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Preface

Since 1977, CEB's title, *California Breach of Contract Remedies*, has provided advice and guidance for California attorneys handling breach of contract matters. Yet CEB believed that there was a need for a more comprehensive practical guide to modern California contract law for California attorneys, and that CEB's older title should be incorporated in a more extensive and up-to-date work. This new title, *California Law of Contracts*, now supersedes and replaces *California Breach of Contract Remedies* in its entirety.

California Law of Contracts is intended to serve as an essential reference for business lawyers seeking to assure that their contracts are fully enforceable and for litigators seeking to challenge or defend enforceability. It is intended to provide a clear and concise, yet thorough, treatment of all aspects of California contract law—from contract formation and interpretation, to performance and remedies for nonperformance. It integrates discussion of current California case law with relevant Civil Code and other California code provisions, including the Uniform Commercial Code. Its looseleaf format will allow incorporation of updates into the text, eliminating the need for separate supplements, and its convenient chapter outlines and index should enable the reader to quickly locate topics of interest. A fresh and up-to-date alternative, California Law of Contracts brings coverage of this essential legal subject in line with modern needs and practices.

CEB gratefully acknowledges the work of the lead authors of this book, George W. Kuney and Donna C. Looper, each of the University of Tennessee School of Law, Knoxville, and both practicing California lawyers. Each of the authors gave generously of his or her knowledge and specialized skills. See About the Authors on the following pages for biographical information.

CEB Publications Attorney Suzanne L. Weakley and Legal Editors Jean Magistrale, Sally St. Lawrence, Christopher Dow, and Alice Kostin contributed to this title. Administrative support was provided by Debby Harrison. The book was designed by Grier Thornburg. Richard Dempewolf copyedited this book and supervised production. The index was prepared by Robert Burke. Composition was performed by CEB's Electronic Publishing staff.

April 2010 Update

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- Marla A. Hoehn and Carrie M. LeRoy, of Pillsbury Winthrop LLP, Palo Alto. Selected material from their article, *Website User Agreements*: *Electronic Contracting Issues and Tips for Drafting*, 18 CEB Cal Bus L Prac 10 (Winter 2003), was used in preparation of the discussion of electronic contracting in Chapter 4 of this title.
- Jason L. Hoffman of Nemecek & Cole, Sherman Oaks. Selected material from his article, *Attorney Fee Clauses in California Contracts*, 21 CEB Cal Bus L Prac 82 (Summer 2006), was used in preparation of the discussion of attorney fees in Chapter 9 of this title.
- Palmer Brown Madden of ADR Services, Alamo. Selected material from his chapter on Dispute Resolution Procedures in *Drafting Business Contracts: Principles, Techniques & Forms* (Cal CEB 1994) was used in preparation of the discussion of arbitration and mediation in Chapter 9 of this title.

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Selected Developments

April 2010 Update

Plaintiffs exposed to long-term tobacco company advertising were not required "to demonstrate individualized reliance on specific misrepresentations to satisfy the reliance requirement." *In re Tobacco II Cases* (2009) 46 C4th 298, 327, 93 CR3d 559. See §3.15.

A contract for the sale of property that allowed plaintiff to waive the filing of a final map violated the Subdivision Map Act (Govt C §§66410-66499.37). See §3.37.

In *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 181, 90 CR3d 818, the court held unenforceable an arbitration agreement containing an arbitrator selection clause that designated a "panel" of arbitrators that in fact comprised only one arbitrator selected by the employer. See §3.38.

An arbitration clause beginning "I agree" did not render the provision illusory for lack of mutuality because the arbitration clause expressly covered all disputes. *Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153. See §3.48.

Disputes arising after a contract is formed should not be construed as evidence that no agreement was reached. *Patel v Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366. See §4.48.

In May 2009, the American Law Institute approved the Proposed Final Draft of its "Principles of Software Contracts," the purpose of which is to "guide courts in deciding disputes involving transactions in software and to guide those drafting software contracts." See §4.62A.

In ruling on the validity of a browse-wrap agreement, courts consider primarily "whether a website user has actual or constructive knowledge of a site's terms and conditions prior to using the site." *Hines v Overstock.com, Inc.* (ED NY, Sept. 8, 2009, No. 09 CV 991) 2009 US Dist Lexis 81204. See §4.66.

The court in *Starlight Ridge S. Homeowners Ass'n v Hunter-Bloor* (2009) 177 CA4th 440, 447, 99 CR3d 20, applying CCP §1859 to the interpretation of CC&Rs, addressed a dispute in which the parties—the homeowners association and the homeowner—identified different provisions as being more specific. See §5.18.

In *DVD Copy Control Ass'n v Kaleidescape, Inc.* (2009) 176 CA4th 697, 97 CR3d 856, the court defined when the terms of an extrinsic document may be incorporated by reference into a contract. See §5.37.

Finding unequal bargaining power, a court held procedurally unconscionable a dispute resolution policy distributed to low-wage employees that required arbitration. The court further held a class action waiver in the agreement substantively unconscionable because only the employees—not the employer—would be affected. *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65. See §§5.76-5.78.

Plaintiffs may not recover for prospective violations of the Consumers Legal Remedies Act. *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 88 CR3d 859. See §6.23.

Prejudgment interest under CC §3287(a) is available for violations of the Song-Beverly Consumer Warranty Act. *Doppes v Bentley Motors, Inc.* (2009) 174 CA4th 1004, 1006, 94 CR3d 797. See §6.24.

The court in *Bosetti v United States Life Ins. Co.* (2009) 175 CA4th 1208, 96 CR3d 744, disagreed with *Brehm v 21st Century Ins. Co.* (2008) 166 CA4th 1225, 83 CR3d 410, to the extent the *Brehm* court intended to hold that there is a distinct subjective good faith requirement to the genuine dispute doctrine. See §6.37.

An insurer's failure to disclose an applicable insurance policy pursuant to 10 Cal Code Regs §2695.4(a) may support an inference of lack of reasonableness. *Safeco Ins. Co. v Parks* (2009) 170 CA4th 992, 88 CR3d 730. See §6.37.

A defendant in equitable indemnity action may utilize "whatever immunities or other limitations on liability would otherwise be available against the injured party." *Prince v PG&E* (2009) 45 C4th 1151, 1161, 90 CR3d 721. See §6.58.

In *Peak-Las Positas Partners v Bollag* (2009) 172 CA4th 101, 90 CR3d 775, the court held that the seller's refusal to extend escrow when the buyer had paid most of the purchase price and incurred $5 million in costs to obtain a lot line adjustment violated the covenant of good faith and fair dealing. See §7.23.

Commercial Code §9408 applies to structured settlement payments because they are considered general intangibles. *321 Henderson Receivables Origination, Inc. v Sioteco* (2009) 173 CA4th 1059, 1060, 93 CR3d 321. See §7.25.

In *Tin Tin Corp. v Pacific Rim Park, LLC* (2009) 170 CA4th 1220, 1234, 88 CR3d 816, the court found it unreasonable for a party to assume it could delay onset of statute of limitations indefinitely by agreeing to wait for other party to perform. See §9.2.

California courts will generally enforce a foreign judgment that contains attorney fees. *Java Oil, Ltd. v Sullivan* (2008) 168 CA4th 1178, 86 CR3d 177. See §9.12.

For purposes of CC §1717, courts construe the term "on a contract" to apply to any action that involves a contract. *Turner v Schultz* (2009) 175 CA4th 974, 979, 96 CR3d 659. See §9.13.

The Federal Arbitration Act is not an independent source of federal court jurisdiction. *Vaden v Discover Bank* (2009) __ US __, 173 L Ed 2d 206, 219, 129 S Ct 1262. See §9.39.

Where an arbitration agreement in a contract not involving interstate commerce provided that "Interpretation of this agreement shall be governed by the Federal Arbitration Act," the court interpreted this to mean that the parties had not intended to contract for more expansive judicial review. *Christensen v Smith* (2009) 171 CA4th 931, 937, 90 CR3d 57. See §§9.40, 9.52.

The Supreme Court held that a collective bargaining agreement that required union members to arbitrate a claim under the Age Discrimination in Employment Act (29 USC §§621-634) was enforceable. *14 Penn Plaza LLC v Pyett* (2009) __US __, 173 L Ed 2d 398, 129 S Ct 1456. See §9.47.

In *D.C. v Harvard-Westlake Sch.* (2009) 176 CA4th 836, 98 CR3d 300, the court applied *Armendariz* to claims involving California hate crime laws, which allow attorney fees to be awarded only to plaintiffs, and invalidated a fee award to the defendant. See §9.47.

The Mandatory Fee Arbitration Act (Bus & P C §§6200-6206) did not impliedly repeal the California Arbitration Act (CCP §§1280-1294.2). *Schatz v Allen, Matkins, Leck, Gamble & Mallory* (2009) 45 C4th 557, 87 CR 700. See §9.49.

In *Goldman v KPMG, LLP* (2009) 173 CA4th 209, 92 CR3d 534, a suit involving fraudulent tax shelter schemes, the court held that defendant accountants and lawyers who were nonsignatories to operating agreements containing arbitration clauses could not compel arbitration based on an equitable estoppel theory. See §9.50.

An arbitrator exceeded his authority where he attempted to bind a trademark licensee's nonparty relatives and ex-spouses to the award and enjoin them from owning or operating comedy clubs. *Comedy Club, Inc. v Al Copeland Invs. Inc.* (9th Cir 2009) 553 F3d 1277. See §9.51.

A plaintiff who had suffered an increased risk of identity theft could not recover for breach of contract because his identity had not been stolen; an increased risk of identity theft was not "appreciable and actual damage." *Ruiz v Gap, Inc.* (ND Cal 2009) 622 F Supp 2d 908. See §10.10.

When the contract provides for the payment of interest, prevailing parties "need not resort to [CC §3287(a)] to obtain prejudgment interest." *Roodenburg v Pavestone Co.* (2009) 171 CA4th 185, 192, 197 CR3d 348. See §10.23.

The court in *Brewer v Premier Golf Props., LP* (2009) 168 CA4th 1243, 1256, 86 CR3d 225, held that punitive damages were not available for violations of Labor Code provisions governing meal and rest breaks, minimum wage, and pay stubs. See §10.36.

In *Fairbanks v Superior Court* (2009) 46 C4th 56, 92 CR3d 279, the court held that life insurance is neither a good nor a service under the Consumers Legal Remedies Act. See §10.52.

If resolution of a controversy over future remedies would have little practical effect on the parties' behavior, the court may deny declaratory relief because it "is not necessary or proper at the time." *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 647, 88 CR3d 859. See §11.43.

In *Troyk v Farmers Group, Inc.* (2008) 171 CA4th 1305, 1338, 90 CR3d 589, the court found that if the defendant insurance exchange and subsidiaries of the attorney-in-fact were acting as a single enterprise, the defendant could be liable under Bus & P C §17203 for restitution of service charges paid in violation of Ins C §381, even though the defendant did not directly receive the service charges. See §11.70.

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Introduction

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§1.1 I. SCOPE OF TREATISE

This treatise is intended to provide a summary of modern California contract law, as reflected in the Civil Code, relevant portions of the Commercial Code, and recent case law. It is intended to serve as a basic resource for attorneys and other legal professionals seeking to understand contract law principles as expressed in California jurisprudence today. It is hoped that litigators seeking relevant citations to the current California law of contracts for memorandums of points and authorities and appellate briefs will find this book especially useful. Readers should note that this title is not a guide to contract drafting. The book presents examples of typical contract clauses in its discussion of topics such as the enforceability of attorney fee clauses, but readers desiring a comprehensive introduction to the principles of contract drafting should consult Drafting Business Contracts: Principles, Techniques & Forms (Cal CEB 1994).

There are thousands of published California contract law decisions. This book cannot, and does not attempt to, furnish citations to all case decisions potentially relevant to particular topics, but, through annual updating, this book will attempt to enable readers to stay abreast of the most current judicial as well as statutory developments in this broad field.

Contract law forms an essential part of the foundation of many more specialized areas of California law, including real estate, insurance, construction law, health care, banking, employment law, and family law. This book does not cover the more specialized aspects of these areas of law, many of which are governed by California Codes other than the Civil Code. Counsel advising clients in the following areas should consult these more specialized CEB practice guides:

- For real estate matters, California Landlord-Tenant Practice (2d ed Cal CEB 1997); California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009); California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000); California Real Property Remedies and Damages (2d ed Cal CEB 2002); California Real Property Sales Transactions (4th ed Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease (Cal CEB 1996); and Retail Leasing: Drafting and Negotiating the Lease (Cal CEB 2007);
- For construction contracts, California Construction Contracts, Defects, and Litigation (Cal CEB 2008);
- For insurance matters, California Liability Insurance Practice: Claims & Litigation (Cal CEB 1991);
- For employment contracts, Advising California Employers and Employees (Cal CEB 2005); and
- For agreements in the context of family relations, California Marital Settlement and Other Family Law Agreements (3d ed Cal CEB 2005).

Further, the Civil Code itself includes detailed statutory requirements for contracts utilized in many different types of California businesses, which are beyond the scope of this treatise. Most, although not all, of these types of contracts involve consumer transactions. For a list, with citations to applicable Civil Code sections, see §6.39.

This book addresses contracts for the sale or lease of goods subject to Divisions 2 and 10 of the Commercial Code in the context of its discussion of basic contract law principles, such as contract formation, contract interpretation, and remedies for breach of contract. For a more comprehensive treatment of contracts subject to Divisions 2 and 10 of the Commercial Code, readers should consult California UCC Sales and Leases (Cal CEB 2002).

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Source: Business Law/California Law of Contracts/1 Introduction/§1.2 II. SUMMARY OF CHAPTER CONTENTS

§1.2 II. SUMMARY OF CHAPTER CONTENTS

Following are highlights of the coverage of the substantive chapters of this book.

Chapter 2, Contract Formation: Capacity to Contract. Chapter 2 addresses the first element necessary to contract formation: parties capable of contracting. See CC §1550. Topics include the capacity of minors—what contracts a minor cannot make, what contracts a minor may disaffirm, and what contracts are binding on minors—and the capacity of mentally incapacitated persons, of prisoners, and of other persons deprived of civil rights. Chapter 2 also discusses the authority of agents to make contracts on behalf of a principal, powers of attorney, and the authority of entities to contract, including corporations, general and limited partnerships, limited liability companies, trusts, and municipalities.

Chapter 3, Contract Formation: Consent, Legality, Consideration. Chapter 3 addresses the other three elements necessary to contract formation: mutual consent, legality, and consideration. See CC §1550. Topics include fraud in the execution, communication of consent, and factors that vitiate consent (duress, menace, fraud in the inducement, actual and constructive fraud, undue influence, mistake of fact, and mistake of law). This chapter also reviews various types of fiduciary and confidential relationships where undue influence may be present. Finally, it covers illegal contracts and consideration (including the preexisting duty rule, moral obligations, unilateral contracts, and promissory estoppel).

Chapter 4, Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting. Chapter 4 discusses the two aspects of mutual consent: offer and acceptance, including revocable and irrevocable offers, agreements to agree, the mirror image rule, counteroffers, communication of acceptance, the mailbox rule, acceptance by conduct (including silence), implied-in-fact contracts, and rejection of offers. Chapter 4 also covers formation of contracts for the sale or lease of goods under the Commercial Code and contract formalities, including signatures, the statute of frauds, and electronic contracting.

Chapter 5, Contract Interpretation, Modification, Waiver. Chapter 5 reviews the Civil Code and Code of Civil Procedure rules of contract interpretation, the parol evidence rule, and the enforceability of choice-of-forum and choice-of-law clauses. It also addresses the Commercial Code rules of contract interpretation, including the concepts of course of dealing, usage of trade, and course of performance, and the gap-filling rules. Chapter 5 also covers severability of unenforceable contract terms, adhesion contracts, the doctrine of unconscionability, foreign language translations, contract modifications, waivers, novations, releases, settlement agreements, and CCP §998 offers to compromise.

