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VENDOR AND PURCHASER - FRAUD - NORTH DAKOTA'S CREATION OF CAVEAT VENDOR

In the fall of 1981 the Zinkes listed their home for sale with a local realtor.¹ Shortly thereafter, the Holcombs viewed the Zinkes' home with Nitschke, a real estate agent, while the Zinkes were away.² The Holcombs spent an hour walking through the home and the lot but did not inspect the appliances, sewer system, or water system.³ The Zinkes made no representations concerning the home;⁴ however, Nitschke and another real estate agent represented that as far as they knew, everything was in good condition.⁵ The Holcombs executed a purchase agreement and, shortly after moving in, discovered numerous defects with the water system, appliances, and sewer system.⁶

Although the Holcombs ultimately corrected most of the problems,⁷ they gave the Zinkes notice of rescission of the purchase agreement.⁸ The Zinkes refused to rescind the contract.⁹ The

1. *Holcomb v. Zinke*, 365 N.W.2d 507, 509 (N.D. 1985). The Zinkes entered into a listing agreement with Hometown Realty granting Hometown the exclusive right to sell the Zinkes' home. *Id.* Hometown was represented by Mark Johnson and Jolene Nitschke. *Id.*

2. *Id.*

3. *Id.*

4. Brief for Appellees at 2-3, *Holcomb v. Zinke*, 365 N.W.2d 507 (N.D. 1985). When the Holcombs viewed the house, Mr. Zinke was out of town and Mrs. Zinke was intentionally absent at Nitschke's request. *Id.* Nitschke informed Mrs. Zinke that it would be best if the sellers were not home during the buyers' inspection of the home. *Id.*

5. 365 N.W.2d at 509. Jolene Nitschke and Mark Johnson, the owner of Hometown Realty, stated to the Holcombs that the house was "almost new, in excellent shape, and that everything was in good condition as far as they knew." *Id.*

6. *Id.* at 509-10. The Holcombs discovered that the water emitted a strange odor and that the dishwasher, garbage disposal, television antenna, water softener, and kitchen heating system were defective. *Id.* at 510. The sewer system backed up on several occasions and flooded the basement. *Id.* The home also violated a zoning ordinance, but Johnson and Nitschke assured the Holcombs that zoning commission would grant a variance. *Id.* at 509-10. A variance was not granted. *Id.* at 510 n.1.

7. *Id.* at 510. In addition to the installation of new sewer pipes and a drain field to remedy the drainage problem, the Holcombs repaired or replaced the other defective appliances and systems. *Id.*

8. *Id.*

9. *Id.*

Holcombs then brought suit for rescission of the contract in the North Dakota District Court for the Southeast Judicial District.¹⁰ The court concluded that the Zinkes had committed fraud by suppressing material facts¹¹ and that the realtors had made affirmative misrepresentations concerning the home.¹² The court granted rescission, and set off the Holcombs' repair and replacement costs against the use of the home.¹³ The Zinkes appealed, but the North Dakota Supreme Court affirmed the district court and *held* that, if a seller of defective real property passively conceals a material fact of which he knows or should know, and which is not reasonably discoverable by the buyer, the seller has breached a duty of disclosure and if he gains an advantage over the buyer to the buyer's prejudice through this breach, he has committed constructive fraud.¹⁴ *Holcomb v. Zinke*, 365 N.W.2d 507 (N.D. 1985).

Historically, the rule of caveat emptor¹⁵ did not apply when the seller made intentional misrepresentations or actively concealed a defect; thus, courts could grant remedial relief to buyers of defective real property.¹⁶ On the other hand, caveat emptor has

10. *Id.*

11. *Id.* at 511. The district court concluded that the Zinkes knew of, but failed to disclose, the various problems with the home. *Id.* at 512.

12. *Id.* at 510. The district court concluded that Johnson, Nitschke, and Hometown Realty had made affirmative misrepresentations concerning the property's physical condition and its zoning status. *Id.* Johnson, Nitschke, and Hometown Realty did not appeal the district court's judgment ordering the return of the realtor's commission to the Zinkes. *Id.* at 509.

13. *Id.* at 510.

14. *Id.* at 510-13.

15. See Hamilton, *Caveat Emptor*, in 3 ENCYCLOPAEDIA OF THE SOCIAL SCIENCES, 280 (1930). Hamilton noted that the doctrine of caveat emptor developed in England during the Middle Ages. *Id.* At that time, trading occurred between buyers and sellers who knew each other and the goods they were trading. *Id.* Consequently, disputes concerning the goods sold were settled in a friendly manner between the parties. *Id.* Because this informal dispute resolution system existed, no legal safeguards were needed to protect the purchaser. *Id.*

16. See *Diemert v. Johnson*, 299 N.W.2d 546 (N.D. 1980). In *Diemert* the plaintiff bought a campsite from the defendant. *Id.* at 547. The seller knew prior to the sale that a billboard on the premises was not in conformity with highway department standards and would have to be removed. *Id.* After the purchasers discovered the problem with the billboard, they sought rescission of the contract based on actual fraud. *Id.* At trial, conflicting evidence was presented as to whether the seller made a positive misstatement. *Id.* at 548. The North Dakota Supreme Court in *Diemert* held that fraud could be found without the existence of a positive false statement. *Id.* The court based these findings on § 9-03-08 of the North Dakota Century Code, which defines actual fraud as follows:

