ARIZONA STATE UNIVERSITY

COLLEGE OF LAW

PROPERTY I, LAW 523

Professor Karjala

FINAL EXAMINATION
Part 1 (1-1/2 hours)
Model Answer

Monday, December 9, 2002 8:30 a.m.

Instructions

Part 1 of this examination consists of one essay problem. You have 1-1/2 hours to complete Part 1, after which the exam and your bluebooks will be picked up. Part 2, consisting of 22 multiple choice questions, will then be distributed, along with answer sheets for Part 2. The two parts will be weighted roughly equally in determining the final grade, although some deviations may be made depending on the general quality of the answers or of a particular exam. You are permitted to have with you and to use during the examination your textbook, any class handout materials, your class notes, and any other written materials made by you (not photocopied from printed materials).

Please write legibly, DOUBLE SPACE, and on ONE side of a bluebook page only.

In answering these problems, do not begin with an elaborate discussion of the facts. Indeed, mere repetition of the facts without relevant legal doctrine will not get you any points at all. Neither, for that matter, will abstract discussion of legal doctrine that is not tied to the facts of the problems. Your analysis should weave relevant legal doctrine together with the facts to create a response that is directly relevant to what has been asked. A corollary is that you should be sure to read the questions in each problem carefully and answer those. Correct answers to questions that have not been asked will likely get you no points. On both Parts, your answers should be based solely on the reading assignments and our class discussion.

GOOD LUCK!
Problem 1

Subdivider S purchased in 1970 a 4-acre piece of land that, in 1980, remained undeveloped on the heavily forested outskirts of City. S divided this piece into four 1-acre lots, unimaginatively called Lots 1-4. He intended the lots to be used for large and expensive single-family residences, reserving Lot 4 for himself. In 1980 S sold Lot 1 to Purchaser 1 (P₁). The deed from S to P₁ contained the following language:

Purchaser [P₁] agrees that any structure built on the Property [i.e., Lot 1] will be suitable for and used only as a single-family residence with a minimum of 3,000 square feet of living space. Neither the Property nor any structure erected on the Property will be used for business or commercial operations. These restrictions are for the benefit of, and are hereby imposed on, each of the other lots now owned by Seller, namely [Lots 2, 3, & 4].

P₁ recorded the deed. Thereafter, S built a 3,500-square-foot house on Lot 4, which he used as his personal residence. In 1982, S sold Lot 2 to P₂ and Lot 3 to P₃, pursuant to general warranty deeds, and each deed was recorded. The price of each lot was $20,000. Neither deed made any mention of the restriction contained in the deed from S to P₁ nor did P₂ or P₃ have actual knowledge of the restriction. P₂ built a 4,000-square-foot house on Lot 2 and P₃ built a 5,000-square-foot house, with six bedrooms, on Lot 3. Both P₂ and P₃ used their respective houses as their personal residences. In 1990, P₃ sold his property to X, pursuant to general warranty deed. The sale price was $320,000. X had no actual knowledge of any restrictions on the property. X has used the property solely as her personal residence.

By 2001, the area around Lots 1-4 had developed into a popular vacation spot, with several large resort hotels not too far away and many parks and other outdoor recreation activities close by. Buyer B inquired of X whether Lot 4 was for sale. B’s intent was to use the property as an up-scale Bed and Breakfast establishment. B and X agreed on a price of $420,000 and executed a contract of sale. However, in searching the records before the closing, B decided to look at all deeds from S relating to properties in the neighborhood. B thus found the deed from S to P₁ and learned of the prohibition against using the property for commercial activities. B thereupon rescinded the sales contract with X (as permitted by the contract).