Chapter 6, Representations, Warranties, Covenants, Conditions, Indemnities. Chapter 6 addresses representations, contractual warranties, Commercial Code warranties, consumer protection warranties, covenants (including the implied covenant of good faith and fair dealing and covenants not to compete), and conditions (including express or implied conditions; conditions precedent, concurrent, and subsequent; the condition of "satisfaction"; the condition of "no material adverse change"; and waiver and excuse of conditions). This chapter also discusses indemnity agreements under the Civil Code.

Chapter 7, Assignment and Delegation, Third Party Beneficiaries, Joint and Several Obligations. Chapter 7 covers the principles of assignment and delegation, including assignments of payment rights and their relationship to the UCC, assumption of obligations, "successors and assigns" clauses, contractual and legal restrictions on assignments, and assignments for the benefit of creditors. The chapter also covers assignment and delegation of contracts for the sale or lease of goods subject to the Commercial Code. Finally, Chapter 7 discusses third party beneficiaries (including creditor and donee beneficiaries, and intended and incidental beneficiaries) and joint and several contractual obligations.

Chapter 8, Performance or Breach of Contract. Chapter 8 addresses performance of contracts under the Civil Code, including full or partial performance, time for performance, "time of the essence" clauses, offers of performance, and when performance is excused (including force majeure events, impossibility, impracticability, frustration of purpose, accord and satisfaction, novation, and release). This chapter also discusses performance of contracts for the sale or lease of goods under the Commercial Code. Finally, the chapter addresses breach of contract, including the elements of a cause of action for breach, the concepts of material and immaterial breach, and anticipatory repudiation.

Chapter 9, Selected Enforcement Issues. Chapter 9 discusses a number of special issues that may arise in connection with a contract dispute, including statutes of limitation, jurisdiction, venue, recovery of attorney fees

(including the determination of "prevailing party"), predispute waivers of the right to a jury trial, arbitration and mediation of contract disputes, and election of judicial remedies.

Chapter 10, Remedies: Damages. Chapter 10 addresses recovery of damages for breach of contract under the Civil Code, including the requirements of foreseeability, reasonableness, reasonable certainty, the rule against windfalls, general and special damages, nominal damages, mitigation of damages, specific items recoverable (including lost profits, interest, reliance damages, and tort damages). The chapter also covers liquidated damages, punitive or exemplary damages, and the Consumers Legal Remedies Act.

Chapter 11, Remedies: Injunctive and Declaratory Relief; Other Remedies. Chapter 11 covers injunctive relief generally, including preventive relief and when specific performance is available. The chapter also addresses declaratory relief, rescission, cancellation, abandonment, reformation, lost or destroyed documents, quasi-contract, and restitution.

Chapter 12, Remedies: Commercial Code. Chapter 12 reviews prelitigation and litigation remedies for breach of contracts for the sale of goods, including seller's remedies (withholding delivery, refusing delivery, stopping delivery, reclamation of goods, identifying goods to the contract, reselling goods, canceling the contract) and buyer's remedies (rejecting goods, revoking acceptance, covering, canceling the contract). The chapter discusses damages, consequential damages, specific performance, and restriction, qualification, and enlargement of remedies. Chapter 12 also discusses remedies for breach of personal property leases.

Chapter 13, Selected International Issues. Chapter 13 reviews the United Nations Convention on Contracts for the International Sale of Goods, promulgated by the United Nations Commission on International Trade Law, and the UNIDROIT Principles of International Commercial Contracts 2004, promulgated by the International Institute for the Unification of Private Law.

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III. NATURE OF CONTRACT

§1.3 A. Definition of "Contract"

The California Supreme Court in *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 992, 22 CR3d 352, explained the contractual relationship as follows:

> [W]hen two parties make a contract, they agree upon the rules and regulations which will govern their relationship; the risks inherent in the agreement and the likelihood of its breach. The parties to the contract in essence create a mini-universe for themselves, in which each voluntarily chooses his contracting partner, each trusts the other's willingness to keep his word and honor his commitments, and in which they define their respective obligations, rewards and risks.

See also *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 517, 28 CR2d 475. The Restatement (Second) of Contracts §1 (1981) defines a "contract" as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." A contract therefore represents a legal conclusion that arises from a set of facts and circumstances; it is not itself a matter of fact. This distinction is clearly reflected in the Commercial Code: Com C §1201(b)(12) (former Com C §1201(11)) defines "contract" (as distinguished from "agreement") as "the total legal obligation that results from the parties' agreement as determined by this code and as supplemented by any other applicable law," while Com C §1201(b)(3) (former Com C §1201(3)) defines "agreement" (as distinguished from "contract") as "the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade as provided in Section 1303." The Civil Code definition is not as clear. It equates the terms "contract" and "agreement." See CC §1549 ("A contract is an agreement to do or not to do a certain thing"). In drafting opinions, most California courts do not distinguish between the terms "contract" and "agreement," and this book likewise uses the terms interchangeably.

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§1.4 B. Freedom of Contract and Its Limits

Freedom of contract has been characterized as an "ancient concept." *Net2Phone, Inc. v Superior Court* (2003) 109 CA4th 583, 588, 135 CR2d 149. As the federal district court in *Adobe Sys. v Stargate Software, Inc.* (ND Cal 2002) 216 F Supp 2d 1051, 1059 (citations omitted), observed:

> Fundamental to any free society is the liberty of its members to formulate contracts in accordance with the terms that they agree and consent to mutually execute. The right to contract freely with the expectation that the contract shall endure according to its terms is as fundamental to the society as the right to write and to speak without restraint.

Freedom of contract is an important public policy of the State of California, particularly in the context of commercial agreements. See *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 363, 6 CR2d 467. In *Carma Developers,* the California Supreme Court found that the strong public policy favoring freedom of contract in commercial leasing transactions outweighed any marginal restraint on alienation represented by lease provisions prohibiting the lessee from assigning or subletting without the lessor's consent and giving the lessor the right to terminate the lease and recapture rent on notice by the lessee of its intent to sublet or assign.

California courts do not, however, "uncritically endorse unregulated freedom of contract." *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 965, 32 CR3d 5. The courts recognize that in many contexts, the legislature has determined that there are other public policy considerations that override the value of freedom of contract, and in such cases the courts will acknowledge and enforce that legislative policy determination. *William R. Clarke Corp. v Safeco Ins. Co.* (1997) 15 C4th 882, 891, 64 CR2d 578. The right to contract is "subordinate to the exercise of the police power by the state for the public welfare." *Hess Collection Winery v Agricultural Labor Relations Bd.* (2006) 140 CA4th 1584, 1599, 45 CR3d 609, citing *Nebbia v New York* (1934) 291 US 502, 523, 78 L Ed 940, 948, 54 S Ct 505. Even in the absence of express legislative directives, the courts will apply doctrines such as unconscionability or the implied covenant of good faith and fair dealing to prevent overreaching or exploitation by one party in the name of freedom of contract. See, *e.g., Ilkhchooyi v Best* (1995) 37 CA4th 395, 411, 45 CR2d 766.

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Source: Business Law/California Law of Contracts/1 Introduction/§1.5 C. Boundaries of Contract Law: Transactions Excluded and Included

§1.5 C. Boundaries of Contract Law: Transactions Excluded and Included

Contract law does not govern all consensual transactions between individuals or entities. Examples of noncontractual transactions include wills (governed by Prob C §§6100-6390) and gifts (governed by CC §§1146-1148 and Prob C §§5700-5705). Further, letters of credit are considered "undertakings," subject to Division 5 of the Commercial Code but not governed by contract principles. *San Diego Gas & Elec. Co. v Bank Leumi* (1996) 42 CA4th 928, 933, 50 CR2d 20.

In contrast, a number of transactions that one might not initially consider as governed by the law of contracts have been recognized as such. These include:

- Constitutions and bylaws of unincorporated associations, which define the relationship of the association with its members. See *Jost v Communications Workers of Am.* (1970) 13 CA3d Supp 7, 10, 91 CR 722; *Bernstein v Alameda-Contra Costa Med. Ass'n* (1956) 139 CA2d 241, 247, 293 P2d 862.
- Articles of incorporation, by-laws, and other corporate documents, which define the contract between a corporation and its shareholders, subject to the Corporations Code. See *Hard v California State Employees' Ass'n* (2002) 96 CA4th 708, 117 CR2d 615.
- Organizational documents of partnerships and limited liability companies, which define the relationship between the entity and its partners or members, also subject to applicable provisions of the Corporations Code. See, *e.g., Heller v Pillsbury, Madison & Sutro* (1996) 50 CA4th 1367, 58 CR2d 336.
- Catalogs, bulletins, circulars, regulations, and statements on websites of colleges and universities, which are part of a contract between the institution and its students. *Kashmiri v Regents of Univ. of Cal.* (2007) 156 CA4th 809, 67 CR3d 635 (public university breached terms of implied contract formed when students accepted offer of enrollment); *Zumbrun v University of S. Cal.* (1972) 25 CA3d 1, 10, 101 CR 499 (private college bound by statement in catalog).
- Unconfirmed arbitration awards, which can be enforced as contracts between the parties, even after the time for their confirmation in a court judgment has elapsed. See CCP §1287.6; *Doyle v Giuliucci* (1965) 62 C2d 606, 43 CR 697; *Thibodeau v Crum* (1992) 4 CA4th 749, 6 CR2d 27.
- Prenuptial and postnuptial agreements, subject to the Family Code. See *Marriage of Shaban* (2001) 88 CA4th 398, 105 CR2d 863.
- Promissory notes, subject to Division 3 of the Commercial Code. See *Law Offices of Dixon R. Howell v Valley* (2005) 129 CA4th 1076, 1085, 29 CR3d 499.
- Deeds of trust, which constitute a contract between the trustor and the beneficiary, with the trustee acting as agent for both in accordance with the terms of the instrument and their instructions, subject to other applicable law. *Hatch v Collins* (1990) 225 CA3d 1104, 1111, 275 CR 476. A standard form deed of trust furnished by a bank or other financial institution is generally considered a contract of adhesion under California law. *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1445, 1 CR3d 162.
- Guaranties, surety bonds, and other suretyship obligations are subject to the same rules that govern interpretation and enforcement of other types of contracts and are generally enforceable as contracts, subject to other applicable law (such as the California antideficiency legislation). See *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 39, 86 CR2d 855; *First Nat'l Ins. Co. v Cam Painting, Inc.* (2009) 173 CA4th 1355, 93 CR3d 808.
- Insurance policies, subject to the Insurance Code. *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 96 CR3d 316; *National Cas. Co. v Sovereign Gen. Ins. Servs., Inc.* (2006) 137 CA4th 812, 40 CR3d 591.
- Plea agreements in criminal cases. *People v Gipson* (2004) 117 CA4th 1065, 12 CR3d 478.
- Listing agreements under CC §1086. *McAvoy v Hilbert* (2009) 172 CA4th 707, 91 CR3d 437.

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IV. SOURCES OF LAW

§1.6 A. Civil Code: Its Origins and Relative Importance

In the latter part of the 19th century, California witnessed a state-wide bipartisan, progressive movement in support of legal reform and codification, and in 1872 the state became one of the first in the nation to codify its statutory and common law rules. The common law of contract formed a part of this codification, and was included in the Civil Code. The codification did not, as it might have, replace the common law with a code designated as the sole or ultimate source of law for the state. Instead, the codification was intended to be a declaration and restatement of common law rules as they existed in 1872, to be interpreted using common law precedent and customs. See generally Grossman, *Codification and the California Mentality*, 45 Hastings L J 617 (1994). This legislative purpose is reflected in CC §4, which provides in part that "[t]he [civil] code establishes the law of this state respecting the subjects to which it relates, and its provisions are to be liberally construed with a view to effect its objects and to promote justice," and CC §5, which provides that "[t]he provisions of this Code, so far as they are substantially the same as existing statutes or the common law, must be construed as continuations thereof, and not as new enactments." In *Morris v Oney* (1963) 217 CA2d 864, 870, 32 CR 88, the court explained:

> The Civil Code was not designed to embody the whole law of private and civil relations, rights, and duties; it is incomplete and partial; and except in those instances where its language clearly and unequivocally discloses an intention to depart from, alter, or abrogate the common-law rule concerning a particular subject matter, a section of the code purporting to embody such doctrine or rule will be construed in the light of common-law decisions on the same subject.

The courts remain free to embellish, and have since embellished, the codification of California law through the process of judicial interpretation and issuance of precedential opinions. The state legislature also has continued to amend the California Codes in reaction to constituent needs or in response to what it deems to be judicial mistakes. The Civil Code therefore constitutes the basic framework, and California court decisions the essential fabric, of California contract law. The discussion of California contract law topics in this treatise is organized accordingly.

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§1.7 B. Commercial Code

Contracts for the sale of goods are governed by Division 2 of the Commercial Code (Com C §§2101-2801). Leases of goods are governed by Division 10 of the Commercial Code (Com C §§10101-10600), whether the leases are categorized as "true leases" or "financing leases." Com C §10102. The term "goods" is defined as all things that are movable at the time of identification to the contract for sale—other than money used as the purchase price, investment securities, and claims (choses in action). The term specifically includes specially manufactured goods, the unborn young of animals, minerals or fixtures if the contract provides for the seller to sever the items from the real property involved and thus make them movable, growing crops, and other items attached to real property but capable of severance without material harm to the real estate. Conversely, the term "goods" does not include real property, money (unless money is being sold, as in foreign currency exchanges), investment securities (covered by Division 8), or choses in action (also known as claims or causes of action). Com C §§2105(1), 2107. Further, Division 2 does not apply to a transaction involving goods that is intended only as a security transaction. Com C §2102. Secured transactions are governed by Division 9 (Com C §§9101-9629).

If a sale or lease transaction includes both goods and services, the courts look to the main features of the transaction to determine whether the goods predominate, in which case the Commercial Code applies; otherwise, the transaction is governed by other law. California UCC Sales and Leases §§1.9-1.10 (Cal CEB 2002).

Unless expressly displaced or preempted by the Commercial Code, other sources of law supplement the Commercial Code in regard to the transactions to which it applies. Com C §1103(b).

NOTE: The National Conference of Commissioners on Uniform State Laws (NCCUSL) amended UCC Article 2 in 2003, although neither California nor any other state has yet adopted the revised version. Some sections of Article 2 and the official comments interpreting them underwent minor or no revisions; others were completely rewritten. As a result, references in this book to the official comments give citations to both the pre-2003 Article 2 comments and the revised Article 2 comments. Both versions of Article 2 are available from Lexis and Westlaw online. See also the NCCUSL website for information on ordering an official version of the revised act, which is subject to copyright protection.

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§1.8 C. Other California Codes

In addition to commercial law, many other specialized areas of California law, such as insurance, construction law, health care, banking, employment law, trust law, and family law, are governed by California Codes other than the Civil Code. Although contracts in these disciplines are also subject to general principles of contract law as embodied in the Civil Code and relevant case decisions, more specific statutes in other applicable Codes will control in the event of an irreconcilable conflict. See *Pacific Lumber Co. v State Water Resources Control Bd.* (2006) 37 C4th 921, 942, 38 CR3d 220. As noted in §1.1, this treatise does not attempt to address the more specialized aspects of contracts in these disciplines.

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§1.9 D. Decisions of California State Courts

Along with the Civil Code, published decisions of California state courts are the primary source of contract law in this state. All inferior state courts in California are bound to follow decisions of the California Supreme Court, and all state trial courts are bound to follow the decisions of any court of appeal in the state if there is no split of authority between the administrative districts of the court of appeal. *Auto Equity Sales, Inc. v Superior Court* (1962) 57 C2d 450, 455, 20 CR 321. In this respect, the system of case precedent in California differs from the federal system, which subdivides the United States into 13 judicial circuits under the United States Supreme Court. Within each federal circuit, federal district courts are required to follow decisions of the United States Court of Appeals in that circuit, and precedent is (at least theoretically) uniform. California's judicial system is based on a single statewide court of appeal, subdivided into six administrative districts. From the perspective of a trial court in California, in the absence of a split of authority, all court of appeal opinions are controlling, whether or not they are issued by the court of appeal in the same district as the trial court. If there is more than one court of appeal decision and the decisions are in conflict, the trial court must make a choice between the conflicting decisions. 57 C2d at 455. Further, the courts of appeal are not bound to follow the decisions of courts of appeal in other districts, or even decisions of other divisions within their own district. *McCallum v McCallum* (1987) 190 CA3d 308, 315, 235 CR 396.