Actual fraud within the meaning of this title consists in any of the following acts committed by a party to the contract, or with his connivance, with intent to deceive another party thereto or to induce him to enter into the contract:

1. The suggestion as a fact of that which is not true by one who does not believe it to be true;
2. The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true though he believes it to be true;
3. The suppression of that which is true by one having knowledge or belief of the fact;
4. A promise made without any intention of performing it; or
5. Any other act fitted to deceive.

generally been applied to cases of mere nondisclosure or passive concealment by the seller.¹⁷ Therefore, the doctrine prevented recourse against a seller when a buyer purchased defective real property under the latter set of circumstances.¹⁸

The general rules of caveat emptor have been slowly modified by the courts as changing circumstances have required.¹⁹ At the end of World War II demand for housing increased dramatically, resulting in quickly built, poorly constructed housing.²⁰ To overcome the injustice resulting from the application of caveat emptor,²¹ courts and legislatures created four exceptions to the general rule of caveat emptor that there is no liability for mere nondisclosure.²² These exceptions create a duty of disclosure: (1) when disclosure is needed to prevent a half-true statement from being misleading;²³ (2) when disclosure of newly acquired information is needed to prevent a prior statement from being misleading;²⁴ (3) when one party, due to superior knowledge,

problems with the sewer system after being specifically questioned about it by the purchaser. *Id.* at 763.

17. See *Peek v. Gurney*, 6 L.R.-E. & I. App. 377 (H.L. 1873). In *Peek* Lord Cairns determined that there was no actionable fraud for mere nondisclosure of material facts. *Id.* at 403. The term "passive concealment" is synonymous with the term "mere nondisclosure" used by Lord Cairns in the *Peek* opinion. *Id.* See also *Wilhite v. Mays*, 140 Ga. App. 816, 232 S.E.2d 141 (1976), *aff'd*, 239 Ga. 31, 235 S.E.2d 532 (1977). The Georgia Court of Appeals noted that fraud by the seller can occur in three ways: (1) positive misrepresentations by words or actions; (2) active concealment where seller does not discuss the defect and takes steps to prevent the purchaser from discovering the defect; and (3) passive concealment where the seller knows of the material defect and does not try to hide the defect but "simply keeps his mouth shut." *Id.* at _____, 232 S.E.2d at 142.

18. See Bearman, *Caveat Emptor in Sales of Realty - Recent Assaults Upon the Rule*, 14 VAND. L. REV. 541 (1961). Bearman noted that prior to 1945, caveat emptor safely protected sellers from buyers' claims of fraud because of mere nondisclosure. *Id.* at 561.

19. See *id.* at 542. Bearman noted that the doctrine of caveat emptor was limited in regard to the sale of personal property before any such limitation was made regarding the sale of real property. *Id.* Bearman noted that this distinction existed because mass production of personal property had already occurred prior to 1945 while mass production methods in the building industry were not developed until the end of World War II. *Id.*

20. *Id.* Bearman noted that it was inevitable that houses would be constructed poorly because of the high demand for new homes. *Id.* The increase in demand for housing caused builders to compete for raw materials, and once procured, to utilize them in building homes as quickly as possible. See *id.* (citation omitted).

21. *Id.* at 542. Bearman noted that the increase in the number of defective homes being built naturally led to an increase in the number of disgruntled homeowners who turned to the courts for relief. *Id.* The development of implied warranties was one source of relief for the disgruntled homeowners. *Id.* at 543.

22. See Keeton, *Fraud - Concealment and Non-disclosure*, 15 TEX. L. REV. 1 (1936). In examining the changing application of caveat emptor in today's society, Keeton noted as follows:

The attitude of the courts toward non-disclosure is undergoing a change and contrary to Lord Cairns' famous remark [in *Peek v. Gurney*] it would seem that the object of the law in these cases should be to impose on parties to the transaction a duty to speak whenever justice, equity, and fair dealing demand it.

Id. at 31. See also W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 106 (5th ed. 1984) (liability imposed for representation and nondisclosure); *RESTATEMENT (SECOND) OF TORTS* § 551 (1976) (liability imposed for nondisclosure).

23. See *Smith v. Pope*, 103 N.H. 555, 176 A.2d 321 (1961). In *Smith* the seller was held liable for fraud when she inaccurately and incompletely described the quality of the well water. *Id.* at _____, 176 A.2d at 324.

24. See *Morykwias v. McKnight*, 37 Mich. App. 304, 194 N.W.2d 522 (1971). In *Morykwias* the

knows of a fact basic to the transaction that is unknown to the other party;²⁵ and (4) when the parties stand in a fiduciary or confidential relationship.²⁶

Many jurisdictions have utilized the first three exceptions to the general rule of caveat emptor to require sellers to disclose latent defects in real property if the defects are material facts that the buyer cannot discover through a reasonable inspection.²⁷ In North Dakota, breach of the duty to disclose under the first three exceptions to the general rule of caveat emptor would result in liability for actual fraud.²⁸

A few courts have not accepted the theory that the seller of a home is liable for mere nondisclosure without the existence of a fiduciary relationship²⁹ or the communication of a half-true statement.³⁰ These cases, however, have been criticized by both

seller was held liable for fraud for failing to disclose after-acquired information which made prior statements to the buyer misleading. *Id.* at ____, 194 N.W.2d at 523-24.