X brings an action to quiet title, naming S, P₁, and P₂ as defendants. She also sues P₃ and S for damages, claiming breach of the covenant against encumbrances and breach of the covenant of quiet enjoyment. (You may assume that both actions take place at the same time, before you as the judge.) The jurisdiction has a race-notice recording statute. The statute of limitations for breaches of a present covenant is 10 years, and the state indexes land records by grantor and grantee. As judge, with the above-stated facts proved, how do you decide these claims (including damages)?
Model Answer

There is an unfortunate typographical error in the problem statement. It says that B inquired of X whether Lot 4 was for sale, while X was the owner of Lot 3, not Lot 4. If we attempt to answer the problem as stated, assuming X and B were negotiating over Lot 4 rather than Lot 3, it becomes largely a nonproblem. X has agreed to sell a lot she did not own. Nothing in the facts indicates that X was under any misapprehension about her lot. She purchased Lot 3 from P, and has been living there. The owner of Lot 4 (S) has been continuously occupying that property, so no adverse possession issues arise. While B might have some sort of claim against X for the time and trouble caused by negotiating purchase of property knowingly not owned by the other side, the action we are asked to decide does not involve B as either a plaintiff or a defendant. X can claim no damages against P, or S for any loss due to the broken sale of property that X did not own. Such “sale,” had it gone through, would have been invalid. B could not acquire good title from X to Lot 4, because an investigation of the records shows S as the owner of that property, and X is nowhere in the chain of title. Anyone who made any of these observations got extra points, to compensate them for the time they could have spent solving the intended problem.

It appears that the majority of exam takers recognized the problem and simply treated it as an attempted sale of Lot 3, as intended. Most of the rest attempted to answer the problem both ways, recognizing that there was not much to say if Lot 4 was really the subject of the X-B negotiations. The issues involved in X’s quiet title suit are not in any event different from those had the typo not occurred. X is the owner of Lot 3 and seeks to be free of restriction established by the S-P deed. (Moreover, Lot 4 is also subject to the restriction. In this case, S had actual knowledge, and it would be a major issue whether S’s knowledge would be attributed to S’s hypothetical adverse possessor X. It gets even more complicated by X’s potential constructive notice of the restriction for Lot 3, because that investigation would have revealed the restrictions on Lot 4 as well. No answer got into any of this. It just shows how things can get out of hand when you start making major assumptions for which there is zero factual basis in the problem statement.) X’s claim for damages for breach of the covenant against encumbrances is also the same, because Lot 3 was encumbered by the restriction at the time of X’s acquisition. Even X’s claim for breach of the covenant of quiet enjoyment is nearly the same. The only difference is that there is no longer a constructive eviction issue based on the failed sale of the lot to B. From reading the answers, it does not appear to me that anyone was severely prejudiced by the error. This does not excuse making the error, for which I apologize. But it does mean that final grades will not be much, if at all, affected by its presence.
Preliminary Remark

Many student answers showed confusion between the result of finding constructive notice under the recording acts and a seller’s liability on warranties contained in the deed of sale. Constructive notice under the recording act means that a subsequent purchaser is bound by the recorded document. In this case, if X or P, had constructive notice of a valid restriction on use of Lot 3, they acquired Lot 3 subject to the restriction; that is, they are bound by it. This has nothing to do with whether the title subject to the restriction is or is not “marketable.” X must then lose his quiet title action to have the restriction removed as a cloud on his title. On the other hand, whether or not X had notice is generally irrelevant to an action on the warranties. If someone warrants that property is subject to no encumbrances at the time of delivery, constructive notice never relieves him of liability for breach. Even actual notice may not be sufficient to escape liability. Here, marketability may enter the analysis of determining whether something is or is not an “encumbrance” within the meaning of the warranty (although that was not an issue in the actual problem).

It is important not to mix these two issues up. The first one is involved in the quiet title action. The second one is involved in the breach of warranty actions. Probably half the answers conflated these two very separate issues.

The Quiet Title Action

X seeks to quiet title to Lot 3, that is, to have an order from this court, binding on the current owners of the other lots subject to the restrictive covenant at issue, that removes the cloud from X’s title arising from the restriction on the use of Lot 3 contained in the S-P, deed. Such an order would give X an unrestricted title in fee simple. The issue is whether X is bound by a covenant restriction contained in a deed from a prior common owner to a third party. The general rule is that contractual restrictions imposed on the use of land are enforceable against the parties to the contract and against subsequent purchasers from those parties who have knowledge, actual or constructive, of the restrictive covenant. In this case, neither P, nor X had actual knowledge of the restriction to noncommercial uses. Therefore, the restriction is binding on them only if they had constructive notice. The only way they could have constructive notice (there being no special facts to put them on inquiry notice) is whether the recorded deed from S to P, containing the restriction, is deemed to give them such notice.