The California Supreme Court often looks to well-reasoned decisions of the state courts of appeal for persuasive authority, but the court is, of course, not bound to follow a decision of any court of appeal and will not rely on court of appeal decisions if called on to determine in the first instance whether those decisions were correct. See *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 963, 32 CR3d 5; *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 689 n28, 254 CR 211.

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§1.10 E. Federal and Out-of-State Decisions

Except in specialized fields (such as government contracts, antitrust, banking, consumer transactions, or bankruptcy) that Congress has determined to regulate by federal legislation enacted under the Commerce Clause (US Const art I, §8, cl 3) or other provisions of the U.S. Constitution, there is no supervening federal law of contracts. See *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 432, 38 CR2d 521. As the Ninth Circuit has admitted, "[s]tate law controls both the construction of the contract and the question of breach." *Sulmeyer v Sycamore Inv. Co. (In re Aslan)* (9th Cir 1990) 909 F2d 367, 369. See also *Ingle v Circuit City Stores, Inc.* (9th Cir 2003) 328 F3d 1165, 1170. Accordingly, California courts may view federal precedent as persuasive authority in the absence of state law on a particular point, but if there is an existing body of California law, either statutory or based on the state's common law tradition, California courts will rely on California law in their analysis. *Anderson v Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1476, 66 CR2d 512. Similarly, California courts are not bound by, and generally will not rely on, decisions of courts of other states, even if those decisions represent a majority of other jurisdictions. *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 962, 32 CR3d 5. Because there are thousands of California state court decisions on contract law, there is usually no need to look beyond the state's borders for applicable precedent.

If there is no California case directly on point, however, California courts may find out-of-state decisions involving similar statutes and similar factual situations of great value. *Martinez v Enterprise Rent-a-Car Co.* (2004) 119 CA4th 46, 55, 13 CR3d 857. Out-of-state decisions may be especially persuasive if they relate to interpretation and application of the Uniform Commercial Code. See *Oswald Machine & Equip., Inc. v Yip* (1992) 10 CA4th 1238, 1247, 13 CR2d 193; *Reeves v Reeves* (1991) 233 CA3d 651, 657, 284 CR 650.

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§1.11 F. Restatement (Second) of Contracts

California courts are often guided on contract issues by the Restatement (Second) of Contracts (1981). Although the Restatement constitutes persuasive authority for California courts in analyzing breach of contract cases, California courts will reject parts of the Restatement that are in conflict with California statutes or decisional law. *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 850 n8, 89 CR2d 540; *Southern Cal. Edison Co. v Harnischfeger Corp.* (1979) 99 CA3d 9, 14, 160 CR 23. For example, in *Donovan v RRL Corp.* (2001) 26 C4th 261, 281, 109 CR2d 807, the California Supreme Court adopted as California law the Restatement rule allowing rescission for unilateral mistake of fact when enforcement would be unconscionable, but only because the rule was consistent with the court's previous decisions. Some other cases expressly adopting Restatement rules include *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 423, 58 CR2d 875 (fraud in execution); *US Ecology, Inc. v State* (2005) 129 CA4th 887, 901, 28 CR3d 894 (promissory estoppel); *Jara v Suprema Meats, Inc.* (2004) 121 CA4th 1238, 1249, 18 CR3d 187 (consideration); and *Binder v Aetna Life Ins. Co., supra* (contract formation).

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Preface

Since 1977, CEB's title, *California Breach of Contract Remedies*, has provided advice and guidance for California attorneys handling breach of contract matters. Yet CEB believed that there was a need for a more comprehensive practical guide to modern California contract law for California attorneys, and that CEB's older title should be incorporated in a more extensive and up-to-date work. This new title, *California Law of Contracts*, now supersedes and replaces *California Breach of Contract Remedies* in its entirety.

California Law of Contracts is intended to serve as an essential reference for business lawyers seeking to assure that their contracts are fully enforceable and for litigators seeking to challenge or defend enforceability. It is intended to provide a clear and concise, yet thorough, treatment of all aspects of California contract law—from contract formation and interpretation, to performance and remedies for nonperformance. It integrates discussion of current California case law with relevant Civil Code and other California code provisions, including the Uniform Commercial Code. Its looseleaf format will allow incorporation of updates into the text, eliminating the need for separate supplements, and its convenient chapter outlines and index should enable the reader to quickly locate topics of interest. A fresh and up-to-date alternative, California Law of Contracts brings coverage of this essential legal subject in line with modern needs and practices.

CEB gratefully acknowledges the work of the lead authors of this book, George W. Kuney and Donna C. Looper, each of the University of Tennessee School of Law, Knoxville, and both practicing California lawyers. Each of the authors gave generously of his or her knowledge and specialized skills. See About the Authors on the following pages for biographical information.

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- Jason L. Hoffman of Nemecek & Cole, Sherman Oaks. Selected material from his article, *Attorney Fee Clauses in California Contracts*, 21 CEB Cal Bus L Prac 82 (Summer 2006), was used in preparation of the discussion of attorney fees in Chapter 9 of this title.
- Palmer Brown Madden of ADR Services, Alamo. Selected material from his chapter on Dispute Resolution Procedures in *Drafting Business Contracts: Principles, Techniques & Forms* (Cal CEB 1994) was used in preparation of the discussion of arbitration and mediation in Chapter 9 of this title.

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Selected Developments

April 2010 Update

Plaintiffs exposed to long-term tobacco company advertising were not required "to demonstrate individualized reliance on specific misrepresentations to satisfy the reliance requirement." *In re Tobacco II Cases* (2009) 46 C4th 298, 327, 93 CR3d 559. See §3.15.

A contract for the sale of property that allowed plaintiff to waive the filing of a final map violated the Subdivision Map Act (Govt C §§66410-66499.37). See §3.37.

In *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 181, 90 CR3d 818, the court held unenforceable an arbitration agreement containing an arbitrator selection clause that designated a "panel" of arbitrators that in fact comprised only one arbitrator selected by the employer. See §3.38.

An arbitration clause beginning "I agree" did not render the provision illusory for lack of mutuality because the arbitration clause expressly covered all disputes. *Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153. See §3.48.

Disputes arising after a contract is formed should not be construed as evidence that no agreement was reached. *Patel v Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366. See §4.48.

In May 2009, the American Law Institute approved the Proposed Final Draft of its "Principles of Software Contracts," the purpose of which is to "guide courts in deciding disputes involving transactions in software and to guide those drafting software contracts." See §4.62A.

In ruling on the validity of a browse-wrap agreement, courts consider primarily "whether a website user has actual or constructive knowledge of a site's terms and conditions prior to using the site." *Hines v Overstock.com, Inc.* (ED NY, Sept. 8, 2009, No. 09 CV 991) 2009 US Dist Lexis 81204. See §4.66.

The court in *Starlight Ridge S. Homeowners Ass'n v Hunter-Bloor* (2009) 177 CA4th 440, 447, 99 CR3d 20, applying CCP §1859 to the interpretation of CC&Rs, addressed a dispute in which the parties—the homeowners association and the homeowner—identified different provisions as being more specific. See §5.18.

In *DVD Copy Control Ass'n v Kaleidescape, Inc.* (2009) 176 CA4th 697, 97 CR3d 856, the court defined when the terms of an extrinsic document may be incorporated by reference into a contract. See §5.37.

Finding unequal bargaining power, a court held procedurally unconscionable a dispute resolution policy distributed to low-wage employees that required arbitration. The court further held a class action waiver in the agreement substantively unconscionable because only the employees—not the employer—would be affected. *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65. See §§5.76-5.78.

Plaintiffs may not recover for prospective violations of the Consumers Legal Remedies Act. *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 88 CR3d 859. See §6.23.

Prejudgment interest under CC §3287(a) is available for violations of the Song-Beverly Consumer Warranty Act. *Doppes v Bentley Motors, Inc.* (2009) 174 CA4th 1004, 1006, 94 CR3d 797. See §6.24.

The court in *Bosetti v United States Life Ins. Co.* (2009) 175 CA4th 1208, 96 CR3d 744, disagreed with *Brehm v 21st Century Ins. Co.* (2008) 166 CA4th 1225, 83 CR3d 410, to the extent the *Brehm* court intended to hold that there is a distinct subjective good faith requirement to the genuine dispute doctrine. See §6.37.

An insurer's failure to disclose an applicable insurance policy pursuant to 10 Cal Code Regs §2695.4(a) may support an inference of lack of reasonableness. *Safeco Ins. Co. v Parks* (2009) 170 CA4th 992, 88 CR3d 730. See §6.37.

A defendant in equitable indemnity action may utilize "whatever immunities or other limitations on liability would otherwise be available against the injured party." *Prince v PG&E* (2009) 45 C4th 1151, 1161, 90 CR3d 721. See §6.58.

In *Peak-Las Positas Partners v Bollag* (2009) 172 CA4th 101, 90 CR3d 775, the court held that the seller's refusal to extend escrow when the buyer had paid most of the purchase price and incurred $5 million in costs to obtain a lot line adjustment violated the covenant of good faith and fair dealing. See §7.23.

Commercial Code §9408 applies to structured settlement payments because they are considered general intangibles. *321 Henderson Receivables Origination, Inc. v Sioteco* (2009) 173 CA4th 1059, 1060, 93 CR3d 321. See §7.25.

In *Tin Tin Corp. v Pacific Rim Park, LLC* (2009) 170 CA4th 1220, 1234, 88 CR3d 816, the court found it unreasonable for a party to assume it could delay onset of statute of limitations indefinitely by agreeing to wait for other party to perform. See §9.2.

California courts will generally enforce a foreign judgment that contains attorney fees. *Java Oil, Ltd. v Sullivan* (2008) 168 CA4th 1178, 86 CR3d 177. See §9.12.

For purposes of CC §1717, courts construe the term "on a contract" to apply to any action that involves a contract. *Turner v Schultz* (2009) 175 CA4th 974, 979, 96 CR3d 659. See §9.13.

The Federal Arbitration Act is not an independent source of federal court jurisdiction. *Vaden v Discover Bank* (2009) __ US __, 173 L Ed 2d 206, 219, 129 S Ct 1262. See §9.39.

Where an arbitration agreement in a contract not involving interstate commerce provided that "Interpretation of this agreement shall be governed by the Federal Arbitration Act," the court interpreted this to mean that the parties had not intended to contract for more expansive judicial review. *Christensen v Smith* (2009) 171 CA4th 931, 937, 90 CR3d 57. See §§9.40, 9.52.

The Supreme Court held that a collective bargaining agreement that required union members to arbitrate a claim under the Age Discrimination in Employment Act (29 USC §§621-634) was enforceable. *14 Penn Plaza LLC v Pyett* (2009) __US __, 173 L Ed 2d 398, 129 S Ct 1456. See §9.47.

In *D.C. v Harvard-Westlake Sch.* (2009) 176 CA4th 836, 98 CR3d 300, the court applied *Armendariz* to claims involving California hate crime laws, which allow attorney fees to be awarded only to plaintiffs, and invalidated a fee award to the defendant. See §9.47.

The Mandatory Fee Arbitration Act (Bus & P C §§6200-6206) did not impliedly repeal the California Arbitration Act (CCP §§1280-1294.2). *Schatz v Allen, Matkins, Leck, Gamble & Mallory* (2009) 45 C4th 557, 87 CR 700. See §9.49.

In *Goldman v KPMG, LLP* (2009) 173 CA4th 209, 92 CR3d 534, a suit involving fraudulent tax shelter schemes, the court held that defendant accountants and lawyers who were nonsignatories to operating agreements containing arbitration clauses could not compel arbitration based on an equitable estoppel theory. See §9.50.

An arbitrator exceeded his authority where he attempted to bind a trademark licensee's nonparty relatives and ex-spouses to the award and enjoin them from owning or operating comedy clubs. *Comedy Club, Inc. v Al Copeland Invs. Inc.* (9th Cir 2009) 553 F3d 1277. See §9.51.

A plaintiff who had suffered an increased risk of identity theft could not recover for breach of contract because his identity had not been stolen; an increased risk of identity theft was not "appreciable and actual damage." *Ruiz v Gap, Inc.* (ND Cal 2009) 622 F Supp 2d 908. See §10.10.

When the contract provides for the payment of interest, prevailing parties "need not resort to [CC §3287(a)] to obtain prejudgment interest." *Roodenburg v Pavestone Co.* (2009) 171 CA4th 185, 192, 197 CR3d 348. See §10.23.

The court in *Brewer v Premier Golf Props., LP* (2009) 168 CA4th 1243, 1256, 86 CR3d 225, held that punitive damages were not available for violations of Labor Code provisions governing meal and rest breaks, minimum wage, and pay stubs. See §10.36.

In *Fairbanks v Superior Court* (2009) 46 C4th 56, 92 CR3d 279, the court held that life insurance is neither a good nor a service under the Consumers Legal Remedies Act. See §10.52.

If resolution of a controversy over future remedies would have little practical effect on the parties' behavior, the court may deny declaratory relief because it "is not necessary or proper at the time." *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 647, 88 CR3d 859. See §11.43.

In *Troyk v Farmers Group, Inc.* (2008) 171 CA4th 1305, 1338, 90 CR3d 589, the court found that if the defendant insurance exchange and subsidiaries of the attorney-in-fact were acting as a single enterprise, the defendant could be liable under Bus & P C §17203 for restitution of service charges paid in violation of Ins C §381, even though the defendant did not directly receive the service charges. See §11.70.

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Introduction

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§1.1 I. SCOPE OF TREATISE

This treatise is intended to provide a summary of modern California contract law, as reflected in the Civil Code, relevant portions of the Commercial Code, and recent case law. It is intended to serve as a basic resource for attorneys and other legal professionals seeking to understand contract law principles as expressed in California jurisprudence today. It is hoped that litigators seeking relevant citations to the current California law of contracts for memorandums of points and authorities and appellate briefs will find this book especially useful. Readers should note that this title is not a guide to contract drafting. The book presents examples of typical contract clauses in its discussion of topics such as the enforceability of attorney fee clauses, but readers desiring a comprehensive introduction to the principles of contract drafting should consult Drafting Business Contracts: Principles, Techniques & Forms (Cal CEB 1994).

There are thousands of published California contract law decisions. This book cannot, and does not attempt to, furnish citations to all case decisions potentially relevant to particular topics, but, through annual updating, this book will attempt to enable readers to stay abreast of the most current judicial as well as statutory developments in this broad field.

Contract law forms an essential part of the foundation of many more specialized areas of California law, including real estate, insurance, construction law, health care, banking, employment law, and family law. This book does not cover the more specialized aspects of these areas of law, many of which are governed by California Codes other than the Civil Code. Counsel advising clients in the following areas should consult these more specialized CEB practice guides:

- For real estate matters, California Landlord-Tenant Practice (2d ed Cal CEB 1997); California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009); California Real Estate Finance Practice: Strategies and Forms (Cal CEB 2000); California Real Property Remedies and Damages (2d ed Cal CEB 2002); California Real Property Sales Transactions (4th ed Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease (Cal CEB 1996); and Retail Leasing: Drafting and Negotiating the Lease (Cal CEB 2007);
- For construction contracts, California Construction Contracts, Defects, and Litigation (Cal CEB 2008);
- For insurance matters, California Liability Insurance Practice: Claims & Litigation (Cal CEB 1991);
- For employment contracts, Advising California Employers and Employees (Cal CEB 2005); and
- For agreements in the context of family relations, California Marital Settlement and Other Family Law Agreements (3d ed Cal CEB 2005).

Further, the Civil Code itself includes detailed statutory requirements for contracts utilized in many different types of California businesses, which are beyond the scope of this treatise. Most, although not all, of these types of contracts involve consumer transactions. For a list, with citations to applicable Civil Code sections, see §6.39.