25. See *Kunkle Water and Elec. Inc. v. City of Prescott*, 347 N.W.2d 648 (Iowa 1984). In *Kunkle Water and Elec.* the water company was held liable for fraud for failure to disclose to the city the extent of repairs needed for a water system. *Id.* at 653. The court determined that the extent of repairs needed was not only a material fact, but also one which was known only by the water company. See *id.* at 653-54.

26. See *infra* notes 34-38 and accompanying text for a discussion of the use of the fiduciary or confidential relationship theory as a basis for a determination of constructive fraud in the real estate setting in North Dakota.

27. Courts in the following jurisdictions have determined that a vendor has a duty to disclose material facts known to him if such facts are undiscoverable through a purchaser's reasonable inspection: California (*Lingsch v. Savage*, 213 Cal. App. 2d 729, ____, 29 Cal. Rptr. 201, 204-05 (Cal. Dist. Ct. App. 1963)); Colorado (*Cohen v. Vivian*, 141 Colo. 443, 447, 349 P.2d 366, 367 (1960)); Florida (*Johnson v. Davis*, 449 So. 2d 344, 347-48 (Fla. Dist. Ct. App. 1984)); Illinois (*Posner v. Davis*, 76 Ill. App. 3d 638, 644, 395 N.E.2d 133, 137 (1979)); Iowa (*Loghry v. Capel*, 257 Iowa 285, 289, 132 N.W.2d 417, 419 (1965)); Michigan (*Williams v. Benson*, 3 Mich. App. 9, ____, 141 N.W.2d 650, 656 (1966)); New Jersey (*Weintraub v. Krobatsch*, 64 N.J. 445, ____, 317 A.2d 68, 74 (1974)); South Carolina (*Lawson v. Citizens and S. Nat'l Bank*, 259 S.C. 477, ____, 193 S.E.2d 124, 128 (1972)); Texas (*Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 658 (Tex. 1979)); Washington (*Obde v. Schlemeyer*, 56 Wash. 2d 449, ____, 353 P.2d 672, 674-75 (1960)); West Virginia (*Thacker v. Tyree*, 297 S.E.2d 885, 888 (W. Va. 1982)).

28. See N.D. CENT. CODE § 9-03-08(3) (1975). Subsection 3 of § 9-03-08 defines actual fraud as follows:

Actual fraud within the meaning of this title consists in any of the following acts committed by a party to the contract, or with his connivance, with intent to deceive another party thereto or to induce him to enter into the contract:

-
 3. The suppression of that which is true by one having knowledge or belief of the fact;

Id. It appears that a finding of actual fraud could occur under subsection 3 if a party breached a duty to disclose by: (1) failing to prevent a previous half-true statement from being misleading; (2) failing to disclose newly acquired information to prevent a prior statement from being misleading; (3) failing to disclose known facts basic to the transaction that are unknown to the other party. See *id.* See *supra* note 16 and accompanying text for a discussion of North Dakota cases in which the court found actual fraud in real estate transactions.

29. See *Ray v. Montgomery*, 399 So. 2d 230 (Ala. 1980). In *Ray* the seller failed to disclose to the buyers that the home had suffered termite damage. *Id.* at 232. The court did not impose liability on the seller and held there was no duty to disclose defects unless the buyer requested the information or a confidential relationship existed. *Id.*

30. See, e.g., *Swinton v. Whitinsville Sav. Bank*, 311 Mass. 677, 42 N.E.2d 808 (1942). In

commentator³¹ and court.³² In North Dakota, breach of the duty to disclose in a fiduciary or confidential relationship under the fourth exception to the general rule of caveat emptor results in liability for constructive fraud.³³

The North Dakota Supreme Court examined a claim of constructive fraud in a real estate transaction in *Asleson v. West Branch Land Co.*³⁴ In *Asleson*, both the seller and realtor unintentionally misrepresented the zoning status of a piece of property in a Multiple Listing Service.³⁵ The court in *Asleson* noted that constructive fraud is found most often when there has been a breach of a fiduciary or confidential relationship.³⁶ Despite the lack of such a relationship, the court held that the seller and realtor had violated North Dakota's constructive fraud statute by breaching their duty to accurately represent the zoning status of the property.³⁷ The court noted that a high degree of accuracy in the description of the property is necessary so members of the Multiple Listing Service may use the information without misrepresenting the condition of the property.³⁸

The Montana Supreme Court interpreted a constructive fraud statute identical to North Dakota's in *Russell v. Russell*.³⁹ The Montana Supreme Court used constructive fraud as a basis for

Swinton the seller failed to disclose to the buyer that the house was infested with termites. *Id.* at _____, 42 N. E.2d at 808. The court refused to impose liability for mere nondisclosure absent a half-true or a fiduciary relationship. *See id.*

31. *See* PROSSER & KEETON, THE LAW OF TORTS § 106 (5th ed. 1984). Prosser described the cases that prohibit liability for mere nondisclosure as "surely singularly unappetizing cases." *Id.* at 738.

32. *See* Johnson v. Davis, 449 So. 2d 344 (Fla. Dist. Ct. App. 1984). In *Johnson* the Third District Court of Appeals imposed liability for mere nondisclosure and stated: "However, having acknowledged this authority [from the Fourth District Court of Appeals], by which we are not bound and which we feel represents an offensive view of societal duties and fails to embody the ideals which the law should always strive to reflect, we choose not to follow it." *Id.* at 347-48.