The case of Guillette v. Daly Dry Wall (text p.699) is on point and holds that any recorded deed by a grantor in grantee’s chain of title is constructive notice of any restrictions placed on adjacent property during the time it was owned by the grantor. Although there are some distinctions between this case and Guillette, a general reading of it would require dismissal of X’s action. However, not all states follow the approach of Guillette. Indeed, the states appear
to be about equally divided (text p.701). The case of Luthi v. Evans (text p. 668) raises a similar issue and seems at least philosophically contrary. Luthi involved the issue of whether a prior grant that covered other property and failed to describe the property in question in other than general terms (“all S’s property in the county”) gave notice to a subsequent purchaser. The Luthi court said it did not. Here the prior grant covered other property (Lot 1) but expressly referred to the property in question (Lot 3). The search burden here is therefore easier than in Luthi even if this court were to hold that the prior deed gave constructive notice. Here it would mean only that a subsequent purchaser must look at all deeds from the seller to adjacent property owned by the seller concurrently with the property in question. An opposite result in Luthi would mean a search of all prior sales by seller to find a Mother Hubbard clause and then, if one is found, a search of what other property was owned by the seller (in the county, at least) at the time. Therefore, this court must consider which approach best comports with optimal the social policies underlying the recording statutes.

Our state uses a grantor/grantee method of indexing, as in Guillette. (However, the basic problem would not be different if our state indexed by tract name. The question remains, which tracts other than the one in question must be searched in seeking prior encumbrances?) In this case, X purchased from P
\textsubscript{3}, and a search of the grantee index would reveal that P
\textsubscript{3} purchased from S in 1982. A search of the grantee index under S’s name would have revealed the 1970 conveyance to S from S’s grantor of the 4-acre parcel that included what became Lots 1-4 in 1980. (We may assume that searches any further back than S’s grantor are irrelevant to this case, as here everyone concedes that S was the sole owner of the 4-acre parcel in 1980.) A 1990 search of the grantor index under S’s name from 1970 would have revealed the sale of Lot 1 to P
\textsubscript{1} in 1980 and the sale of Lots 2 and 3 to P
\textsubscript{2} and P
\textsubscript{3}, respectively, in 1982. (Similarly, a 1982 search by P
\textsubscript{3} with respect to Lot 3 would have revealed the 1980 sale of Lot 1 to P
\textsubscript{1}, and perhaps the 1982 sale of Lot 2 to P
\textsubscript{2}, depending on when in 1982 the sale and recording concerning Lot 2 actually took place. It makes no difference to the resolution of this case.) The question is whether P
\textsubscript{3} in 1982, and X in 1990, could reasonably be expected to look at deeds from earlier sales by S conveying property other than the property of interest but executed by S at a time that S did still own the property in question (Lot 3) and thereby possibly subjecting it to restrictions.

As mentioned above, the question has been resolved differently in roughly half the states of the United States, indicating that it is a close one. On the one hand, there is much to be said for X’s argument that, in searching title, a potential buyer should not have to look for grants from a given grantor earlier than the grant that shows up in the grantee index from that grantor. If the potential buyer finds no intervening recorded grant from that grantor covering the property of interest (Lot 3 in this case), he can be sure that he will be the first to record, and if he is a BFP, he will be safe. Requiring such a buyer to go back further in time places significant additional burdens on potential buyers, and increases the cost of title assurance.
On the other hand, consider the position of $P_1$ in this case. (We might be less concerned about $S$, because $S$ could have avoided all problems by inserting the restrictions into the deeds for Lots 2 and 3.) $P_1$ acquired Lot 1 along with the benefit of knowing that the other lots in his immediate neighborhood would be burdened by the same use restrictions as his. But if $P_3$ or $X$ are held not to have constructive notice from $P_1$'s recorded deed, how can $P_1$ insure that he will get the benefit of his bargain? Had $P_1$ been sophisticated, he could perhaps have insisted that, at the time of his deal, $S$ convey all the lots to a straw who would reconvey Lots 2, 3, & 4 to $S$, subject to the restriction, and Lot 1 to $P_1$, also subject to the restriction. That would have put the restriction into the direct chain of title for each lot. That, however, demands a good deal of formality and increases the costs of transactions, especially if many lots, rather than just four as is the case here, are involved. Here, the record gives no indication of what, if anything, $P_1$ has done with Lot 1, but that is not relevant to the quiet title action. $P_1$ acquired Lot 1 subject to a restrictive covenant on Lots 2-4 that were designed to benefit Lot 1. To deny enforceability of that covenant is to take away from $P_1$ some of the benefit of his bargain.