This book addresses contracts for the sale or lease of goods subject to Divisions 2 and 10 of the Commercial Code in the context of its discussion of basic contract law principles, such as contract formation, contract interpretation, and remedies for breach of contract. For a more comprehensive treatment of contracts subject to Divisions 2 and 10 of the Commercial Code, readers should consult California UCC Sales and Leases (Cal CEB 2002).

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Source: Business Law/California Law of Contracts/1 Introduction/§1.2 II. SUMMARY OF CHAPTER CONTENTS

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Following are highlights of the coverage of the substantive chapters of this book.

Chapter 2, Contract Formation: Capacity to Contract. Chapter 2 addresses the first element necessary to contract formation: parties capable of contracting. See CC §1550. Topics include the capacity of minors—what contracts a minor cannot make, what contracts a minor may disaffirm, and what contracts are binding on minors—and the capacity of mentally incapacitated persons, of prisoners, and of other persons deprived of civil rights. Chapter 2 also discusses the authority of agents to make contracts on behalf of a principal, powers of attorney, and the authority of entities to contract, including corporations, general and limited partnerships, limited liability companies, trusts, and municipalities.

Chapter 3, Contract Formation: Consent, Legality, Consideration. Chapter 3 addresses the other three elements necessary to contract formation: mutual consent, legality, and consideration. See CC §1550. Topics include fraud in the execution, communication of consent, and factors that vitiate consent (duress, menace, fraud in the inducement, actual and constructive fraud, undue influence, mistake of fact, and mistake of law). This chapter also reviews various types of fiduciary and confidential relationships where undue influence may be present. Finally, it covers illegal contracts and consideration (including the preexisting duty rule, moral obligations, unilateral contracts, and promissory estoppel).

Chapter 4, Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting. Chapter 4 discusses the two aspects of mutual consent: offer and acceptance, including revocable and irrevocable offers, agreements to agree, the mirror image rule, counteroffers, communication of acceptance, the mailbox rule, acceptance by conduct (including silence), implied-in-fact contracts, and rejection of offers. Chapter 4 also covers formation of contracts for the sale or lease of goods under the Commercial Code and contract formalities, including signatures, the statute of frauds, and electronic contracting.

Chapter 5, Contract Interpretation, Modification, Waiver. Chapter 5 reviews the Civil Code and Code of Civil Procedure rules of contract interpretation, the parol evidence rule, and the enforceability of choice-of-forum and choice-of-law clauses. It also addresses the Commercial Code rules of contract interpretation, including the concepts of course of dealing, usage of trade, and course of performance, and the gap-filling rules. Chapter 5 also covers severability of unenforceable contract terms, adhesion contracts, the doctrine of unconscionability, foreign language translations, contract modifications, waivers, novations, releases, settlement agreements, and CCP §998 offers to compromise.

Chapter 6, Representations, Warranties, Covenants, Conditions, Indemnities. Chapter 6 addresses representations, contractual warranties, Commercial Code warranties, consumer protection warranties, covenants (including the implied covenant of good faith and fair dealing and covenants not to compete), and conditions (including express or implied conditions; conditions precedent, concurrent, and subsequent; the condition of "satisfaction"; the condition of "no material adverse change"; and waiver and excuse of conditions). This chapter also discusses indemnity agreements under the Civil Code.

Chapter 7, Assignment and Delegation, Third Party Beneficiaries, Joint and Several Obligations. Chapter 7 covers the principles of assignment and delegation, including assignments of payment rights and their relationship to the UCC, assumption of obligations, "successors and assigns" clauses, contractual and legal restrictions on assignments, and assignments for the benefit of creditors. The chapter also covers assignment and delegation of contracts for the sale or lease of goods subject to the Commercial Code. Finally, Chapter 7 discusses third party beneficiaries (including creditor and donee beneficiaries, and intended and incidental beneficiaries) and joint and several contractual obligations.

Chapter 8, Performance or Breach of Contract. Chapter 8 addresses performance of contracts under the Civil Code, including full or partial performance, time for performance, "time of the essence" clauses, offers of performance, and when performance is excused (including force majeure events, impossibility, impracticability, frustration of purpose, accord and satisfaction, novation, and release). This chapter also discusses performance of contracts for the sale or lease of goods under the Commercial Code. Finally, the chapter addresses breach of contract, including the elements of a cause of action for breach, the concepts of material and immaterial breach, and anticipatory repudiation.

Chapter 9, Selected Enforcement Issues. Chapter 9 discusses a number of special issues that may arise in connection with a contract dispute, including statutes of limitation, jurisdiction, venue, recovery of attorney fees

(including the determination of "prevailing party"), predispute waivers of the right to a jury trial, arbitration and mediation of contract disputes, and election of judicial remedies.

Chapter 10, Remedies: Damages. Chapter 10 addresses recovery of damages for breach of contract under the Civil Code, including the requirements of foreseeability, reasonableness, reasonable certainty, the rule against windfalls, general and special damages, nominal damages, mitigation of damages, specific items recoverable (including lost profits, interest, reliance damages, and tort damages). The chapter also covers liquidated damages, punitive or exemplary damages, and the Consumers Legal Remedies Act.

Chapter 11, Remedies: Injunctive and Declaratory Relief; Other Remedies. Chapter 11 covers injunctive relief generally, including preventive relief and when specific performance is available. The chapter also addresses declaratory relief, rescission, cancellation, abandonment, reformation, lost or destroyed documents, quasi-contract, and restitution.

Chapter 12, Remedies: Commercial Code. Chapter 12 reviews prelitigation and litigation remedies for breach of contracts for the sale of goods, including seller's remedies (withholding delivery, refusing delivery, stopping delivery, reclamation of goods, identifying goods to the contract, reselling goods, canceling the contract) and buyer's remedies (rejecting goods, revoking acceptance, covering, canceling the contract). The chapter discusses damages, consequential damages, specific performance, and restriction, qualification, and enlargement of remedies. Chapter 12 also discusses remedies for breach of personal property leases.

Chapter 13, Selected International Issues. Chapter 13 reviews the United Nations Convention on Contracts for the International Sale of Goods, promulgated by the United Nations Commission on International Trade Law, and the UNIDROIT Principles of International Commercial Contracts 2004, promulgated by the International Institute for the Unification of Private Law.

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III. NATURE OF CONTRACT

§1.3 A. Definition of "Contract"

The California Supreme Court in *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 992, 22 CR3d 352, explained the contractual relationship as follows:

> [W]hen two parties make a contract, they agree upon the rules and regulations which will govern their relationship; the risks inherent in the agreement and the likelihood of its breach. The parties to the contract in essence create a mini-universe for themselves, in which each voluntarily chooses his contracting partner, each trusts the other's willingness to keep his word and honor his commitments, and in which they define their respective obligations, rewards and risks.

See also *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 517, 28 CR2d 475. The Restatement (Second) of Contracts §1 (1981) defines a "contract" as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." A contract therefore represents a legal conclusion that arises from a set of facts and circumstances; it is not itself a matter of fact. This distinction is clearly reflected in the Commercial Code: Com C §1201(b)(12) (former Com C §1201(11)) defines "contract" (as distinguished from "agreement") as "the total legal obligation that results from the parties' agreement as determined by this code and as supplemented by any other applicable law," while Com C §1201(b)(3) (former Com C §1201(3)) defines "agreement" (as distinguished from "contract") as "the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade as provided in Section 1303." The Civil Code definition is not as clear. It equates the terms "contract" and "agreement." See CC §1549 ("A contract is an agreement to do or not to do a certain thing"). In drafting opinions, most California courts do not distinguish between the terms "contract" and "agreement," and this book likewise uses the terms interchangeably.

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§1.4 B. Freedom of Contract and Its Limits

Freedom of contract has been characterized as an "ancient concept." *Net2Phone, Inc. v Superior Court* (2003) 109 CA4th 583, 588, 135 CR2d 149. As the federal district court in *Adobe Sys. v Stargate Software, Inc.* (ND Cal 2002) 216 F Supp 2d 1051, 1059 (citations omitted), observed:

> Fundamental to any free society is the liberty of its members to formulate contracts in accordance with the terms that they agree and consent to mutually execute. The right to contract freely with the expectation that the contract shall endure according to its terms is as fundamental to the society as the right to write and to speak without restraint.

Freedom of contract is an important public policy of the State of California, particularly in the context of commercial agreements. See *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 363, 6 CR2d 467. In *Carma Developers,* the California Supreme Court found that the strong public policy favoring freedom of contract in commercial leasing transactions outweighed any marginal restraint on alienation represented by lease provisions prohibiting the lessee from assigning or subletting without the lessor's consent and giving the lessor the right to terminate the lease and recapture rent on notice by the lessee of its intent to sublet or assign.

California courts do not, however, "uncritically endorse unregulated freedom of contract." *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 965, 32 CR3d 5. The courts recognize that in many contexts, the legislature has determined that there are other public policy considerations that override the value of freedom of contract, and in such cases the courts will acknowledge and enforce that legislative policy determination. *William R. Clarke Corp. v Safeco Ins. Co.* (1997) 15 C4th 882, 891, 64 CR2d 578. The right to contract is "subordinate to the exercise of the police power by the state for the public welfare." *Hess Collection Winery v Agricultural Labor Relations Bd.* (2006) 140 CA4th 1584, 1599, 45 CR3d 609, citing *Nebbia v New York* (1934) 291 US 502, 523, 78 L Ed 940, 948, 54 S Ct 505. Even in the absence of express legislative directives, the courts will apply doctrines such as unconscionability or the implied covenant of good faith and fair dealing to prevent overreaching or exploitation by one party in the name of freedom of contract. See, *e.g., Ilkhchooyi v Best* (1995) 37 CA4th 395, 411, 45 CR2d 766.

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Source: Business Law/California Law of Contracts/1 Introduction/§1.5 C. Boundaries of Contract Law: Transactions Excluded and Included

§1.5 C. Boundaries of Contract Law: Transactions Excluded and Included

Contract law does not govern all consensual transactions between individuals or entities. Examples of noncontractual transactions include wills (governed by Prob C §§6100-6390) and gifts (governed by CC §§1146-1148 and Prob C §§5700-5705). Further, letters of credit are considered "undertakings," subject to Division 5 of the Commercial Code but not governed by contract principles. *San Diego Gas & Elec. Co. v Bank Leumi* (1996) 42 CA4th 928, 933, 50 CR2d 20.

In contrast, a number of transactions that one might not initially consider as governed by the law of contracts have been recognized as such. These include:

- Constitutions and bylaws of unincorporated associations, which define the relationship of the association with its members. See *Jost v Communications Workers of Am.* (1970) 13 CA3d Supp 7, 10, 91 CR 722; *Bernstein v Alameda-Contra Costa Med. Ass'n* (1956) 139 CA2d 241, 247, 293 P2d 862.
- Articles of incorporation, by-laws, and other corporate documents, which define the contract between a corporation and its shareholders, subject to the Corporations Code. See *Hard v California State Employees' Ass'n* (2002) 96 CA4th 708, 117 CR2d 615.
- Organizational documents of partnerships and limited liability companies, which define the relationship between the entity and its partners or members, also subject to applicable provisions of the Corporations Code. See, *e.g., Heller v Pillsbury, Madison & Sutro* (1996) 50 CA4th 1367, 58 CR2d 336.
- Catalogs, bulletins, circulars, regulations, and statements on websites of colleges and universities, which are part of a contract between the institution and its students. *Kashmiri v Regents of Univ. of Cal.* (2007) 156 CA4th 809, 67 CR3d 635 (public university breached terms of implied contract formed when students accepted offer of enrollment); *Zumbrun v University of S. Cal.* (1972) 25 CA3d 1, 10, 101 CR 499 (private college bound by statement in catalog).
- Unconfirmed arbitration awards, which can be enforced as contracts between the parties, even after the time for their confirmation in a court judgment has elapsed. See CCP §1287.6; *Doyle v Giuliucci* (1965) 62 C2d 606, 43 CR 697; *Thibodeau v Crum* (1992) 4 CA4th 749, 6 CR2d 27.
- Prenuptial and postnuptial agreements, subject to the Family Code. See *Marriage of Shaban* (2001) 88 CA4th 398, 105 CR2d 863.
- Promissory notes, subject to Division 3 of the Commercial Code. See *Law Offices of Dixon R. Howell v Valley* (2005) 129 CA4th 1076, 1085, 29 CR3d 499.
- Deeds of trust, which constitute a contract between the trustor and the beneficiary, with the trustee acting as agent for both in accordance with the terms of the instrument and their instructions, subject to other applicable law. *Hatch v Collins* (1990) 225 CA3d 1104, 1111, 275 CR 476. A standard form deed of trust furnished by a bank or other financial institution is generally considered a contract of adhesion under California law. *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1445, 1 CR3d 162.
- Guaranties, surety bonds, and other suretyship obligations are subject to the same rules that govern interpretation and enforcement of other types of contracts and are generally enforceable as contracts, subject to other applicable law (such as the California antideficiency legislation). See *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 39, 86 CR2d 855; *First Nat'l Ins. Co. v Cam Painting, Inc.* (2009) 173 CA4th 1355, 93 CR3d 808.
- Insurance policies, subject to the Insurance Code. *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 96 CR3d 316; *National Cas. Co. v Sovereign Gen. Ins. Servs., Inc.* (2006) 137 CA4th 812, 40 CR3d 591.
- Plea agreements in criminal cases. *People v Gipson* (2004) 117 CA4th 1065, 12 CR3d 478.
- Listing agreements under CC §1086. *McAvoy v Hilbert* (2009) 172 CA4th 707, 91 CR3d 437.

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IV. SOURCES OF LAW

§1.6 A. Civil Code: Its Origins and Relative Importance

In the latter part of the 19th century, California witnessed a state-wide bipartisan, progressive movement in support of legal reform and codification, and in 1872 the state became one of the first in the nation to codify its statutory and common law rules. The common law of contract formed a part of this codification, and was included in the Civil Code. The codification did not, as it might have, replace the common law with a code designated as the sole or ultimate source of law for the state. Instead, the codification was intended to be a declaration and restatement of common law rules as they existed in 1872, to be interpreted using common law precedent and customs. See generally Grossman, *Codification and the California Mentality*, 45 Hastings L J 617 (1994). This legislative purpose is reflected in CC §4, which provides in part that "[t]he [civil] code establishes the law of this state respecting the subjects to which it relates, and its provisions are to be liberally construed with a view to effect its objects and to promote justice," and CC §5, which provides that "[t]he provisions of this Code, so far as they are substantially the same as existing statutes or the common law, must be construed as continuations thereof, and not as new enactments." In *Morris v Oney* (1963) 217 CA2d 864, 870, 32 CR 88, the court explained:

> The Civil Code was not designed to embody the whole law of private and civil relations, rights, and duties; it is incomplete and partial; and except in those instances where its language clearly and unequivocally discloses an intention to depart from, alter, or abrogate the common-law rule concerning a particular subject matter, a section of the code purporting to embody such doctrine or rule will be construed in the light of common-law decisions on the same subject.

The courts remain free to embellish, and have since embellished, the codification of California law through the process of judicial interpretation and issuance of precedential opinions. The state legislature also has continued to amend the California Codes in reaction to constituent needs or in response to what it deems to be judicial mistakes. The Civil Code therefore constitutes the basic framework, and California court decisions the essential fabric, of California contract law. The discussion of California contract law topics in this treatise is organized accordingly.

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§1.7 B. Commercial Code

Contracts for the sale of goods are governed by Division 2 of the Commercial Code (Com C §§2101-2801). Leases of goods are governed by Division 10 of the Commercial Code (Com C §§10101-10600), whether the leases are categorized as "true leases" or "financing leases." Com C §10102. The term "goods" is defined as all things that are movable at the time of identification to the contract for sale—other than money used as the purchase price, investment securities, and claims (choses in action). The term specifically includes specially manufactured goods, the unborn young of animals, minerals or fixtures if the contract provides for the seller to sever the items from the real property involved and thus make them movable, growing crops, and other items attached to real property but capable of severance without material harm to the real estate. Conversely, the term "goods" does not include real property, money (unless money is being sold, as in foreign currency exchanges), investment securities (covered by Division 8), or choses in action (also known as claims or causes of action). Com C §§2105(1), 2107. Further, Division 2 does not apply to a transaction involving goods that is intended only as a security transaction. Com C §2102. Secured transactions are governed by Division 9 (Com C §§9101-9629).