33. *See* N.D. CENT. CODE § 9-03-09 (1975). Section 9-03-09 defines constructive fraud as follows:

Constructive fraud consists:

1. In any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault or anyone claiming under him, by misleading another to his prejudice or to the prejudice of anyone claiming under him; or
2. In any such act or omission as the law specially declares to be fraudulent without respect to actual fraud.

Id. *See infra* Notes 34-45 and accompanying text for a discussion of cases that have applied constructive fraud in analyzing real estate transactions.

34. 311 N.W.2d 533 (N.D. 1981).

35. *Asleson v. West Branch Land Co.*, 311 N.W.2d 533 (N.D. 1981). In *Asleson* the property was advertised in the Multiple Listing Service list sheet as properly zoned for 35 townhouses, when in fact the property contained only 3.04 acres and was suitable for only 30 townhouses. *Id.* at 535.

36. *Id.* at 539.

37. *Id.* at 539-43. The court in *Asleson* noted that under special circumstances constructive fraud may exist in the absence of a fiduciary or confidential relationship. *Id.* at 540. The court based the duty to accurately list property upon the nature and purpose of the Multiple Listing Service. *Id.* at 538.

38. *Id.*

39. 152 Mont. 461, 452 P.2d 77 (1969); compare MONT. CODE ANN. § 28-2-406 (1985) with N.D.

requiring the seller to disclose hidden defects in the property.⁴⁰ In *Russell* the state health department had warned the seller of a bar and restaurant of a violation of sanitation regulations.⁴¹ The seller failed to inform the buyers of the state health department warning.⁴² After the buyers began to operate the bar and restaurant, the state health department informed the buyers that licenses to operate the premises would not be issued until repairs were made.⁴³ The buyers sued the seller for rescission, basing their claim on fraud.⁴⁴ The court in *Russell* held that the seller had committed constructive fraud, not actual fraud, by failing to inform the buyers of the state health department warning.⁴⁵

With this expansion of constructive fraud to build on, the North Dakota Supreme Court decided *Holcomb v. Zinke*.⁴⁶ The court determined that, before rescission of the contract could be granted, the plaintiff had to prove the following: "(1) the Holcombs' consent to enter into the contract was obtained through fraud;⁴⁷ (2) the Holcombs exercised reasonable diligence in

CENT. CODE § 9-03-09 (1975). See *infra* note 45 for a discussion of the similarities between MONT. CODE ANN. §§ 28-2-405 to -406 and N.D. CENT. CODE §§ 9-03-08 to -09.

40. *Russell v. Russell*, 152 Mont. 461, 465-66, 452 P.2d 77, 79 (1969).

41. *Id.* at 464, 452 P.2d at 78. In *Russell* the state health department informed the seller that the sewage system violated state regulations. *Id.* at 79.

42. *Id.*

43. *Id.* at 464, 452 P.2d at 79. The state health department informed the buyers that repairs to the water system and sewer system were required before it would issue licenses to operate the bar and restaurant. *Id.*

44. *Id.* at 463, 452 P.2d at 78. The buyers sued the seller for the return of their down payment, claiming that the seller had made fraudulent misrepresentations and had concealed material facts. *Id.* finding of constructive fraud, as opposed to actual fraud. *Id.* The court stated that "we do not think the instant case was one of actual fraud. . . . We think, instead, it was concealment, more in the nature of a constructive fraud." *Id.* Montana's actual fraud and constructive fraud statutes are identical to North Dakota's. Compare MONT. CODE ANN. §§ 28-2-405 to -406 (1985) with N.D. CENT. CODE §§ 9-03-08 to -09 (1975). In *Russell* the Montana court relied on the statutory language in the Montana code that is paralleled to section 9-03-09(2) of the North Dakota Century Code in reaching its holding. See 152 Mont. at 465-66, 452 P.2d at 79. Compare *Russell v. Russell*, 152 Mont. 461, 452 P.2d 77 (1969) with *Lingsch v. Savage*, 213 Cal. App. 2d 729, 29 Cal. Rptr. 201 (Cal. Dist. Ct. App. 1963). In *Lingsch* the buyer alleged that the seller failed to inform the buyer that the building in question had been condemned. *Lingsch v. Savage*, 213 Cal. App. 2d 729, ____, 29 Cal. Rptr. 201, 203 (Cal. Dist. Ct. App. 1963). The California Court of Appeals, after noting that the seller has a duty to disclose material facts known to him but unknown to the buyer, held that the failure to disclose the condemnation constituted actual fraud instead of constructive fraud. *Id.* at ____, 29 Cal. Rptr. at 204-05. The California statutes defining actual and constructive fraud are identical to North Dakota's. Compare CAL. CIV. CODE §§ 1572-1573 (West 1982) with N.D. CENT. CODE §§ 9-03-08 to -09 (1975).

46. 365 N.W.2d 507 (N.D. 1985).

47. *Id.* at 510. Rescission of a contract based on fraud is governed by subsection 1 of § 9-09-02 of the North Dakota Century Code. See N.D. CENT. CODE § 9-09-02(1) (1975).