In this case, $X$ need only have gone back 10 years, and $P_3$ 2 years, to find the conveyance of Lot 1 by $S$ to $P_1$, and inspection of that deed would have revealed the restriction. That B found the restriction later shows, at a minimum, that it was not impossible. There were only three other lots that had to be checked. On the other hand, where subdivision involves many lots, careful inspection of many deeds, at first glance irrelevant to the transaction in question, would often be necessary to have complete assurance of unrestricted title. Moreover, this case is somewhat distinguishable from *Guillette*, in that *Guillette* involved a common plan for the subdivision that was referred to in all the deeds. While the plan did not itself refer to the restrictions at issue, purchasers were on notice that the property was, at one time, part of a single subdivision created under some sort of common plan. That alone would encourage the careful potential buyer to inquire further as to whether there were any restrictions contained in deeds to properties included in the subdivision. Here there was no reference to any common plan. While the question is a close one, this court follows the approach of *Luthi* and concludes that, in this jurisdiction, absent some additional indication that would encourage a cautious buyer to search further, a buyer need not search every deed contained in the records from a common grantor for restrictions on properties other than those conveyed in such deeds. Consequently, both $P_3$ and $X$ acquired Lot 3 without notice of the restriction, and $X$'s demand to quiet title will be granted, giving $X$ full fee ownership in Lot 3 without regard to the restrictive covenant.

*Breach of Warranties*

$X$ also seeks damages against $S$ and $P_3$ for breach of the covenant against encumbrances and breach of the covenant of quiet enjoyment contained in the general warranty deeds that $S$ used to convey to $P_3$ and $P_3$ used to convey to $X$. Our resolution of the previous issue means that the restriction of use was not enforceable against $X$ because of the recording statute, but that does
not dispose of the issue of whether the covenant against encumbrances was breached by the existence of the restriction. While our decision to grant X’s demand to quiet title removes the encumbrance as to Lot 3, the covenant against encumbrances is breached, if at all, at the time of the conveyance. If it was breached upon the conveyance from S to P₃, P₃ acquired a claim against S that was impliedly assigned to X upon transfer of Lot 3 to X, as is made clear by the Rockafellor case (text p.626). Moreover, if the encumbrance was breached again upon the sale by P₃ to X, X owns that claim directly. So, X has “standing” to bring a claim for breach of the covenant against encumbrances against both S and P₃. The problem, however, is that even if the covenant against encumbrances was breached in either or both cases, the statute of limitations began to run with each sale, and this action was not instituted until at least 11 years after the second such sale. Consequently, any claim that X might have had against either S or P₃ has expired. This obviates the need to discuss whether the restrictions, unenforceable against a BFP, were nevertheless “encumbrances” within the meaning of the covenant. That the issue is not free from doubt is made clear by what actually happened in this case: X had a valuable offer on her property that fell through because of the existence of the restriction, even though we have now decided that the restriction is not enforceable against X. We may leave this interesting issue for a case that raises it in the context of a real controversy.

