



Damages Available Against a Real Estate Professional in a Civil Malpractice Lawsuit

One issue that almost always arises in cases in which my firm is representing a real estate professional, whether it is a real estate agent, real estate broker, appraiser or home inspector, is the proper measure of damages that can be recovered against our client. This proper measure of damages, called “out of pocket” damages, is a critical aspect of the case and in any civil trial, as it obviously affects the instructions that are provided to the jury and will guide their deliberations in terms of the appropriate type and amount of damages that can be assessed against a defendant real estate professional (as opposed to another party to a real estate transaction, typically, the seller). Most judges, and many attorneys, are not well-versed in this aspect of real estate law, so it can be challenging for the real estate attorney to educate both opposing counsel and the trial judge. The proper measure of damages in a real estate transaction case, regardless of whether the causes of action are negligence, fraud, or breach of contract, is also important because it affects the type of evidence, e.g. expert opinion, that can properly be introduced at trial.

Generally, whether a plaintiff is entitled to a particular measure of damages is a question of law. *See Toscano v. Greene Music* (2004) 124 Cal. App. 4th 685, citing *Kajima/Ray Wilson v. Los Angeles Metropolitan Transp. Authority* (2000) 23 Cal.4th 305, 315; *Hurtado v. Superior Court* (1974) 11 Cal.3d 574, 579; *Rose v. Medtronics, Inc.* (1980) 107 Cal. App. 3d 150, 157. The trial judge will have to determine the correct measure of damages that can be considered by the jury through proper jury instruction. Under California law, the measure of damages recoverable by a plaintiff suing for fraud arising from a real estate transaction is generally defined by statute. California Civil Code Section 3343, which limits purchasers of property to recovering only their “out of pocket” damages for fraud in a real estate transaction, reads in relevant part:

One defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received, together with any additional damage arising from the particular transaction...

Thus, a plaintiff suing for fraud as a result of a real estate transaction is statutorily limited to recover only his “out of pocket” damages. “Out of pocket” damages are the difference between the actual value of the consideration parted with and the value of the consideration actually received. Civil Code Section 3343; *Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal. 4th 1226, 1240. “Out of pocket” damages are measured at the time that the purchase has been completed, i.e. usually at the close of escrow. *Burkett v. J.A. Thompson & Son* (1957) 150 Cal.App.2d 523, 527. Examples of “out of pocket” damages include but are not limited to:

- Moving costs;
- Costs of attempting to subdivide the property;

- Escrow fees;
- Building permit fees; and
- Expenses for remedying a defective condition.

In contrast, “benefit of the bargain” damages are the difference between the value of the property *as represented* to the defrauded party and the actual value of the property. See Civil Code Section 3333 (emphasis added). One notable example of “benefit of the bargain” damages is lost anticipated profits, which can be quite significant, especially in cases of commercial property slated for development.

In California, the “out of pocket” and “benefit of bargain” measures of damages have historically *both* been held to apply to real property transactions. *Channell v. Anthony* (1976) 58 Cal. App. 3d 290. However, since the enactment of Civil Code Section 3343, in cases of alleged fraud arising from the “purchase, sale or exchange of property,” the California Legislature expressly provided that the “out of pocket” rather than the “benefit of the bargain” measure of damages should apply. Civil Code § 3343 subds. (a), (b)(1). *Stout v. Turney* (1978) 22 Cal. 3d 718, 725 (For at least the past 77 years, since the initial enactment of section 3343 was in 1935. The cornerstone of the California standard for the assessment of damages for fraud in property transactions has been the so-called "out of pocket" rule.)

The “out of pocket” measure of damages applies to all plaintiffs who have filed suit arising from a real estate transaction and have alleged fraud, or other “species” of fraud, such as intentional misrepresentation or constructive fraud (fraud by a fiduciary) and also applies regardless of whether the plaintiff was the seller or buyer, in a given real estate transaction. Moreover, although Section 3343 specifically refers to fraud, the California Supreme Court has since held that in cases in which a plaintiff also alleges a cause of action for negligence or negligent misrepresentation arising from a real estate transaction, the measure of damages is still “out of pocket” damages. *Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal. 4th 1226, 1240.

In *Alliance Mortgage*, a real estate appraiser, escrow agent and title insurer fraudulently induced a mortgage company to lend funds for the purchase of several residences. The fictitious borrowers defaulted and the mortgage company purchased the properties at non-judicial foreclosure sales. The mortgage company then filed an action against the real estate appraiser, escrow agent and title insurer to recover damages, alleging it was fraudulently induced in making the loans. The court went into a detailed analysis about what the proper measure of damages is in cases involving fiduciaries and non-fiduciaries. The *Alliance Mortgage* court went on to extend the “out of pocket” measure of damages to cases that involved not just fraud claims, but claims for negligence or negligent misrepresentation, and not just cases between buyer and seller, but cases in which real estate professionals who were also involved in the real estate transaction, but were not actually parties to the transaction. California appellate courts have followed the standard set forth in *Alliance Mortgage*, holding the “out of pocket” measure of damages to apply to cases brought against real estate brokers, appraisers, home inspectors and title companies. See *e.g.*, *Gray v. Don Miller & Assoc., Inc.* (1984) 35 Cal. 3d 498; *Alfaro v. Community Housing Improvement System & Planning Assn., Inc.* (2009) 171 Cal. App. 4th 1356; *Fragale v. Faulkner* (2003) 110 Cal. App. 4th 229.

However, despite the California Supreme Court's ruling, the *Alliance Mortgage* court also implied – but did not specifically hold – that there may be a historical exception to the general rule of “out of pocket damages” in property transaction cases for fraudulent fiduciaries. See *Savage v. Mayer* (1949) 33 Cal.2d 548, 551; *Walsh v. Hooker & Fay* (1963) 212 Cal.App.2d 450, 458-462. In cases involving an intentional misrepresentation by a fiduciary, the broader “benefit of the bargain” measure of damages may be applied. *Alliance Mortgage, supra*, 10 Cal. 4th at 1250. However, in cases of intentional misrepresentation by a non-fiduciary, the measure of damages is still the “out of pocket” rule. *Id.* at 1240. There is currently a split of authority among California courts as to what type of fraud damages are recoverable. Some California courts allow “out of pocket” damages, and other courts have allowed damages based on the “benefit of the bargain,” largely depending in which appellate district the suit is filed.

What this means for legal practitioners, and their clients, is that except in cases where a fiduciary (such as a real estate agent or broker for a party, or as recently held, a mortgage broker) is found liable for fraud, the only proper measure of damages that can be put forth in the instructions to a jury is the “out of pocket” measure of damages. In a typical real estate malpractice case, the parties retain expert appraisers to establish the value of the property at various points in time, typically at the time of the close of escrow. “Out of pocket” damages are measured at the time of the close of escrow and involve measuring the difference between what the property was actually worth versus its market value. The difference is typically zero, since actual worth and market value are almost always the same and never negative, especially since the property usually must appraise – at the minimum – for the market value, i.e. purchase price, in order to provide sufficient security for the lender, i.e. mortgagor. “Benefit of the bargain” damages, on the other hand, measure the difference between the actual value of the property and *what it was represented to be at the time the representation was made.*

Depending on numerous factors, but especially the market at the time of the damages measurement is conducted, the difference in appraisals based on different periods of time can be widely divergent, perhaps in the thousands to even millions of dollars.

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