Subsection 1 states as follows:

A party to a contract may rescind the same in the following cases only:

1. *If the consent of the party rescinding or of any party jointly contracting with him was given by mistake or obtained through duress, menace, fraud, or undue influence exercised by or with the connivance of the party as to whom he rescinds or of any other party to the contract jointly interested with such party;*

Id. (emphasis added).

rescinding promptly upon discovery of the fraud;⁴⁸ and (3) the Holcombs restored the status quo.⁴⁹ The court examined each of these requirements in turn.⁵⁰

In determining whether the Holcombs' consent was obtained by fraud, the court noted that the district court appeared to rely on constructive fraud doctrines to support its memorandum decision.⁵¹ Therefore, the court reviewed the case as if the district court had found constructive fraud on the part of the Zinkes.⁵²

Constructive fraud occurs when a person, without any fraudulent intent, breaches a duty and thereby gains an advantage by misleading another to his prejudice.⁵³ Because constructive fraud cannot be found unless a duty has been breached, the court in *Holcomb* began its analysis by stating that whether or not a duty exists is a question of law.⁵⁴ The court then noted that the duty to

48. 365 N.W.2d at 510. See N.D. CENT. CODE § 9-09-04 (1975) (general rules governing rescission). Section 9-09-04 states as follows:

Rescission, when not effected by consent or pursuant to sections 9-08-08 and 9-08-09, can be accomplished only by the use, on the part of the party rescinding, of reasonable diligence to comply with the following rules:

1. *He must rescind promptly upon discovering the facts which entitle him to rescind, if he is free from duress, menace, undue influence, or disability and is aware of his right to rescind; and*
2. *He must restore to the other party everything of value which he has received from him under the contract or must offer to restore the same upon condition that such party shall do likewise, unless the latter is unable or positively refuses to do so.*

Id. (emphasis added). See also *Robertson Co., Inc. v. Kenner*, 311 N.W.2d 194 (N.D. 1981). In *Robertson* the plaintiff hired the defendant to construct steel buildings to store sunflowers after harvest. *Id.* at 196. The defendant worked on the project for almost a year but the buildings, which could have been completed in six days, were never completed. *Id.* at 198. The defendant claimed that the plaintiff waived his right to rescind because of a lapse of time. *Id.* The court, however, determined that the promptness of rescission is dependent upon the facts of each case and not exclusively upon the lapse of time. *Id.*

49. 365 N.W.2d at 510. See *supra* note 48 discussing North Dakota's statutes governing rescission. See also *Blair v. Boulger*, 358 N.W.2d 522 (N.D. 1984). In *Blair* the defendant purchased rental property from the plaintiff. *Id.* The defendant gave the plaintiff a down payment with the balance to be paid to the plaintiff in the form of rent credits at the rate of \$100 per month. *Id.* The defendant was also to pay interest on the unpaid principal and to provide insurance, heat, water, and needed repairs. *Id.* The plaintiff demanded rescission but did not offer to restore the insurance premiums and expense paid by the defendant, nor did the plaintiff offer to restore the \$7,000 she received in the form of rent credit. *Id.* at 523. The court held that the plaintiff's failure to offer restoration of all that she had received under the contract precluded the court from granting rescission. *Id.* at 524.

50. 365 N.W.2d at 511-13.

51. *Id.* at 511. The court in *Holcomb* noted that, although the trial court did not state the type of fraud, the trial court did rely on *Asleson v. West Branch Land Co.*, 311 N.W.2d 533 (N.D. 1981), as authority in its memorandum opinion. 365 N.W.2d at 511. The court continued by pointing out that the *Asleson* decision was based on constructive fraud. *Id.* See *supra* notes 34-38 and accompanying text for a discussion of *Asleson* and constructive fraud.

52. 365 N.W.2d at 511. See also Brief of Appellees at 11-16, *Holcomb v. Zinke*, 365 N.W.2d 507 (N.D. 1985). The Holcombs urged that the Zinkes' suppression of material facts constituted actual and constructive fraud. *Id.*

53. See N.D. CENT. CODE § 9-03-09 (1975). See *supra* note 33 for the text of North Dakota's constructive fraud statute.

54. 365 N.W.2d at 511. The court cited *Kirton v. Williams Elec. Coop., Inc.*, 265 N.W.2d 702 (N.D. 1978), for the proposition that the existence of a duty is a matter of law. 365 N.W.2d at 511. See *Kirton v. Williams Elec. Coop., Inc.*, 265 N.W.2d 702 (N.D. 1978). The existence of a duty as a

disclose is generally based on a fiduciary or confidential relationship.⁵⁵ The court stated that since such a relationship between the Zinkes and Holcombs did not exist, "any duty of disclosure must arise from other circumstances."⁵⁶

The court then discussed the historical use of caveat emptor as a shield to prevent placing any duty upon the seller to disclose information.⁵⁷ The court noted that caveat emptor was appropriate in the agrarian society in which it evolved, but the rule was inappropriate in today's complex society.⁵⁸

After discarding caveat emptor, the court found the rationale for a new duty to inform a buyer of facts basic to the transaction in *Liland v. Tweto*.⁵⁹ In *Liland* the defendant fraudulently induced the plaintiff to exchange his farm and personal property for the defendant's shares of stock.⁶⁰ The North Dakota Supreme Court stated in *Liland* that, while caveat emptor applies to arms length transactions, it does not apply if the seller makes a false statement of fact and the buyer does not know it is false.⁶¹ In such a case, the buyer has an implicit right to rely on the false statement.⁶²

matter of law is generally well accepted. See PROSSER & KEETON, *supra* note 31, § 37. The existence of a duty is "entirely a question of law, to be determined by reference to the body of statutes, rules, principles and precedents which make up the law; and it must be determined only by the court." *Id.* at 236.