If a sale or lease transaction includes both goods and services, the courts look to the main features of the transaction to determine whether the goods predominate, in which case the Commercial Code applies; otherwise, the transaction is governed by other law. California UCC Sales and Leases §§1.9-1.10 (Cal CEB 2002).

Unless expressly displaced or preempted by the Commercial Code, other sources of law supplement the Commercial Code in regard to the transactions to which it applies. Com C §1103(b).

NOTE: The National Conference of Commissioners on Uniform State Laws (NCCUSL) amended UCC Article 2 in 2003, although neither California nor any other state has yet adopted the revised version. Some sections of Article 2 and the official comments interpreting them underwent minor or no revisions; others were completely rewritten. As a result, references in this book to the official comments give citations to both the pre-2003 Article 2 comments and the revised Article 2 comments. Both versions of Article 2 are available from Lexis and Westlaw online. See also the NCCUSL website for information on ordering an official version of the revised act, which is subject to copyright protection.

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§1.8 C. Other California Codes

In addition to commercial law, many other specialized areas of California law, such as insurance, construction law, health care, banking, employment law, trust law, and family law, are governed by California Codes other than the Civil Code. Although contracts in these disciplines are also subject to general principles of contract law as embodied in the Civil Code and relevant case decisions, more specific statutes in other applicable Codes will control in the event of an irreconcilable conflict. See *Pacific Lumber Co. v State Water Resources Control Bd.* (2006) 37 C4th 921, 942, 38 CR3d 220. As noted in §1.1, this treatise does not attempt to address the more specialized aspects of contracts in these disciplines.

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§1.9 D. Decisions of California State Courts

Along with the Civil Code, published decisions of California state courts are the primary source of contract law in this state. All inferior state courts in California are bound to follow decisions of the California Supreme Court, and all state trial courts are bound to follow the decisions of any court of appeal in the state if there is no split of authority between the administrative districts of the court of appeal. *Auto Equity Sales, Inc. v Superior Court* (1962) 57 C2d 450, 455, 20 CR 321. In this respect, the system of case precedent in California differs from the federal system, which subdivides the United States into 13 judicial circuits under the United States Supreme Court. Within each federal circuit, federal district courts are required to follow decisions of the United States Court of Appeals in that circuit, and precedent is (at least theoretically) uniform. California's judicial system is based on a single statewide court of appeal, subdivided into six administrative districts. From the perspective of a trial court in California, in the absence of a split of authority, all court of appeal opinions are controlling, whether or not they are issued by the court of appeal in the same district as the trial court. If there is more than one court of appeal decision and the decisions are in conflict, the trial court must make a choice between the conflicting decisions. 57 C2d at 455. Further, the courts of appeal are not bound to follow the decisions of courts of appeal in other districts, or even decisions of other divisions within their own district. *McCallum v McCallum* (1987) 190 CA3d 308, 315, 235 CR 396.

The California Supreme Court often looks to well-reasoned decisions of the state courts of appeal for persuasive authority, but the court is, of course, not bound to follow a decision of any court of appeal and will not rely on court of appeal decisions if called on to determine in the first instance whether those decisions were correct. See *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 963, 32 CR3d 5; *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 689 n28, 254 CR 211.

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§1.10 E. Federal and Out-of-State Decisions

Except in specialized fields (such as government contracts, antitrust, banking, consumer transactions, or bankruptcy) that Congress has determined to regulate by federal legislation enacted under the Commerce Clause (US Const art I, §8, cl 3) or other provisions of the U.S. Constitution, there is no supervening federal law of contracts. See *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 432, 38 CR2d 521. As the Ninth Circuit has admitted, "[s]tate law controls both the construction of the contract and the question of breach." *Sulmeyer v Sycamore Inv. Co. (In re Aslan)* (9th Cir 1990) 909 F2d 367, 369. See also *Ingle v Circuit City Stores, Inc.* (9th Cir 2003) 328 F3d 1165, 1170. Accordingly, California courts may view federal precedent as persuasive authority in the absence of state law on a particular point, but if there is an existing body of California law, either statutory or based on the state's common law tradition, California courts will rely on California law in their analysis. *Anderson v Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1476, 66 CR2d 512. Similarly, California courts are not bound by, and generally will not rely on, decisions of courts of other states, even if those decisions represent a majority of other jurisdictions. *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 962, 32 CR3d 5. Because there are thousands of California state court decisions on contract law, there is usually no need to look beyond the state's borders for applicable precedent.

If there is no California case directly on point, however, California courts may find out-of-state decisions involving similar statutes and similar factual situations of great value. *Martinez v Enterprise Rent-a-Car Co.* (2004) 119 CA4th 46, 55, 13 CR3d 857. Out-of-state decisions may be especially persuasive if they relate to interpretation and application of the Uniform Commercial Code. See *Oswald Machine & Equip., Inc. v Yip* (1992) 10 CA4th 1238, 1247, 13 CR2d 193; *Reeves v Reeves* (1991) 233 CA3d 651, 657, 284 CR 650.

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§1.11 F. Restatement (Second) of Contracts

California courts are often guided on contract issues by the Restatement (Second) of Contracts (1981). Although the Restatement constitutes persuasive authority for California courts in analyzing breach of contract cases, California courts will reject parts of the Restatement that are in conflict with California statutes or decisional law. *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 850 n8, 89 CR2d 540; *Southern Cal. Edison Co. v Harnischfeger Corp.* (1979) 99 CA3d 9, 14, 160 CR 23. For example, in *Donovan v RRL Corp.* (2001) 26 C4th 261, 281, 109 CR2d 807, the California Supreme Court adopted as California law the Restatement rule allowing rescission for unilateral mistake of fact when enforcement would be unconscionable, but only because the rule was consistent with the court's previous decisions. Some other cases expressly adopting Restatement rules include *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 423, 58 CR2d 875 (fraud in execution); *US Ecology, Inc. v State* (2005) 129 CA4th 887, 901, 28 CR3d 894 (promissory estoppel); *Jara v Suprema Meats, Inc.* (2004) 121 CA4th 1238, 1249, 18 CR3d 187 (consideration); and *Binder v Aetna Life Ins. Co., supra* (contract formation).

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Contract Formation: Capacity to Contract

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§2.1 I. INTRODUCTION (CC §§1550, 1556)

Under the California Civil Code, there are four essential elements to the existence of a contract (CC §1550; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 13 CR3d 544): (1) parties capable of contracting; (2) consent of the parties; (3) a lawful object; and (4) sufficient cause or consideration. This chapter discusses the first element: parties with the capacity to contract. The other three elements—consent, legality, and consideration—are discussed in chap 3.

Civil Code §1556 states that "[a]ll persons are capable of contracting" except for minors (see §§2.2-2.23), persons of unsound mind (see §§2.24-2.28), and persons deprived of civil rights (see §2.29). The capacity of entities such as corporations, partnerships, and limited liability companies to enter into binding contracts is largely governed by statute. See §§2.69-2.81.

Although it has been said that courts show a bias toward finding capacity to contract when possible as a matter of policy, especially when the other party to the contract could not reasonably have known of the incapacity (see Hunter, Modern Law of Contracts §2:14 (3d ed 2007)), this does not appear to be the rule in California. See, *e.g., Williams v Leon T. Shettler Co.* (1929) 98 CA 282, 276 P 1065 (minor could disaffirm contract even though he misrepresented his age). See also *Rosman v Cuevas* (1959) 176 CA2d Supp 867, 869, 1 CR 485 (because contract by convicted felon was void under §1556, defendant was not estopped from asserting incapacity as defense to suit on contract).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.2 II. MINORS (CC §1557; Fam C §§6710-6713, 6751)

§2.2 II. MINORS (CC §1557; Fam C §§6710-6713, 6751)

A minor is defined as an individual under 18 years of age. Fam C §6500. The capacity of a minor to enter into a contract is governed by Fam C §§6500-7143. CC §1557.

As a general rule, a minor may avoid liability on contracts (see Fam C §6710), subject to certain exceptions (see Fam C §§6711-6713). It is often said that "he who affirmatively deals with a minor, does so at his peril." *Holland v Universal Underwriters Ins. Co.* (1969) 270 CA2d 417, 422, 75 CR 669. This rule reflects California's policy in favor of protecting minors from their own immaturity, lack of experience, and susceptibility to suggestion, and of discouraging adults from contracting with minors. See *American Academy of Pediatrics v Lungren* (1997) 16 C4th 307, 66 CR2d 210; *Pollock v Superior Court* (1969) 272 CA2d 548, 77 CR 565.

A minor's lack of capacity affects only the ability of others to enforce the contract against the minor, not the minor's ability to enforce the contract against the other party. Thus, only the minor may disaffirm a contract. See Fam C §6710. This distinction is grounded in the policy behind the rule: protection of the minor. See *Ballard v Anderson* (1971) 4 C3d 873, 95 CR 1. When a minor elects to disaffirm a contract, he or she must disaffirm the entire contract. There is no such thing as partial disaffirmance; the act is final and not reversible. See *Scollan v Government Employees Ins. Co.* (1963) 222 CA2d 181, 35 CR 40 (disaffirmance of contract by minor has effect of rescission; rescission voids and extinguishes contract).

Contracts involving minors fall into one of three categories:

- Contracts that are void (Fam C §6701; see §§2.3-2.6);
- Contracts that are voidable by the minor (Fam C §§6700, 6710; see §§2.7-2.11); and
- Contracts that are binding on the minor (Fam C §§6711-6713, 6751; see §§2.12-2.22).

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§2.3 A. Void Contracts: Contracts a Minor Cannot Make (Fam C §6701)

A minor cannot do any of the following (Fam C §6701):

- Delegate a power (see §2.4);
- Make a contract relating to real property or any interest in it (see §2.5); or
- Make a contract relating to personal property not in the minor's immediate possession or control (see §2.6).

A contract or delegation made in violation of §6701 is void, not voidable, and requires no act of disaffirmance by the minor. See *Sisco v Cosgrove, Michelizzi, Schwabacher, Ward & Bianchi* (1996) 51 CA4th 1302, 59 CR2d 647 (attempt by deceased minor to assign future interest in settlement proceeds to one parent or to disinherit other parent would have been void under §6701). A void contract cannot be validated by ratification. *G.L. Mezzetta, Inc. v City of Am. Canyon* (2000) 78 CA4th 1087, 93 CR2d 292.

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§2.4 1. Delegation of Power (Fam C §6701(a))

A minor may not make a delegation of power. Fam C §6701(a). Delegation of power or authority, however, is an essential element in creation of an agency relationship. *Channel Lumber Co. v Porter Simon* (2000) 78 CA4th 1222, 1227, 93 CR2d 482. See §2.30. Therefore, a minor cannot appoint an agent with authority to bind the minor or make the minor liable for the acts of the agent. For example, a minor cannot be a member of a partnership, because partners are each agents of the partnership. Corp C §16301. Courts have held that title to an automobile was not effectively transferred when the buyer gave the seller a power of attorney to make the transfer that the buyer, a minor, was powerless to give because it constituted a delegation of power (*Ellis v Community Chevrolet, Inc.* (1966) 242 CA2d 79, 51 CR 154) and that a minor could not authorize an agency to endorse the minor's name on checks, because the authorization was a delegation of power (*Morgan v Morgan* (1963) 220 CA2d 665, 674, 34 CR 82).

Although a minor cannot delegate power, a principal may nevertheless enter into a contract to which a minor is a third party beneficiary. *Schumm v Berg* (1951) 37 C2d 174, 184, 231 P2d 39 (child was third party beneficiary, not principal, when pregnant woman entered into contract with child's father). A parent can bind a child to a release. *Berg v Traylor* (2007) 148 CA4th 809, 819, 56 CR3d 140, citing *Aaris v Las Virgenes Unified Sch. Dist.* (1998) 64 CA4th 1112, 75 CR2d 801 (release signed by mother on behalf of minor cheerleader binding on minor). See §2.11. Moreover, a minor may enter into a contract with a licensed talent agency, and if the contract is court-approved, the minor cannot disaffirm it. Lab C §1700.37. See Fam C §§6750 (contracts by minors for artistic or sports services), 6751 (minor's contract for artistic or sports services may not be disaffirmed on grounds of minority). See also §§2.17-2.18.

Family Code §6701(a) applies only to delegations of power that a minor makes voluntarily and not to delegations by operation of law. *Silver Swan Liquor Corp. v Adams* (1941) 43 CA2d Supp 851, 110 P2d 1097 (Vehicle Code provision stating nonresident drivers deemed to have authorized Department of Motor Vehicles to accept service of process applies to minors). Similarly, although a minor cannot contract with or hire an attorney, one can be appointed to represent him or her. See, *e.g.,* Prob C §1470(a) (appointment of attorney for proposed minor in guardianship proceedings). See also *Silver Swan Liquor Corp. v Adams, supra*.

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§2.5 2. Contracts Relating to Real Property (Fam C §6701(b))

A minor cannot make a contract relating to real property or any interest in it, including a future interest. Fam C §6701(b); *Sisco v Cosgrove, Michelizzi, Schwabacher, Ward & Bianchi* (1996) 51 CA4th 1302, 1307, 59 CR2d 647 (citing Fam C §6701). A minor's contracts relating to real property or any interest in it are void. *Hakes Inv. Co. v Lyons* (1913) 166 C 557, 559, 137 P 911. Deeds executed by minors and contracts for the purchase of land entered into by minors, being wholly void, are not subject to disaffirmance or ratification. *Sparks v Sparks* (1950) 101 CA2d 129, 225 P2d 238. Because deeds executed by minors are not subject to disaffirmance, there is no requirement that the consideration for them be restored. See *Lee v Hibernia Sav. & Loan Soc'y* (1918) 177 C 656, 660, 171 P 677.

Further, deeds executed by minors do not in themselves, or through being recorded, create an estoppel that could validate them. *Hakes Inv. Co. v Lyons* (1913) 166 C 557, 662, 137 P 911. Nor does the minor's mature appearance and misrepresentation of her age create an estoppel, although conduct after the minor reaches majority may do so. *Lee*, 177 C at 660. Still, the conduct required for an estoppel must be more than merely continuing to make payment on a real estate contract entered into as a minor. *Maier v Harbor Ctr. Land Co.* (1919) 41 CA 79, 81, 182 P 345.

Although a minor may not contract regarding real property, a minor may take and hold title to it. See *Fare v Scott K. (In re Scott K.)* (1979) 24 C3d 395, 405, 155 CR 671. A minor may also take and hold legal title to land in trust for another, but may not act as trustee while a minor. See Restatement (Third) of Trusts §32, Comment c (2003). A minor's property is the minor's own, not his or her parents', although a parent may have a "protectable interest" in such property for search and seizure purposes. *Fare v Scott K. (In re Scott K.)*, *supra*.

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§2.6 3. Contracts Relating to Personal Property Not in Minor's Immediate Possession or Control (Fam C §6701(c))

A minor cannot make a contract relating to personal property that is not in his or her immediate possession or control. Fam C §6701(c). Such a contract is void and requires no act of disaffirmance. See *Sisco v Cosgrove, Michelizzi, Schwabacher, Ward & Bianchi* (1996) 51 CA4th 1302, 59 CR2d 647.

In general, a minor's right to receive wages or earnings is not property within his or her possession and control, and any assignment of such a right is void. *Morgan v Morgan* (1963) 220 CA2d 665, 675, 34 CR 82. However, an emancipated minor's (see Fam C §§7000-7143) right to receive earnings (*i.e.,* a debt owned for labor) is personal property within the minor's possession and control, and is assignable. *Taylor v Hill* (1896) 115 C 143, 151, 46 P 922. When publishers delivered newspaper to a minor to fold and then deliver, the papers were personal property within the minor's immediate possession and control, and the minor had the capacity to contract with the publishers for the sale of the papers. *Taylor v Industrial Acc. Comm'n* (1963) 216 CA2d 466, 473, 30 CR 877.