The covenant of quiet enjoyment is another story. That covenant also runs to subsequent purchasers, so X may sue both S and P₃ for its breach. Here X claims that she was not able to “enjoy” her property, quietly or otherwise, to the extent of its highest use, because a desirable sale fell through due to the existence of the apparent restriction. But as Brown v. Lober (text p. 617) makes clear, the covenant of quiet enjoyment does not guarantee perfect title but rather possession and enjoyment of the premises. Here the only thing X did not enjoy was the ability to sell the premises for a potentially higher price than might otherwise have been available. X has not been evicted and has not been compelled to buy out a paramount claim. X did incur the costs of a quiet title action, but she has won that action, and the covenants do not provide an insurance policy against litigation. X has had unfettered use of the property and has not been stopped from using it in any way. (Had X personally attempted to open a bed and breakfast and been stopped by assertion of the covenant, the story would be different.) Consequently, X’s claim against both S and P₃ for breach of the covenant of quiet enjoyment is also dismissed.

For completeness, and in case this court is overruled by a higher court on the issues raised in the quiet title claim, let us now assume that the deed from S to P₃ did, in fact, constitute constructive notice to P₃ and to X of the restrictive covenant affecting Lot 3. That X and P₃ had constructive notice of the existence of the restriction does not mean that the covenant was not breached. So, there would have been a breach of the covenant against encumbrances at the time of each sale, but again, as above, the statute of limitations has run even as to the latter of those claims, namely, that of X against P₃. Consequently, X’s failure to check the records at the time
of her purchase or at any time during the first 10 years of her occupancy precludes her from asserting such a claim at this late date.

As for the covenant of quiet enjoyment, the analysis is perhaps slightly more complex. X finds herself owning property subject to a restriction against which her seller, P, and P’s seller, S, warranted. That warranty, however, was contained in the covenant of seisin and/or the covenant against encumbrances. As in Brown v. Lober, this court hesitates to convert the covenant of quiet enjoyment into a general insurance policy that would eliminate the distinction between the present and the future covenants. As of this trial, X has not had her occupancy interfered with. X has not tried to operate a bed and breakfast, or any other commercial establishment, and been blocked by her neighbors. While B refused to close the deal in view of the apparent encumbrance, and while other buyers likely will also not purchase with a view to commercial operation when they learn of the restriction (we are assuming now that the restriction is enforceable), X’s own enjoyment of the property remains unfettered. This covenant is not breached unless and until X attempts to use the property in some otherwise legal manner and finds herself stymied by assertion of the restriction. Consequently, X’s claim for breach of the covenant of quiet enjoyment is also denied.

Were we to have found liability for breach of either covenant, damages would have to be determined from the difference in value of the property with and without the restriction. For the covenant against encumbrances, in an action against P, these damages are appropriately measured on the date of X’s closing, because that is the date of the breach (if any). Consequently, B’s offer 11 years later to pay X some $100,000 more than X paid for Lot 3 (as improved) is of little relevance. It is likely that the property would have appreciated in the interim. Because both X and P thought they were dealing in unrestricted property, the 1990 sale price of $320,000 is probably a fair measure of its unrestricted value at that time. Expert witnesses, however, would likely be necessary to determine its value subject to the restriction. It seems plausible that X would have paid no less for Lot 3 had she known of the restriction, and maybe even more, if at the time the restriction was thought to maintain property values by assuring a united front against commercial development. An alternative measure of damages might be to attempt to find out how much it would have cost X at that time to buy her way out of the restrictive covenant, that is, how much would S, P, and P have demanded to release Lot 3 from the restriction? If that amount is lower than the difference in value, it seems appropriate to use it for X’s measure of damages. Similar considerations would be applied to X’s hypothetical claim for breach of this covenant against S, which claim was “assigned” to X upon X’s acquisition of the property. However, it seems likely that the difference between unrestricted fair market value and the $20,000 price paid by P would likely be less than in X’s action directly against P. Moreover, damages could not exceed the $20,000 sale price S received from P.
If the covenant of quiet enjoyment had been breached, X’s damages flow from her inability to “enjoy” the property to the extent of selling it for its full unrestricted fair market value. B was willing to pay $420,000 for unrestricted property but cancelled the deal when learning of the restriction. That is some evidence, although not conclusive, that X has been damaged to the tune of the difference between $420,000 and the value of the property subject to the restriction. Again, an alternative measure of damages might be the amount it would have cost X to buy a release from the restriction. In an action against S for breach of the future covenant, damages would be measured in the same way, but they would be limited by the $20,000 sale price S received from P.