendant, but rather it was the mistake or misconduct of the City National Bank as escrow agent, which constituted the proximate cause of plaintiff's loss. The only possible basis upon which defendant could claim freedom from negligence was his contention that he had justifiably relied upon an asserted custom and practice among escrow agents which the City National Bank violated when it delivered the two deeds of trust

for recordation. This contention necessarily implies that defendant contemplated the taking of further unspecified steps to protect his client's interests prior to the closing of the escrow.

Since the trial court submitted the issue of defendant's negligence to the jury upon legally correct instructions, we need not decide the arguable contention that defendant was guilty of negligence as a matter of law.

The trial court's instructions clearly advised the jury that plaintiff could not recover unless she had proved by a preponderance of the evidence that defendant's negligence was a proximate cause of her injury. Defendant's argument fails to recognize that an attorney's negligence need not be the sole cause of the client's loss in order to subject him to liability. That is to say, where there is causation in fact it need not be the sole proximate cause.

The judgment and the order denying defendant's motion for judgment notwithstanding the verdict are affirmed.

FLEMING, J.—I concur in the opinion but find an additional basis for defendant's liability viz. his negligence in allowing his client to be defrauded and swindled out of her property.

Under the purported sale of plaintiff's real property for \$60,000, the purchaser put up nothing and used the seller's own property as security to borrow \$30,000, out of which he paid \$10,000 to the seller and pocketed the balance of \$20,000 for his own use. When the document is stripped of its documentary window dressing, it becomes readily apparent that plaintiff was relieved of assets of a value of \$20,000. Such a transaction amounts to elementary fraud, for protection against which persons employ lawyers to provide advice and counsel. If a lawyer fails to provide advice and counsel of sufficient quality to enable his client to protect herself against such an obvious swindle, he may be held liable for the ensuing loss.

The foregoing covers the bare-faced swindle. The more genteel, dressed up version concocted by the buyer and his agents was only slightly less rapacious. Under this version the buyer agreed to put up the \$10,000, and the seller agreed to subordinate the unpaid balance of the purchase price, \$50,000, to a \$275,000 construction loan. Even if it should turn out that the lien ahead of plaintiff represented moneys actually expended in improving the property, plaintiff's security would remain wholly vulnerable to a complete wipe-out if any mild deflation in real estate values occurred, for her security interests would have been subordinated to 82 per cent of the total amount put into the venture, and the entire loan of \$275,000 would have to be repaid before she could realize anything on her security. Under such a deal plaintiff would be saddled with the primary risk of speculative loss and wholly excluded from any hope of speculative gain. These terms are so one-sided and so unfair as to be only slightly less fraudulent than the bald fraud which actually took place.

Here again, a lawyer who has been employed to represent the interests of a seller is required to provide advice and counsel which will enable his client to protect herself against such imposition, and if he does not adequately do this he may become liable for losses suffered by his client as a result of his negligence. Needless to say, these considerations have special application to the case at bench, where the client was an eighty-year-old, semi-literate widow of limited means and limited business experience. In representing such clients, lawyers are required to exercise extra caution, for these clients are not equipped to protect themselves.

Notes

1. *The risky real estate law business.* A study by the National Legal Malpractice Data Center of 18,000 cases from 1981 to 1983 showed that “Lawyers face the greatest risk of becoming the target of a malpractice lawsuit in representing clients in real estate matters . . .”

The percentage was 24.9%, compared to the next most risky danger area (plaintiff’s personal injury) of 24%. Furthermore, whereas the major error (48.9%) in personal injury litigation was “administrative” (e.g., missing deadlines), “substantive” errors in real estate accounted for 56.7% of those claims. See William H. Gates, *The Newest Data on Lawyers’ Malpractice Claims*, 70 ABA Journal 78 (April, 1984).

2. *Could you do better?* How obvious is it that Mooslin’s escrow instructions were “unquestionably deficient” and constituted malpractice, even for a general practitioner? If Mooslin had realized that he was into a tricky subordination problem he obviously should have called in an expert real estate attorney to help him out, but his problem appears to be that he did not know that this was a dangerous area. In that regard there are probably many attorneys just like him. Most lawyers consider helping a client sell her property as an easy affair. But \$42,000 is a lot of money to pay for taking the matter too casually.

3. *The thinking of a borrower.* Suppose Foster & Cooper were only out to make an honest dollar on this project. The land cost them \$60,000 and construction will probably cost \$300,000 (the \$275,000 rounded up to make these calculations easier), so the final product must be worth at least \$360,000 to make sense. In fact it had better be worth more, since it will take time to build. Assuming construction takes a year and interest on the loans is 9%, the project has to be worth another \$32,000 to cover that (\$27,000 interest on the construction loan and \$5,000 interest, more or less, to Elena Starr on the \$50,000 owed to her on the price). All told, the completed project has to be worth at least \$392,000 at the end to cover all this. Assume they estimated a finished value of \$400,000, so that they would be able to sell it off at the end for an \$8,000 profit.

Suppose Foster & Cooper had \$360,000 themselves; wouldn’t it make more sense to use their own money, save the interest costs, and thereby make a \$40,000 profit (\$400,000 sale price less \$360,000 costs)? Not at all. By using their own funds, they would make a profit of 11% (\$40,000 profit ÷ \$360,000 investment). But borrowing most of the funds (\$300,000 from the construction lender and \$50,000 from Elena Starr), even though they had to pay interest, gave them a return on investment of 80% (\$8,000 profit on a \$10,000 personal outlay), more than seven times better! Even if Foster & Cooper had the \$360,000 available, they were better off dividing it into 36 similar deals, each costing them \$10,000, rather than putting all the money into this one deal.

This is leverage and Foster & Cooper would probably write a book about how they made millions of dollars in real estate if it always worked out so well. (But calculate what happens if the project sold for 3% less than anticipated.) Although not always successful, the principle of leverage does explain why people borrow money in real estate deals, even if they have the funds themselves. It is how rational borrowers/speculators think.

Most of this book is devoted to how lenders think when lending money, but it may be important to remember that, at the start, it is usually the borrower who decides to get the loan (and to put up with what the lender demands for making the loan).

4. *The wrong villain?* Also note that Elena Starr, the “eighty-year-old, semi-literate widow of limited means and limited business experiences” was the creditor; it was the

debtors, Fisher and Cooper, who were the scoundrels, which is somewhat inconsistent with the classic notion of the scheming, sneering lender of riverboat melodramas. Watch out, in the cases that follow, for who the “bad guys” are.

Acknowledgments

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