55. See 365 N.W.2d at 511. The court stated that the duty to disclose "may arise from a fiduciary or other confidential relationship." *Id.* (emphasis added). The court cited *Asleson v. West Branch Land Co.* 311 N.W.2d 533 (N.D. 1981) in support of this proposition. 365 N.W.2d at 511. The court in *Asleson* stated that "[c]onstructive fraud is most frequently found in a breach of duty arising out of a fiduciary or a confidential relationship." 311 N.W.2d at 539 (quoting 37 C.J.S. *Fraud* § 2 (1943)). See *supra* notes 33-45 and accompanying text for a discussion of constructive fraud arising from a breach of duty.

56. 365 N.W.2d at 511.

57. *Id.* The court cited *Peek v. Gurney*, 6 L.R.-E. & I. App. 377 (H.L. 1873), for the historical rule that no liability exists for mere nondisclosure of material facts. 365 N.W.2d at 511. See *supra* note 15 and accompanying text for a general historical discussion of caveat emptor.

58. 365 N.W.2d at 511 (quoting *Wilhite v. Mays*, 140 Ga. App. 816, ___, 232 S.E.2d 141, 143 (1976), *aff'd*, 293 Ga. 31, 235 S.E.2d 532 (1977)). In *Wilhite* the seller passively concealed the fact that the sewer system in the home did not function properly. *Wilhite*, 140 Ga. App. at ___, 232 S.E.2d at 142. The buyer sued the seller, who defended by claiming that caveat emptor barred such an action. *Id.* The court determined that the seller had committed fraud by failing to disclose the problem with the sewer system. *Id.* The court in *Wilhite* also recognized that buying simple farm acreage is far different from the typical purchase of a modern home with all its mechanical complexities. *Id.* at ___, 232 S.E.2d at 142-43.

59. 19 N.D. 551, 125 N.W. 1032 (1910).

60. *Liland v. Tweto*, 19 N.D. 551, 564, 125 N.W. 1032, 1037 (1950). The defendant represented that the shares of stock exchanged for the plaintiff's property were worth more than their actual value. *Id.* at 555, 125 N.W. at 1033. The defendant also represented that the corporation was prosperous when in fact it was not. *Id.*

61. *Id.* at 567, 125 N.W. at 1039.

62. *Id.* The *Liland* court also stated as follows:

There is no positive duty in the vendor to disclose defects in the article, but if he conceals them, even by silence, where he knows the other party has fallen into a delusion in regard to them, and is making a purchase which he otherwise would not make, or at a price materially beyond what he would otherwise pay, in consequence of such delusion, this is equivalent to a false representation or to the use of artifice to disguise the defect of the article.

The court in *Holcomb* elaborated upon the conclusion in *Liland*, stating that “[s]ilence may be as misleading as a positive misrepresentation of [a] fact,”⁶³ and as such, fraud may occur without actually making a false statement.⁶⁴ The court then noted that if a party is bound by good faith to disclose a material fact, suppression of that fact is equal to a false representation.⁶⁵

The court concluded that, despite the lack of a fiduciary or confidential relationship, when a seller passively conceals material defects in real property of which he knows or should know, and which are not reasonably discoverable by the buyer, he has breached his duty to disclose and has committed constructive fraud if he gains an advantage over the buyer through this breach.⁶⁶ The court reasoned that the relationship between the buyer and seller, although not fiduciary or confidential, is marked by the seller’s superior knowledge of the property.⁶⁷ This possession of superior knowledge creates the duty to disclose.⁶⁸

The Zinkes argued that they, as sellers, should not be liable for failure to disclose facts unknown to them.⁶⁹ In discussing this issue, the court noted that the district court found the Zinkes were aware that the sewer system was defective and that the water had an odor.⁷⁰ The court noted that the trial record supported a finding

Id. at 569, 125 N.W. at 1039 (emphasis added) (quoting *Paddock v. Strowbridge*, 29 Vt. 470 (1857)).

63. 365 N.W.2d at 511. The court in *Holcomb* reasoned that since a positive misrepresentation, which was at issue in *Liland*, could be as misleading as silence, the *Liland* court’s analysis could be applied to the situation at bar. *Id.* at 512. See *supra* notes 59-62 and accompanying text discussing the *Liland* court’s finding of actual fraud based on positive misrepresentations.

64. 365 N.W.2d at 512.

65. *Id.*

66. 365 N.W.2d at 511-13. In support of its holding, the court cites the following cases, all of which have declared a duty to disclose latent defects: *Lingsch v. Savage*, 213 Cal. App. 2d 729, ____, 29 Cal. Rptr. 201, 204-05 (Cal. Dist. Ct. App. 1963) (breach of duty by seller to disclose *known* material latent defects results in *actual* fraud); *Wilhite v. Mays*, 140 Ga. App. 816, ____, 232 S.E.2d 141, 143 (1976), *aff’d*, 239 Ga. 31, ____, 235 S.E.2d 532, 533 (1977) (suppression of *known* material latent defects results in fraud); *Posner v. Davis*, 76 Ill. App. 3d 638, 643-44, 395 N.E.2d 133, 137 (Ill. App. Ct. 1979) (breach of duty by seller to disclose *known* material latent defects results in fraud); *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 657-58 (Tex. 1979) (breach of a duty by seller to disclose *known* material defects results in fraud). 365 N.W.2d at 512.