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B. Voidable Contracts: Contracts a Minor May Disaffirm

§2.7 1. When Disaffirmance Permitted (Fam C §6710)

Except as provided in Fam C §6701 (see §§2.3-2.6), a minor may contract in the same manner as an adult, subject to the power of disaffirmance. Fam C §6700. Concerning disaffirmance, Fam C §6710 provides that:

> Except as otherwise provided by statute, a contract of a minor may be disaffirmed by the minor before majority or within a reasonable time afterwards or, in case of the minor's death within that period, by the minor's heirs or personal representative.

Thus, when a contract by a minor is neither void (see §§2.3-2.6) nor binding (see §§2.12-2.22), it is voidable (*i.e.,* subject to disaffirmance) by the minor.

Whether disaffirmed before or after majority, the disaffirmance of a minor's contract has the effect of a rescission, and the effect of a rescission is to void a contract. *Scollan v Government Employees Ins. Co.* (1963) 222 CA2d 181, 183, 35 CR 40. For further discussion of the remedy of rescission, see §§11.46-11.58. When a contract is disaffirmed, it is as if the act disaffirmed had never occurred. *Hurley v Southern Cal. Edison Co.* (9th Cir 1950) 183 F2d 125, 132. Disaffirmance of a contract by a minor, however, does not operate to terminate the contractual obligations of a parent who signed the agreement. *Berg v Traylor* (2007) 148 CA4th 809, 822, 56 CR3d 140.

Disaffirmance may be made by any act or declaration, and express notice to the other party is unnecessary. 148 CA4th at 820. For example, filing a civil action is sufficient. *Celli v Sports Car Club of Am., Inc.* (1972) 29 CA3d 511, 517, 105 CR 904. An oral disaffirmance is also sufficient. *Pereira v Toscano* (1927) 84 CA 526, 531, 258 P 429. The act constituting disaffirmance must be unequivocal, however, and notice of rescission should be given to the party with whom the minor contracted, not to an assignee. *Spencer v Collins* (1909) 156 C 298, 304, 104 P 320.

Because a minor has a right to disaffirm or rescind a contract, the other party may not counterclaim for damages incurred by the minor's failure to perform, or for specific performance of the contract. *Le Baron v Berryessa Cattle Co.* (1926) 78 CA 536, 546, 248 P 779. Once the contract is disaffirmed, the minor is entitled to recover all benefits paid under the contract. *Burnand v Irigoyen* (1947) 30 C2d 861, 866, 186 P2d 417. Thus, a minor may repudiate an express contract for his or her services and recover for it on quantum meruit. *Abdullah v Abdullah* (1920) 50 CA 115, 119, 194 P 511.

Because the right of disaffirmance applies only to civil contracts, a minor's criminal plea is not subject to disaffirmance. See *People v Mortera* (1993) 14 CA4th 861, 864, 17 CR2d 782. On the other hand, a judgment entered against a minor who does not appear by general guardian or guardian ad litem as required by CCP §372 is voidable and may be disaffirmed by the minor. *In re Charles T.* (2002) 102 CA4th 869, 876, 125 CR2d 868. Under certain circumstances, however, a minor parent may appear without a guardian ad litem where the minor's child is the subject of proceedings relating to the Uniform Parentage Act (Fam C §§7600-7730), or dependency, guardianship, or custody proceedings. CCP §372(c)(1).

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§2.8 2. Time for Disaffirmance (Fam C §6710)

A minor may disaffirm a contract at any time during his or her minority or within a reasonable time after reaching majority; in the event of the minor's death, the contract may be disaffirmed within a reasonable time by his or her heirs or personal representative. Fam C §6710. Only the minor (or, on his or her death, the minor's heirs or personal representative) may take advantage of his or her infancy and disaffirm a voidable contract. Fam C §6710.

What constitutes a reasonable time for disaffirmance after reaching majority depends on the circumstances. *Hurley v Southern Cal. Edison Co.* (9th Cir 1950) 183 F2d 125, 132. The policy behind granting a reasonable time is to give the minor an opportunity, once he or she is capable of making a judgment, to determine whether the contract is beneficial or prejudicial. When a minor has full knowledge of his or her rights, it is appropriate to use the statute of limitations as a guide to what is a reasonable time. When a minor is ignorant of his rights, the statute of limitations should not be used as a guide. 183 F2d at 132. For discussion of contract statutes of limitation, see §§9.2-9.6.

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§2.9 3. No Estoppel by Misrepresentation of Age

California does not recognize estoppel by misrepresentation of age. Even if a minor intentionally lies and exaggerates his or her age, the minor is not prevented from disaffirming a contract. See *Morgan v Morgan* (1963) 220 CA2d 665, 34 CR 82; *Williams v Leon T. Shettler Co.* (1929) 98 CA 282, 276 P 1065. A minor's conduct after he or she attains majority, however, may constitute an estoppel, preventing the minor from pleading minority as a defense to the contract entered into while under the age of 18. See *Burnand v Irigoyen* (1947) 30 C2d 861, 186 P2d 417. See generally Evid C §623; *State Compensation Ins. Fund v Workers' Comp. Appeals Bd.* (1985) 40 C3d 5, 219 CR 13.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.10 4. No Need to Restore Consideration

§2.10 4. No Need to Restore Consideration

There is no longer any statutory requirement in California that a minor must tender or restore consideration as a condition of disaffirming a contract. See Fam C §6710.

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§2.11 5. Disaffirmance of Releases and Settlements

Releases and settlement agreements regarding claims of minors are subject to special rules. If a minor has a disputed claim for damages, money, or other property and does not have a guardian, either parent (if the parents are not separated), or else the parent with custody of the minor (if the parents are separated), has the right to compromise and settle the claim in accordance with statutory procedures, unless the claim is against one or both of the parents. Prob C §3500(a), (d). If a guardian has been appointed, the guardian has authority to compromise the minor's claim. CCP §372 (authority of guardian to compromise claim of ward with court approval); Fam C §6601 (requiring guardian to conduct any civil action or proceeding on a minor's claim). In each case, the compromise is valid only with court approval. Prob C §3500(b); CCP §372. Once approved by the court in accordance with the statute, the compromise is not subject to later disaffirmance. See Fam C §6711.

A release agreement executed by a minor alone, independently of his or her parent or guardian and outside of a court proceeding, is subject to disaffirmance in the same manner as other contracts. See *Celli v Sports Car Club of Am., Inc.* (1972) 29 CA3d 511, 517, 105 CR 904 (minor injured at race track could disaffirm release he had signed). In contrast, a minor cannot disaffirm a release signed by a parent on his or her behalf. *Hohe v San Diego Unified Sch. Dist.* (1990) 224 CA3d 1559, 274 CR 647). See also *Berg v Traylor* (2007) 148 CA4th 809, 819, 56 CR3d 140 (minor may not disaffirm mere release of liability; minor may, however, disaffirm "a contract that imposes significant affirmative responsibilities").

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§2.12 C. Binding Contracts

Contracts that are neither void nor voidable are binding on the minor. *Morgan v Morgan* (1963) 220 CA2d 665, 34 CR 82. These include:

- Contracts for necessities that meet the requirements of Fam C §6712 (see §2.13);
- Contracts entered into by a minor under express authority or direction of a statute (Fam C §6711, see §§2.14-2.16);
- Certain entertainment contracts approved by a court under Fam C §§6750-6751 (see §§2.17-2.18);
- Contracts entered into by a parent on behalf of his or her minor child (see §2.19);
- Contracts ratified by a minor on reaching majority (see §2.20); and
- Contracts with emancipated minors (see §§2.21-2.22).

In addition, a minor cannot recover goods transferred to an innocent third party purchaser who bought them for value in good faith and without notice that the transferor's purchase from the minor was voidable. Fam C §6713. See §2.23.

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§2.13 1. Contracts for Necessaries (Fam C §6712)

A minor may not disaffirm a contract on the grounds of minority if the contract is entered into during his or her minority and the following conditions are met (Fam C §6712):

- The contract is to pay the reasonable value of things necessary for the support of the minor or the minor's family;
- The things have been actually furnished to the minor or his or her family; and
- The minor enters into the contract when not under the care of a parent or guardian able to provide for him or her or his or her family.

Because California recognizes that minors must have their needs provided for, a minor whose parent is unable to provide for him or her "may contract to pay the reasonable value of things necessary for his support and that of his family and may not disaffirm such a contract either during his minority or at any time thereafter." *Morgan v Morgan* (1963) 220 CA2d 665, 679, 34 CR 82. In *Morgan,* the court held that a minor who authorized funds to be used for him and his mother's maintenance could not recover the funds when he reached majority.

In certain circumstances, contracts for medical services are binding on minors as contracts for necessaries under §6712. See, *e.g., Doyle v Giuliucci* (1965) 62 C2d 606, 610, 43 CR 697 (contract between parent and medical group for health care and for arbitration of claims was binding on minor). Further, attorney services have been held to be necessaries, the reasonable value of which may be recovered from the minor, even if the fees were not approved by the court under Fam C §6602. See *In re Ricky H.* (1970) 2 C3d 513, 86 CR 76 (attorney fees for minor child as "necessaries" for which parents are liable); *Leonard v Alexander* (1942) 50 CA2d 385, 122 P2d 984.

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2. Contracts Authorized or Directed by Statute (Fam C §6711)

§2.14 a. Certain Contracts for Medical and Health-Related Services

The Family Code provides for a number of circumstances in which a minor may give valid consent to medical treatment and parental consent is unnecessary. The minor may not disaffirm the following types of contracts because of his or her minority:

Medical or dental care. A minor may consent to medical or dental care if he or she is emancipated (see §§2.21-2.22), or is at least 15 years old, living separate and apart from his or her parents or guardian, and managing his or her own financial affairs. The minor's parents or guardian are not liable for medical or dental care given under this provision. Fam C §6922.

Mental health treatment or counseling. A minor 12 years old or older may consent to mental health treatment, outpatient counseling, or residential shelter services, provided that (1) the minor in the opinion of the attending care professional is mature enough to participate intelligently in outpatient or residential treatment services, *and* (2) the minor presents a serious danger of physical or mental harm to him- or herself or others without the treatment or services or is the alleged victim of incest or child abuse. Fam C §6924(b). A minor may not receive convulsive therapy, psychosurgery, or psychotropic drugs without consent of the minor's parent or guardian. Fam C §6924(f). The minor's parents or guardian are not liable for payment for care delivered under §6924 unless they participate in a counseling program under the section. Fam C §6924(e).

Pregnancy. A minor may consent to medical care related to the prevention and treatment of pregnancy, although a minor cannot consent to be sterilized without the consent of a parent or guardian. Fam C §6925. Section 6925 also states that a minor cannot consent to an abortion in a nonemergency without the consent of one of her parents or a guardian, or court approval. See Health & S C §123450. However, this portion of the statute was held to violate the right to privacy provision of the California Constitution and has been enjoined. *American Academy of Pediatrics v Lungren* (1997) 16 C4th 307, 66 CR2d 210.

Treatment for communicable disease. A minor 12 years old or older who may have come into contact with any infectious, contagious, or communicable disease requiring reporting to the local health officer, or a related sexually transmitted disease, may consent to hospital, medical, and surgical care related to the diagnosis or treatment of the disease. Fam C §6926(a). Neither the minor's parents nor guardian are liable for payment for such services. Fam C §6926(b).

Treatment for rape, sexual assault. A minor 12 years old or older who is alleged to have been raped or sexually assaulted may consent to medical care relating to the diagnosis or treatment of the condition and the collection of medical evidence. Fam C §§6927, 6928.

Care and counseling for drug or alcohol abuse. A minor 12 years old or older may consent to certain medical care and counseling relating to drug or alcohol abuse (Fam C §6929(b)), but may not consent to receive replacement narcotic abuse treatment. Fam C §6929(e). The minor's parents or guardian are not liable for payment for care delivered under §6929 unless they participate in a counseling program under this section. Fam C §6929(d).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.15 b. Consent Relating to Adoption

§2.15 b. Consent Relating to Adoption

A minor, like an adult, may relinquish a child to an adoption agency for adoption by a written statement signed by the minor before two witnesses and acknowledged before an authorized official of the agency. Fam C §8700(a). See *In re Michael R.* (2006) 137 CA4th 126, 136, 39 CR3d 773, for a general explanation of adoption procedures. The relinquishment is not subject to revocation by reason of minority. Fam C §8700(b). Similarly, a minor may consent in writing to an independent adoption of the minor's child, and the consent is not subject to revocation due to minority. Fam C §8814(d). A minor over the age of 12 cannot be adopted without his or her consent. Fam C §8602.

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§2.16 c. Miscellaneous Contracts Authorized by Statute

Certain types of contracts by minors are authorized by statutes scattered throughout the California codes. These include the following:

- Veterans who are minors may enter into contracts for the purchase of a farm or a home, and the contracts are binding. See Mil & V C §986.10.
- A minor 16 years of age or older may, without the consent of a parent or guardian, enter into certain life, disability insurance, or annuity contracts. Ins C §10112; *Sisco v Cosgrove, Michelizzi, Schwabacher, Ward & Bianchi* (1996) 51 CA4th 1302, 1308, 59 CR2d 647.
- Minors may not disaffirm workers' compensation payments made to them. Lab C §3605.
- Attorney fees approved by the court under Fam C §6602 are binding on minors. See generally §2.13.
- Minors who are public officials or candidates for public office may enter into binding contracts. Govt C §275.2.

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3. Art, Entertainment, and Professional Sports Contracts (Fam C §§6750-6751)

§2.17 a. Generally

Several types of entertainment and sports contracts entered into by minors are not subject to disaffirmance if court-approved. See Fam C §§6750-6751. These include (Fam C §6750(a)(1)-(3)):

- Contracts in which a minor is employed or agrees to render creative or artistic services (either directly or through a third party such as a personal services corporation), including, without limitation, services as an actor, dancer, musician, comedian, singer, stunt person, voice-over artist, or other performer or entertainer, or as a songwriter, musical producer, arranger, writer, director, producer, production executive, choreographer, composer, conductor, or designer;
- Contracts in which a minor agrees to purchase, sell, lease, license, or otherwise dispose of literary, musical, or dramatic properties (tangible or intangible), or agrees to the use of his or her likeness, voice recording, performance, or story of his or her life, or any rights in these things, for use in motion pictures, television, sound recordings, stage, or otherwise in the entertainment field; and
- Sports contracts in which a minor is employed or agrees to render services as a participant or player.

To prevent disaffirmance, the contract must be approved by the superior court of the county in which the minor resides or is employed or in which any party to the contract has its principal business office. Fam C §6751(a). Courts are given broad discretion in deciding whether to approve the contract and may consider whether the terms of the contract are reasonable in the light of the minor's financial and educational interests, the development of his or her talent, and his or her chances for success in the profession. *Warner Bros. Pictures, Inc. v Brodel* (1948) 31 C2d 766, 775, 192 P2d 949. A minor's earnings from these types of contracts remain his or her sole property. Fam C §771(b).

Similarly, under the Talent Agencies Act (Lab C §§1700-1700.47), a minor cannot disaffirm a court-approved contract made with a licensed talent agency. Lab C §1700.37. The definition of a "licensed talent agency," however, does not include an entity that provides personal management services (*Styne v Stevens* (2001) 26 C4th 42, 109 CR2d 14) or that obtains recording contracts for minors (Lab C §1700.4). Presumably, therefore, a minor may disaffirm contracts made with either of these entities. See Lab C §1700.37 (minor cannot disaffirm contract made with "duly licensed talent agency as defined in Section 1700.4"). If the talent agency is not licensed as required by law, any contract made with it will be void. *Yoo v Robi* (2005) 126 CA4th 1089, 24 CR3d 740. See §3.37.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.18 b. Coogan's Law (Fam C §§6752-6753)

§2.18 b. Coogan's Law (Fam C §§6752-6753)

The exploitation of some infant entertainers by their parents led the California legislature to institute restrictions on parents regarding disposition of income earned by their children under art, entertainment, and professional sports contracts. After the parents of child star Jackie Coogan spent $4 million of Coogan's earnings, leaving him penniless, the California legislature responded by enacting what are now Fam C §§6752 and 6753. Among other things, these statutes provide for the set-aside and payment by the minor's employer of 15 percent of the minor's gross earnings over to a special trust account (known as a Coogan Trust Account) in a qualified financial institution, subject to continuing oversight by the court. The law applies to all arts, entertainment, and professional sports contracts listed in Fam C §6750(a), not simply those approved by the courts.

