Sellers of commercial real estate, their brokers and attorneys may be quite surprised by the holding in a recent Arizona Court of Appeals case. In S Development Company v. Pima Capital Management Co. (1 CA-CV 00-0347, 8/30/01), decided by Division 1, the court upheld a jury verdict of almost $3.7 million against the sellers of two Phoenix apartment complexes who had failed to disclose to the buyers the existence of defective plumbing in the buildings.

Tort Liability Possible

The fact that the real estate contracts contained typical “as-is”/disclaimer of warranties clauses and inspection contingencies provided no safe harbor to the sellers. The court held that, notwithstanding the existence of an as-is clause or disclaimer of warranties in the contract, a seller of commercial property is subject to tort liability for nondisclosure if he fails to disclose to the buyer latent defects in the property that are known to the seller or if the buyer is precluded by the seller from discovering “facts basic to the transaction.” The sellers’ counsel has sought review by the Arizona Supreme Court.

The case arose out of the sale of the two complexes in 1993. Both purchase contracts contained typical as-is clauses and disclaimers of warranties providing, among other things, that:

• except as expressly set forth in the contracts, the sellers made no representations or warranties of any kind
• the buyers were purchasing the properties as a result of their own examination in their “as-is” conditions

Both contracts also contained typical “free look” or “inspection contingency” provisions. These allowed the buyers and their representatives access to the properties to investigate their condition.

The buyers retained engineering firms to inspect each of the buildings. The inspections did not reveal any substantial problems with the plumbing in either building. Approximately two years after the closings, however, the buyers learned that polybutylene pipe was present at both properties. This pipe is a defective type of flexible tubing that fails and leaks when used to transport warm water under normal water pressures.

The sellers claimed they were not aware that the defective pipe had been used in the buildings. Despite this, the jury returned a verdict awarding the buyers $3,690,000 in damages based on the buyers’ claim of negligent nondisclosure of facts basic to the parties’ transaction.

Failing to Disclose

The court based its decision on Section 551 of the Restatement (Second) of Torts, which provides that:

One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated ... facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

The Restatement provides that one who fails to disclose such facts is subject to the same liability as though he had represented the nonexistence of the matter that he failed to disclose.

The sellers argued that they were unaware of the defective pipes. They also argued that even if they had actual knowledge of the condition, they were under no duty to disclose the defective plumbing to the buyers because the as-is clauses shifted the burden of discovering the defect to the buyers. The buyers, on the other hand, argued that an as-is clause in a purchase contract operates only as a waiver of breach of warranty claims and not as a waiver of tort claims.

The court agreed with the buyers and held that latent defects in a property sold “as is” that are known to the seller must be disclosed to the purchaser and that a cause of action for negligent nondisclosure is available when the purchaser is precluded by the seller from discovering facts basic to the transaction.

The court distinguished latent defects—those that are hidden or concealed and that could not be discovered by reasonable and customary observation or inspection—from patent defects—those that are plainly visible or which can be discovered by such an inspection as would be made in the exercise of ordinary care and prudence.

In arriving at its holding, the court cited the implied covenant of good faith and fair dealing, which Arizona courts have long found exists in every contract. The court said that to reach a different decision “would allow vendors to conceal latent problems with the property and ‘hide behind contract language purporting to shift the risk of nondisclosure to the purchaser.’”

Preventing Effective Inspection

The court made clear that under Arizona law, the rule of caveat emptor con-
continues to apply to an as-is sale even if facts basic to the transaction have not been disclosed, so long as those facts are patent or the purchaser has been given an appropriate opportunity to discover latent defects. However, the court noted that “preventing a party from conducting an inspection effectively turns what may be a patent defect into an undiscoverable-in-fact latent defect.”

The court found that the jury’s verdict could be upheld on that basis as well because the jury was free to conclude from the facts that the buyers did not have an “equal opportunity” to discover the defects because

- the defective pipes were buried six inches inside the walls
- the contracts precluded the buyers from damaging the property in the course of their inspections
- the sellers’ property manager would not allow the buyers to inspect inside the walls of the buildings
- all visible plumbing was copper piping, not the defective piping

The court also found that if sellers’ property management company knew of the plumbing defect, that knowledge could be imputed to the sellers to satisfy the requirements for the sellers’ nondisclosure liability.

Steps for the Wary
What can sellers, their brokers and attorneys learn from this case?

- Before contracting to sell commercial property, sellers should check with their property managers, maintenance personnel and other insiders to determine if there are latent defects.
- Disclose to the buyer latent defects and facts basic to the transaction, whether patent or latent, that the seller might be found to have precluded the buyer from discovering.
- If there is any doubt as to whether a property defect is patent or latent, it may be advisable to disclose the defect to the buyer.

- In drafting as-is clauses, both contract and tort liability should be expressly disclaimed (although Arizona courts have indicated they will not enforce a disclaimer of the seller’s fraudulent acts).
- In preparing and administering free look or inspection contingency clauses, the buyer should be given the right to examine all aspects and areas of the property, including those areas that ordinarily might be considered inaccessible (with appropriate repair and indemnity obligations from the buyer).

Thus, an as-is clause and inspection contingency may not serve as a safe harbor for sellers of commercial property. However, care in marketing properties, together with well-drafted contracts, will continue to provide sellers with protection against liability for nondisclosure. ▲

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