The court cited *Hauck v. Samus*, 212 Neb. 25, 321 N.W.2d 68 (1982) for support of its holding. *Holcomb*, 365 N.W.2d at 512. In *Hauck* the Nebraska Supreme Court determined that a seller’s breach of the duty to disclose material defects of which the seller knows or should know results in what would be *actual* fraud in North Dakota. See 212 Neb. at 27-28, 321 N.W.2d at 69-70. Compare *Hauck* with *contra* *Williams v. Benson*, 3 Mich. App. 9, 141 N.W.2d 650 (1966). In *Williams* the court imposed a duty to disclose known defects by stating that “[k]nowledge of the prior defect on the part of the vendor, of course is essential, for we do not intend to impose liability where no knowledge has ever existed. Nor do we intend to make everyone an insurer of everything that is sold.” *Williams*, 3 Mich. App. at ____, 141 N.W.2d at 656.

67. 365 N.W.2d at 512. The court appears to reason that although constructive fraud usually involves the breach of a fiduciary or confidential relationship, other circumstances, such as the seller’s superiority of knowledge, may also create a duty, a breach of which would be constructive fraud. See *id.* See *supra* notes 33-45 and accompanying text for a discussion of fiduciary and confidential relationships and constructive fraud.

68. See 365 N.W.2d 511-12.

69. *Id.* at 512.

70. *Id.* The court noted that at trial Mr. Zinke denied any problems with the sewer system. *Id.*

that the defects in the sewer, water, and heating systems were material and not reasonably discoverable.⁷¹ Finally, the court determined that the last elements of constructive fraud were present because the Holcombs suffered a detriment while the Zinkes gained an advantage by their breach of duty.⁷² Thus, all the elements of constructive fraud were established and the first proposition necessary to grant rescission was proved.⁷³

After the court determined that constructive fraud had been established, it considered the last two propositions necessary for rescission.⁷⁴ The court determined that the Holcombs' notice of rescission was timely,⁷⁵ and that the Holcombs had offered to restore the status quo.⁷⁶ Because it found all the prerequisites to the granting of rescission, the court affirmed the district court's order.⁷⁷

The court in *Holcomb* explicitly created another exception to the doctrine of caveat emptor.⁷⁸ Even though the Zinkes knew of the defects, the court will apparently now hold sellers to a "should-have-known"⁷⁹ negligence standard. The use of a negligence

Mr. Zinke had also testified that he had to pump the drain field every two weeks, and that on occasion, the sewer would back up into the basement. *Id.* Mr. Zinke further testified that the water did have a smell on occasion, but the smell did not bother him. *Id.*

71. *Id.* The court compared the material defects not reasonably discoverable in the Zinke home to the defect found in the home sold in *Fitzgerald v. Balkowitsch*, 288 N.W.2d 761 (N.D. 1980). In *Fitzgerald* the buyers specifically asked the sellers if they had any problems with the sewer system. 288 N.W.2d at 761. The sellers claimed they had never had a problem with the sewer system when, in fact, there had been problems. *Id.* at 762. The buyers sued the sellers for fraud. *Id.* at 763. The North Dakota Supreme Court stated that the condition of the sewer system, which the sellers misrepresented, was a material fact, thereby supporting a finding of actual fraud. *Id.*

72. 365 N.W.2d at 513. The court determined that the Zinkes received more money for the house than they would have had they disclosed its true condition. *Id.*

73. *See id.* See *supra* note 33 for the text of North Dakota Century Code § 9-03-09 defining constructive fraud. See *supra* note 47 for the text of North Dakota Century Code § 9-09-02(1) providing for rescission of a contract based on fraud.

74. 365 N.W.2d at 513. The remaining issues to be determined before the court could grant rescission were timeliness and restoration of the status quo. *See id.* See also N.D. CENT. CODE § 9-09-04 (1975) (general provision governing rescission).

75. 365 N.W.2d at 513. See *supra* note 48 for the text of subsection 1 of § 9-09-04 of the North Dakota Century Code, which requires a rescinding party to rescind promptly. The Zinkes alleged that there was a delay between the time the Holcombs discovered the defect and their attempted rescission. 365 N.W.2d at 513. The court, however, determined that the alleged delay did not prejudice the Zinkes. *Id.*

76. 365 N.W.2d at 513. See *supra* note 48 for the text of subsection 2 of § 9-09-04 of the North Dakota Century Code, which requires that the rescinding party must restore, or offer to restore, the status quo. In their offer to restore the status quo, the Holcombs included the reasonable value for the use of the home. 365 N.W.2d at 513. The Zinkes argued that the district court erred in offsetting the reasonable rental value of the home against the Holcomb's cost to repair and replace the defects. *Id.* Although the trial court's decision did not specifically state the reasonable rental value, it did find that the reasonable rental value equaled the \$5300 of costs incurred by the Holcombs. *Id.* at 513-14. The court in *Holcomb* noted that, although it had remanded *Erling v. Homera, Inc.*, 298 N.W.2d 478 (N.D. 1980), for a determination of reasonable rental value, a remand of *Holcomb* would fly in the face of judicial economy. 365 N.W.2d at 514.

77. 365 N.W.2d at 513. See *supra* notes 47-48 for the text of North Dakota's statutes governing rescission.