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§2.19 4. Actions by Parents or Guardians Binding Minors

A parent may enter into contracts on behalf of his or her children. *Hohe v San Diego Unified Sch. Dist.* (1990) 224 CA3d 1559, 1565, 274 CR 647. A parent's contract or release on behalf of his or her child is binding on the child. See Prob C §3500 (minor's parent may compromise minor's claim on court approval) and *Aaris v Las Virgenes Unified Sch. Dist.* (1998) 64 CA4th 1112, 75 CR2d 801 (parent may execute release on behalf of child). But see *Berg v Traylor* (2007) 148 CA4th 809, 56 CR3d 140 (limiting actions by parents or guardians binding minors to simple releases of liability that do not impose significant affirmative responsibilities on minor). Arbitration agreements entered into by parents on behalf of their children are binding on the children. *Buckner v Tamarin* (2002) 98 CA4th 140, 119 CR2d 489. But see *Berg v Traylor, supra* (allowing disaffirmance of contract with arbitration clause and vacating arbitration award against minor). A duly appointed guardian ad litem may bind his or her minor ward on obtaining approval by the court, as long as the guardian's actions are not prejudicial to the minor's interests. See CCP §372(a); *De Los Santos v Superior Court* (1980) 27 C3d 677, 683, 166 CR 172.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.20 5. Ratification on Attaining Majority

§2.20 5. Ratification on Attaining Majority

When minors reach 18—the age of majority in California (Fam C §6500)—they may ratify agreements they entered into while minors, and the agreements are then enforceable as contracts. *Wall v Mines* (1900) 130 C 27, 43, 62 P 386. The ratification need not be express or written; it may be inferred from words or conduct consistent with the agreement, including the acceptance or retention of benefits or consideration or even continuity to perform or suffer a detriment. See, *e.g., Garbutt v Campbell* (1955) 130 CA2d 167, 278 P2d 508 (minor's conduct was not tantamount to ratification when he was unaware of service of process on him during minority and took immediate steps to disaffirm judgment when he attained majority). Silence and inaction present the most difficult cases regarding ratification, and the outcome of those cases appears to turn almost wholly on a court's sense of fairness. See *Keane v Penha* (1946) 76 CA2d 693, 173 CR 835 (minor's rights did not suffer when his silence was tantamount to ratification after minor had announced his readiness and sat through trial).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/ 6. Contracts by Emancipated Minors/§2.21 a. Requirements for Emancipation

6. Contracts by Emancipated Minors

§2.21 a. Requirements for Emancipation

Emancipated minors may enter into valid binding contracts that would otherwise be void or voidable. See Fam C §§7050-7052. A minor is emancipated when he or she (Fam C §7002):

- Has entered into a valid marriage, regardless of whether the marriage has dissolved;
- Is on active duty in the United States armed forces; or
- Has been declared emancipated by a court under Fam C §7122.

A minor may petition the superior court for a declaration of emancipation under Fam C §7120. The petition must state that the minor (Fam C §7120):

- Is at least 14 years old;
- Willingly lives separate and apart from his or her parents or guardian with their acquiescence;
- Is managing his or her own financial affairs, as evidenced by a declaration of income and expenses; and
- Has an income that is not derived from illegal activity.

Courts will issue a declaration of emancipation after reasonable notice to the minor's parents, guardian, or other person entitled to custody of the minor (see Fam C §7121(a)), on a finding that the statements in the minor's petition are correct, and that emancipation would not be contrary to the minor's best interest. Fam C §7122(a). See *Bonnie P. v Superior Court* (2005) 134 CA4th 1249, 1256, 37 CR3d 77, for further discussion of emancipation procedures.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.22 b. Effect of Emancipation (Fam C §7050)

§2.22 b. Effect of Emancipation (Fam C §7050)

An emancipated minor is considered an adult regarding financial matters, *e.g.,* for the purpose of receiving financial support from his or her parents, for any right of the minor's parents to his or her earnings, and for ending all vicarious or imputed liability of the minor's parents or guardian for the minor's torts. Fam C §7050(a)-(b), (d). He or she has the capacity to do any of the following (Fam C §7050(e)):

- Consent to medical, dental, or psychiatric care without parental consent, knowledge, or liability;
- Enter into a binding contract or give a delegation of power;
- Engage in transactions involving real or personal property;
- Sue or be sued;
- Compromise, settle, arbitrate, or adjust a claim, action, or proceeding by or against him or her;
- Make or revoke a will;
- Make a gift outright or in trust;
- Convey or release contingent or expectant interests;
- Exercise or release powers of appointment;
- Create a revocable or irrevocable trust;
- Revoke a revocable trust;
- Elect to take under or against a will;
- Disclaim interests;
- Establish his or her own residence;
- Apply for a work permit without parental consent;
- Enroll in school or college; and
- Make Probate Code-type elections.

Nonetheless, emancipated minors are not treated as adults for all purposes. An emancipated minor charged with a criminal offense is not automatically prosecuted as an adult. See Welf & I C §602. In addition, emancipated minors do not have the right to consent to their own marriages (see Fam C §302) or receive general assistance welfare benefits (see Fam C §7111).

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§2.23 D. Treatment of Minors Under Commercial Code

Contracts governed by the California Commercial Code are subject to the same rules regarding the effect of minority as other contracts. See Com C §1103(b). The rule stated in Com C §2403(1), which provides that a person with voidable title to goods has the power to transfer title to a good faith purchaser for value, is echoed in Fam C §6713, which provides:

> If, before the contract of a minor is disaffirmed, goods the minor has sold are transferred to another purchaser who bought them in good faith for value and without notice of the transferor's defect of title, the minor cannot recover the goods from an innocent purchaser.

One commentator has hypothesized that, under this principle, a minor could purchase a car on credit, sell the car to a good faith purchaser for value, pocket the proceeds, and then disaffirm the loan (a contract). See Hunter, Modern Law of Contracts §2:13 (3d ed 2007). But because the purpose of this section is to protect the innocent purchaser and not to promote fraud and deceit, it is likely that a court would be sympathetic to claims of estoppel or unclean hands to prevent disaffirmance, or to theories of fraud, misrepresentation, or promissory fraud to allow recovery of the sale proceeds and other damages, including exemplary or punitive damages. See also *Weisbart v Flohr* (1968) 260 CA2d 281, 288, 67 CR 114 ("Infancy, being in law a shield and not a sword, cannot be pleaded to avoid liability for frauds, trespasses or torts").

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III. MENTALLY INCAPACITATED PERSONS (CC §§38-41, 1557(b))

§2.24 A. Defining Mental Incapacity

The capacity of a person of unsound mind to contract is governed by CC §§38-41. CC §1557(b). Under these provisions, a "person entirely without understanding" has no capacity to contract, although he or she remains liable for the reasonable value of necessaries furnished for his or her support or the support of his or her family. CC §38. Similarly, when a person's incapacity has been "judicially determined," for example, when a conservatorship is established, he or she cannot make any conveyance or contract or waive any right or delegate power "until his or her restoration to capacity." CC §40.

A contract entered into by someone entirely without understanding under CC §38 or whose incapacity has been judicially determined under CC §40 is void, not merely voidable. *Gibson v Westoby* (1953) 115 CA2d 273, 276, 251 P2d 1003; *Doran v Dreyer* (1956) 143 CA2d 289, 292, 299 P2d 661. On the other hand, a contract entered into by someone "of unsound mind, but not entirely without understanding" before being adjudged an incompetent is voidable and subject to rescission and return of consideration. CC §39.

When a person's incapacity has not been judicially determined, the dividing line between when someone is "entirely without understanding" (CC §38) as distinct from being merely "of unsound mind, but not entirely without understanding" (CC §39) is often unclear. *Burgess v Security-First Nat'l Bank* (1941) 44 CA2d 808, 817, 113 P2d 298. "Entirely without understanding" is generally defined as "want of capacity to understand transactions of the kind involved." *Ripperdan v Weldy* (1906) 149 C 667, 674, 87 P 276. In *Jacks v Deering* (1907) 150 C 272, 88 P 909, however, the California Supreme Court affirmed a lower court determination that a person was not entirely without understanding under §39, even when the lower court found that "*she did not have sufficient mental capacity to understand the nature, purpose and effect of the transaction* in which she was engaged." 150 C at 273 (italics in original).

Probably reflecting the subjective difficulty of determining competence as opposed to the objective certainty possible with determination of age and maturity, courts faced with a claim of unadjudicated mental incapacitation are likely to resolve doubts in favor of sustaining the contract and rejecting the claimed lack of capacity, especially if the other party was not on notice and could not reasonably have detected the claimed incapacitation. See, *e.g., Burgess,* 44 CA2d at 816 (person not entirely without understanding despite fact he was in debilitated mental condition).

In fact, there is a general presumption of sanity and competence. See Prob C §810 (rebuttable presumption that persons with mental or physical disorders are sane and may be capable of contracting, and that judicial determinations relating to mental capacity should be based on deficit in one or more of person's mental functions, not on diagnosis of person's mental or physical disorder). See also *Mattos v Kirby* (1955) 133 CA2d 649, 285 P2d 56. Moreover, a person's mental capacity may be taken into account in determining whether there was consent to the contract. See chap 3.

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§2.25 B. Proving Mental Incapacity

In general, the burden of proving insanity is on the one alleging the condition. Evid C §522. There is a rebuttal presumption, however, that a person is of unsound mind if he or she "is substantially unable to manage his or her own financial resources or resist fraud or undue influence." CC §39(b). Still, substantial inability must be proved by more than "isolated incidents of negligence or improvidence." CC §39(b). The statute of limitations for rescission based on incapacity is 4 years. CCP §343; *Gibson v Household Int'l, Inc.* (9th Cir 2005) 151 Fed Appx 529, 531 (unpublished opinion).

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§2.26 C. Judicial Determination of Incapacity

A person whose incapacity has been judicially determined does not have the capacity to contract. CC §40(a). See Prob C §1872; *Scruton v Korean Airlines Co.* (1995) 39 CA4th 1596, 1605, 46 CR2d 638 (guardians and conservators lack capacity to enter into contract on behalf of incompetent without authorization of court that appointed guardian); *O'Brien v Dudenhoeffer* (1993) 16 CA4th 327, 333, 19 CR2d 826. The establishment of a conservatorship under Prob C §§1400-2893 constitutes a judicial determination of incapacity. CC §40(b).

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§2.27 D. Conveyance of Real Estate by Incapacitated Person

As with minors (see §2.5), if a conveyance by a mentally incapacitated person is void, it does not pass good title, and cannot do so even to a bona fide purchaser. *Gibson v Westoby* (1953) 115 CA2d 273, 276, 251 P2d 1003. However, a voidable conveyance by a mentally incapacitated person does convey title to a good faith purchaser for value. Although the mentally incapacitated person may have rescinded the contract with respect to the party with whom he or she contracted, he or she may not do so in regard to a subsequent good faith purchaser. *Strutt v Ontario Sav. & Loan Ass'n* (1970) 11 CA3d 547, 554, 90 CR 69.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.28 E. Intoxicated Persons

§2.28 E. Intoxicated Persons

A special form of mental incapacity is intoxication resulting from the use of alcohol or drugs. Historically, courts have not looked favorably on claims of intoxication as a defense to contract enforcement, viewing this conduct as a form of voluntary disablement by the affected party that carries with it an assumption of the risk. See *Swan v Talbot* (1907) 152 C 142, 145, 94 P 238. Courts may, however, refuse to enforce contracts entered into by intoxicated persons as a matter of equity when the consideration given by the other party is grossly inadequate (152 C at 146), or may hold that contracts made by intoxicated persons are voidable (not void) on a constructive fraud theory when the other party knew the first party was incapacitated and deliberately procured the contact. *Deasy v Taylor* (1918) 39 CA 235, 178 P 538. Moreover, the California Supreme Court stated in *Guidici v Guidici* (1935) 2 C2d 497, 501, 41 P2d 932:

> The rule that the person alleging his incapacity should be bound by his contract because intoxication is his voluntary act was at first relaxed by allowing him to show that his condition was brought about by the other party. But a more rational view now prevails. The law now regards the fact of intoxication and not the cause of it, and regards that fact as affording proof of want of mental capacity.

See also Restatement (Second) of Contracts §16 (1981) (only voidable contract occurs if one enters into transaction and has reason to know that, because of intoxication, other party is (1) unable to reasonably understand nature and consequences of transaction, or (2) unable to act reasonably in relation to transaction).

Similar to minority and other forms of incapacity, when the incapacity is removed, *i.e.,* when the person has returned to sobriety, a previously intoxicated person can ratify the contract, rendering it enforceable. *Johnson v Harmon* (1876) 94 US (4 Otto) 371, 380, 24 L Ed 271. See Restatement (Second) of Contracts §16, Comment c (1981).

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§2.29 IV. PRISONERS AND PERSONS DEPRIVED OF CIVIL RIGHTS (CC §1556)

"Persons deprived of civil rights" do not have the capacity to contract. CC §1556. Enacted in 1872, this statute has remained unchanged, but other statutes relating to the deprivation of prisoners and parolees' civil rights have changed significantly. *People v Ansell* (2001) 25 C4th 868, 872 n2, 108 CR2d 145. Historically, California statutes depriving prisoners and parolees of civil rights were based on the common law doctrine of "civil death" of those convicted of various crimes, and the statutes eliminated or restricted various rights and privileges for prisoners, including the ability to contract, marry, inherit, and participate in judicial proceedings. *People v Ansell, supra*. However, those statutes have been repealed. The Penal Code now states that a prisoner, during his or her imprisonment, may be deprived only of rights that are "reasonably related to legitimate penological interests." Pen C §2600. Moreover, prisoners have the right, among other things, to convey real and personal property, including written and artistic material (*e.g.,* books and screenplays), to marry, to make a power of appointment, and to make a will. Pen C §2601.

A prison may restrict an inmate's right to contract to acquire obscene material, material likely to incite violence, or material related to gambling or a lottery. CC §2601(c)(1).

Although the California Legislature enacted a "Son of Sam law" (CC §2225) that creates an involuntary trust for a convicted felon's victims of any profits that he or she earns from books, movies, interviews, or memorabilia related to the crime, the California Supreme Court held CC §2225 invalid under the First Amendment. *Keenan v Superior Court* (2002) 27 C4th 413, 415, 117 CR2d 1.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/ V. AGENCY AUTHORITY (CC §§2295-2300)/§2.30 A. Definition of Agency Relationship (CC §2295)

V. AGENCY AUTHORITY (CC §§2295-2300)

§2.30 A. Definition of Agency Relationship (CC §2295)

An agent is defined in the California Civil Code as "one who represents another, called the principal, in dealings with third persons." CC §2295. See *Channel Lumber Co. v Porter Simon* (2000) 78 CA4th 1222, 1227, 93 CR2d 482. Anyone with the capacity to contract may appoint an agent, and anyone may be an agent. CC §2296. Civil Code §§2297-2300 contain a series of additional definitions pertinent to agency relationships in California.

An essential element in formation of an agency relationship is the "delegation of authority from the principal to the agent" permitting the agent to act for and in place of the principal in transactions with third parties. 78 CA4th at 1227. It is also essential for the agent to agree to act on the principal's behalf, subject to the principal's control. *Edwards v Freeman* (1949) 34 C2d 589, 592, 212 P2d 883; *Flores v Evergreen at San Diego, LLC* (2007) 148 CA4th 581, 588, 55 CR3d 823 ("'formation of an agency relationship is a bilateral matter. Words or conduct by both principal and agent are necessary to create the relationship'"). Consideration is not necessary to the creation of an agency relationship. CC §2308. See also CC §2307 (agency may be created by prior authorization or subsequent ratification).