78. 365 N.W.2d at 512. The court stated that its imposition of this duty constituted an exception to the doctrine of caveat emptor. *Id.*

79. See *Asleson*, 311 N.W.2d 533 (constructive fraud found where seller and realtor unintentionally misrepresented zoning status of property).

standard is reflected in the court's holding which requires the seller to disclose defects he *should* know exist in the home, and is based on constructive fraud, which does not require fraudulent intent.⁸⁰ Thus, a seller in North Dakota must not be negligent in discovering defects or disclosing those defects to the buyer.⁸¹ To remain silent and still avoid liability, he must further determine what is discoverable by the buyers' exercise of ordinary care and diligence. If the defect is discoverable by the buyer, the seller would be under no duty to disclose.⁸²

As a result of the holding in *Holcomb*, an increase in litigation could occur.⁸³ Angry buyers who have purchased homes with

80. See 365 N.W.2d at 512; N.D. CENT. CODE § 9-03-09 (1975). See *supra* note 33 for the text of North Dakota's constructive fraud statute.

81. Compare *Asleson*, 311 N.W.2d 533 (constructive fraud found where seller and realtor unintentionally misrepresented zoning status of property) with *Holcomb*, 365 N.W.2d 507 (constructive fraud exists when seller fails to disclose latent defects he knows or should know exist).

82. See *Holcomb*, 365 N.W.2d at 512. The court in *Holcomb* held:

that in cases of passive concealment by the seller of defective real property, there is an exception to the rule of caveat emptor, applicable to this case, which imposes a duty on the seller to disclose material facts which are known or should be known to the seller and which would not be discoverable by the buyer's exercise of ordinary care and diligence.

Id. (citations omitted) (emphasis added).

83. See *id.* It appears that a disgruntled buyer of defective real property has two options: sue under actual fraud or sue under constructive fraud. Compare *Diemert v. Johnson*, 299 N.W.2d 546 (N.D. 1980) (claim for relief against seller who commits actual fraud) with *Holcomb*, 365 N.W.2d 507 (claim for relief against seller who commits constructive fraud).

To bring suit alleging actual fraud under § 9-03-08 of the North Dakota Century Code, the buyer could allege that the seller suppressed a material defect, which he knew existed, in order to induce the buyer to enter into the contract. See N.D. CENT. CODE § 9-03-08 (1975). See *supra* note 16 for text of § 9-03-08 of the North Dakota Century Code. Conceivably, the buyer could receive punitive damages in such an action. See *Powers v. Martinson*, 313 N.W.2d 720 (N.D. 1981). In *Powers* the sellers failed to disclose known latent defects in the 12-plex they sold to the buyer. *Id.* at 723. After discovering the defects, the buyer sued the sellers for actual fraud and was awarded compensatory and punitive damages. *Id.* The court in *Powers* upheld the punitive damages award and noted that punitive damages could only be assessed in accordance with § 32-02-07 of the North Dakota Century Code. *Id.* at 728. See N.D. CENT. CODE § 32-03-07 (Supp. 1985). Section 32-03-07 provides as follows:

In any action for the breach of an obligation not arising from contract, when the defendant has been guilty of oppression, fraud, or malice, actual or presumed, the court or jury, in addition to the actual damages, may give damages for the sake of example and by way of punishing the defendant.

Id. The court also stated that the seller's duty not to make fraudulent representations to the buyer arose from law, not contract. 313 N.W.2d at 728.

The second option is for the buyer to sue under a theory of constructive fraud. See N.D. CENT. CODE § 9-03-09 (1975). See *supra* note 33 for the text of § 9-03-09 of the North Dakota Century Code. This second option will most likely be used when the buyer cannot prove that the seller intended to commit a fraudulent act. Compare N.D. CENT. CODE § 9-03-08 (1975) (intent required for actual fraud) with N.D. CENT. CODE § 9-03-09 (1975) (no intent required for constructive fraud). By suing under constructive fraud, however, the buyer is precluded from receiving punitive damages. See PROSSER & KEETON, *supra* note 31, § 2 (punitive damages can be awarded when the defendant's actions are outrageous, deliberate, or intentional as opposed to negligent).

The quantum of evidence necessary to prove the *Holcomb* negligence standard in a constructive fraud claim would apparently be less than that needed to prove the intent requirement in an actual fraud claim. See PROSSER & KEETON, *supra* note 31, § 8. In discussing intent Prosser states as follows:

The factfinder need not credit the actor's assertion that the actor did not intend the result in question. One of the common lines of argument against crediting the actor's

passively concealed defects will now have a claim for relief.⁸⁴ Further, it is conceivable that litigants could attempt to apply the negligence standard in *Holcomb* to other transactions in which the seller has superior knowledge of the goods being sold.⁸⁵

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assertion is (1) that, given the circumstances disclosed in the evidence, a reasonable person in the actor's position would have known that the consequence in question was substantially certain to follow the act, (2) that the evidence shows that the actor was even brighter and shrewder than most others, and (3) that the inference is therefore compelling that the actor knew even though testifying otherwise. If the factfinder credits inference (1) but not inferences (2) and (3), the finding is negligence. But if the factfinder credits all three inferences, the finding is intent to produce the consequence in question.

Id. at 36. Conceivably, the total number of fraud claims would increase even if the number of actual fraud cases stays the same. *See id.*

84. *See Holcomb v. Zinke*, 365 N.W.2d 507 (N.D. 1985). Buyers who cannot prove the elements necessary for actual fraud may now use constructive fraud as another claim for relief. *See id.*

85. *See id.* at 512. In *Holcomb* the court's rationale for imposing the duty to disclose was that there is a "clearly superior position of the seller vis-a-vis knowledge of the condition of the property being sold." *Id.*