Once appointed (CC §2330),

> [a]n agent represents his principal for all purposes within the scope of his actual or ostensible authority, and all the rights and liabilities which would accrue to the agent from transactions within such limit, if they had been entered into on his own account, accrue to the principal.

The key features of an agency relationship are: "(1) the agent's power to alter legal relations between the principal and others, (2) a fiduciary relationship, and (3) the principal's right to control the agent's conduct." *Vallely Invs., L.P. v Bancamerica Commercial Corp.* (2001) 88 CA4th 816, 826, 106 CR2d 689; *Lewis v Superior Court* (1994) 30 CA4th 1850, 1868, 37 CR2d 63.

Unless an agency relationship is coupled with an interest (see §§2.45-2.47), the relationship is revocable at any time by the principal (CC §2356(a)), although the principal may be subject to liability if the principal has agreed not to revoke or terminate the agency. See *Pacific Landmark Hotel, Ltd. v Marriott Hotels, Inc.* (1993) 19 CA4th 615, 625, 23 CR2d 555 (hotel management company did not have interest in agency relationship created by management contract that would prevent hotel owners from revoking it). An agency relationship is fiduciary in character, and in any dealing with his or her principal the agent is bound to exercise complete honesty, full disclosure, and the highest good faith. *Roberts v Lomanto* (2003) 112 CA4th 1553, 5 CR3d 866.

Agency can be established by agreement between principal and agent—a "true agency"—or be founded on ostensible authority, *i.e.,* some conduct on the part of the principal creating a belief in a third party that an agency exists and reasonable reliance by the third party on that impression.

NOTE: Auctioneers and factors are particular types of agents, subject to special Civil Code rules not discussed below. See CC §§2362-2363, 2367-2369. Attorneys-in-fact acting under powers of attorney are another type of agent subject to special rules, found in the Probate Code and discussed in §§2.46-2.68.

In *Estate of Stephens* (2002) 28 C4th 665, 122 CR2d 358, the California Supreme Court drew a distinction between an agent and an "amanuensis," *i.e.,* someone who merely writes or copies from another person's dictation. The court held that a person can sign a document on behalf of another, in the other's name, without written authority if the person signing acts strictly at the other's request as a ministerial act, without discretion. As long as the person signing does so with the grantor's express authorization, the person signing is not deemed to be an agent but is instead regarded as a mere instrument or amanuensis of the grantor, and the signature is deemed to be that of the grantor. In the *Stephens* case, a relative of the grantor had signed a deed in the grantor's name as the grantor's amanuensis, and the Court ruled that the signature on the deed was deemed to be the grantor's as a matter of law.

Although spouses are fiduciaries and owe a duty of support in the family law context, this alone does not make a spouse an agent of the other spouse under general contract law. *Flores v Evergreen at San Diego, LLC* (2007) 148

CA4th 581, 589, 55 CR3d 823. Although agency will not be implied from marriage alone, much less evidence is needed to establish an agency relationship between spouses than between nonspouses. 148 CA4th at 589.

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§2.31 B. Scope of Authority (CC §§2304-2326)

The authority of agents is outlined in a series of Civil Code provisions. See CC §§2304-2326. In general, an agent can be authorized to do any act that the principal may do. CC §§2304-2305. An agent's authority is derived from what is validly conferred by the principal. See CC §2315. An agent normally has authority to do everything necessary and usual in the ordinary course of business for carrying out the purposes of the agency. CC §2319(1); *van't Rood v County of Santa Clara* (2003) 113 CA4th 549, 572, 6 CR3d 746. Persons dealing with someone presumed to be an agent, however, must ascertain the extent of the agent's authority because a principal cannot be bound when an agent acts beyond the scope of his or her actual or ostensible authority. 113 CA4th at 573. See CC §2333.

There are two basic limits to the authority that a principal can confer on an agent:

- A principal cannot employ an agent to do something that the principal cannot do personally. *Channel Lumber Co. v Porter Simon* (2000) 78 CA4th 1222, 1228, 93 CR2d 482 (relationship between corporation and outside counsel was not one of agency because corporation is legally prohibited from representing itself in court; corporation may hire attorney to perform legal services, but not to act for it in dealings with third parties).
- A principal cannot confer authority on an agent to perform acts the principal is "bound to give his personal attention," *e.g.,* the principal's nondelegable duties. CC §2304. See *Valiyee v Department of Motor Vehicles* (1999) 74 CA4th 1026, 88 CR2d 508 (statutory duties of licensed automobile dealers are not delegable to agents). See also Prob C §4265 (power of attorney cannot authorize attorney-in-fact to make, publish, declare, amend, or revoke principal's will); Comment to Prob C §4265.

An agent may perform any act that the principal could perform, unless the principal's intention to the contrary is clearly apparent. CC §2305. An agent, however, never has authority to perform an act that is known or suspected by the third party to be a fraud on the principal. CC §2306. See, *e.g., Saks v Charity Mission Baptist Church* (2001) 90 CA4th 1116, 110 CR2d 45 (church not liable on promissory notes executed by minister as part of wrongful scheme with third parties to use church's name for their own benefit). Further, an agent has discretion under the Civil Code to disobey a principal's prior instructions if it is clearly in the principal's interest that the agent do so and there is insufficient time to communicate with the principal. CC §2320.

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§2.32 C. Liability of Principal on Agent's Contracts (CC §2330)

An agent represents and binds his or her principal for all purposes within the scope of the agent's actual or ostensible (apparent) authority. CC §2330; *American Builder's Ass'n v Au-Yang* (1990) 226 CA3d 170, 276 CR 262. A disclosed principal is liable on contracts entered into solely by the principal's agent. *Sunset Milling & Grain Co. v Anderson* (1952) 39 C2d 773, 778, 249 P2d 24. With respect to written instruments such as contracts, CC §2337 provides generally that "[a]n instrument within the scope of his authority by which an agent intends to bind his principal, does bind him if such intent is plainly inferable from the instrument itself." See also *Sunset Milling & Grain Co. v Anderson, supra*; *Leonard v Gallagher* (1965) 235 CA2d 362, 45 CR 211. No particular form of signature by the agent is required to bind the principal, as long as it is clear from the instrument itself that this is the result intended. *Sunset Milling & Grain Co. v Anderson, supra*.

NOTE: The specific agency authority of corporate officers and directors to bind the corporation and of members of entities such as partnerships and limited liability companies to bind the entity are subject to special rules in the Corporations Code, discussed in §§2.69-2.80. Corporate officers and other agents should clearly indicate that they are signing in a representative capacity, to avoid possible personal liability. See Com C §3402; Prob C §18000; *Home Fed. Sav. & Loan Ass'n v Ramos* (1991) 229 CA3d 1609, 284 CR 1. Further, the proxy rules take precedence over conflicting Civil Code provisions. See CC §2356(d).

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D. Actual and Ostensible Authority

§2.33 1. Definitions; Creation (CC §§2299-2300, 2315-2317)

Actual authority is authority that the principal expressly confers on the agent or causes the agent to believe he or she has, while *ostensible authority* is authority that the principal (either intentionally or through a lack of ordinary care) causes or allows third parties to believe the agent possesses. *Flores v Evergreen at San Diego, LLC* (2007) 148 CA4th 581, 588, 55 CR3d 823. Compare CC §§2299 and 2316 (actual agency) with CC §§2300 and 2317 (ostensible agency).

NOTE: The California Civil Code uses the term "ostensible authority" in place of the more common term, "apparent authority."

An agent has whatever authority the principal, actually or ostensibly, confers on him or her. CC §2315. A person cannot become the agent of another merely by representing herself or herself as an agent, however. Instead, a person must actually or ostensibly be so employed. *Pagarigan v Libby Care Ctr., Inc.* (2002) 99 CA4th 298, 301, 120 CR2d 892 (adult daughters representing themselves as comatose mother's agents could not bind her to arbitration agreement absent evidence that mother actually employed them as agents or caused hospital to believe daughters were her agents).

A principal's consent to either an actual or ostensible agency need not be express, and it may be implied from the facts of the case, *i.e.*, agency may be proved by circumstantial evidence. See, *e.g.*, *Ripani v Liberty Loan Corp.* (1979) 95 CA3d 603, 611, 157 CR 272 (loan company's branch manager had actual and ostensible authority to exercise option to renew branch's lease). The agent's testimony is admissible to prove both the existence of the agency and the extent of the authority conferred. *Ripani v Liberty Loan Corp., supra*. However, authority to enter into a contract that is required by law to be in writing must be given in a writing, under the "equal dignities" rule. CC §2309. For discussion of the rule, see §§2.38-2.39.

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§2.34 2. Actual Authority (CC §§2299, 2316)

An agent has actual authority when the agent is actually employed by the principal, or when the principal intentionally, or by lack of ordinary care, allows the agent to believe that the agent possesses authority to act for the principal. CC §§2299, 2316; *Ripani v Liberty Loan Corp.* (1979) 95 CA3d 603, 611, 157 CR 272.

Actual authority is usually created by an express written agreement or a power of attorney. For further discussion of California law regarding powers of attorney, see §§2.46-2.68. It may also be created by an oral agreement, although if an underlying contract is required to be in writing, the authorization for the agency must also be in writing. CC §2309; *van't Rood v County of Santa Clara* (2003) 113 CA4th 549, 571, 6 CR3d 746. In addition, actual agency may be implied from the conduct of the parties. 113 CA4th at 571.

Whether actual agency is express or implied, the agreement or consent of both parties is essential to its creation. *Naify v Pacific Indem. Co.* (1938) 11 C2d 5, 12, 76 P2d 663 (agency not created when would-be principal did not see and was not aware of contract provision creating it). Both the principal and the agent must indicate by words or conduct that they wish to create an agency relationship. *van't Rood,* 113 CA4th at 571.

Actual agency may also be created by ratification. CC §§2307, 2310-2314; *van't Rood v County of Santa Clara,* 113 CA4th at 571. See §§2.37-2.43.

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§2.35 3. Ostensible or Apparent Authority (CC §2317)

Ostensible or apparent authority is based on the doctrine of estoppel and arises when a principal intentionally, or by lack of ordinary care, causes or allows a third person to believe that the agent has authority to act for the principal. CC §2317. The elements of ostensible authority are (*Associated Creditors' Agency v Davis* (1975) 13 C3d 374, 118 CR 772):

- A representation by the principal;
- Justifiable reliance by a third person on the representation; and
- Change of position or injury resulting from that reliance.

Whether ostensible agency exists is a question of fact, which may be inferred from the circumstances. *Yanchor v Kagan* (1971) 22 CA3d 544, 550, 99 CR 367. See also *Bear Creek Master Ass'n v Edwards* (2005) 130 CA4th 1470, 1487, 31 CR3d 337.

When ostensible authority exists, the principal is bound by the acts of his or her agent only to persons who have in good faith, and without lack of ordinary care, incurred a liability or parted with value. CC §2334. If a principal has led others to believe that the principal conferred authority on an agent, he or she cannot assert, as against third persons who have relied on the principal's actions in good faith, that he or she did not intend to confer such a power. 22 CA3d at 549. A principal, however, is not bound by the act of the agent when third parties have actual or constructive knowledge of a restriction on the agent's authority. CC §2318. See, *e.g., Turner v Citizens Nat'l Bank* (1962) 206 CA2d 193, 201, 23 CR 698 (buyer could not rely on sellers' agent's ostensible authority to insert additional terms in escrow instructions when instructions themselves indicated no intent to modify original agreement).

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§2.36 E. Acting Without or in Excess of Authority (CC §2333)

If the agent acts without authority or exceeds his or her actual or apparent authority, the resulting transaction is voidable by the principal, *i.e.,* it may be either repudiated or ratified. *Patterson v Crowell* (1910) 15 CA 105, 108, 113 P 700 (principal whose agent exceeded authority by paying higher price than authorized could not reap benefit of transaction without in effect ratifying all its terms, including price). Civil Code §2333 provides that, when an agent exceeds his or her authority, the principal is bound by the agent's authorized acts only to the extent that those acts can be "plainly separated" from the agent's unauthorized acts.

Only the principal can repudiate or ratify an unauthorized act of its agent, not third parties. *Boteler v Conway* (1936) 13 CA2d 79, 83, 56 P2d 587 (only principal corporation, not guarantor of its performance, could repudiate material changes to contract made by corporation's agent).

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1. Ratification by Principal

§2.37 a. Time and Effect of Ratification

Express ratification has been defined as "the voluntary election by a person to adopt in some manner as his own an act which was purportedly done on his behalf by another person, the effect of which, as to some or all persons, is to treat the act as if originally authorized by him." *Behniwal v Mix* (2005) 133 CA4th 1027, 1039, 35 CR3d 320. When the interests of third parties are involved, however, a principal who does not repudiate or disaffirm an unauthorized act of his or her agent within a reasonable period of time after acquiring knowledge of the act will be considered to have ratified the act. *Gates v Bank of America* (1953) 120 CA2d 571, 576, 261 P2d 545. For further discussion of ratification by a principal's acquiescence, see §2.39. But if there are no third parties involved and the controversy relates solely to whether a principal has confirmed the admittedly unauthorized act of the agent, some affirmative conduct by the principal (or conduct inconsistent with disapproval) is required. See 120 CA2d at 577.

The effect of ratification is to treat the unauthorized act as if it had been authorized by the principal originally. *Rakestraw v Rodrigues* (1972) 8 C3d 67, 72, 104 CR 57. See CC §2307. The ratification relates back to the time when the purported agent performed the act at issue. 8 C3d at 73. See also CC §2307. Because the effect of ratification is to authorize the agent's act, the purported agent is released from personal liability for the act. 8 C3d at 73.

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§2.38 b. Equal Dignities Rule (CC §§2309-2310)

Ratification is subject to the equal dignities rule, which provides that a ratification can be made only in the same manner that would have been necessary to confer original authority for the act ratified. CC §2310; *van't Rood v County of Santa Clara* (2003) 113 CA4th 549, 571, 6 CR3d 746. For example, because an agent must have written authority to execute a deed, a subsequent ratification of an invalidly executed deed must also be in writing. *Estate of Stephens* (2002) 28 C4th 665, 673, 122 CR2d 358. "Ratification of an 'invalid execution,' however, must itself be in writing where the agent enters into a contract that must be in writing." *Behniwal v Mix* (2005) 133 CA4th 1027, 1039, 35 CR3d 320. If oral authorization would have been sufficient to confer original authority, the principal may ratify an act by accepting or retaining the benefit of the act, and giving notice that he or she has done so. CC §2310.

An oral authorization usually is sufficient, except that authority to enter into a contract required to be in writing can only be given in writing. CC §2309. Civil Code §2309, however, does not prohibit enforcement of an oral agreement between the principal and the agent, and similarly, §2310 does not apply to an oral or implied ratification as between the principal and agent. *Estate of Stephens,* 28 C4th at 673; *Rakestraw v Rodrigues* (1972) 8 C3d 67, 73, 104 CR 57. An additional exception to §2309 is when the signature of the agent is "purely a mechanical act" that does not involve the exercise of discretion, such as when a principal directs an agent to sign a known document on the principal's behalf. This is known as the "amanuensis rule." See §2.30; *Estate of Stephens,* 28 C4th at 675.

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§2.39 c. Ratification by Principal's Conduct or Acquiescence

Subject to the equal dignities rule of CC §§2309-2310 (see §2.38), ratification may be express or implied. The principal may adopt the purported agent's act expressly, or may adopt the agent's act by implication based on the principal's conduct, if an intent to consent to, or to adopt, the agent's action can be fairly inferred from the principal's conduct, including conduct that is inconsistent with any interpretation other than that the principal intended to approve and adopt it. *Behniwal v Mix* (2005) 133 CA4th 1027, 1040, 35 CR3d 320. See also *Rakestraw v Rodrigues* (1972) 8 C3d 67, 73, 104 CR 57. For example, the principal's signature on subsequent documents relating to a pending sale may ratify the agent's formation of the original contract of sale. *Behniwal v Mix,* 133 CA4th at 1040.

When the rights of innocent third parties who dealt with the agent are involved, a principal must affirmatively disaffirm or repudiate the act of the agent or else his or her silence will be considered ratification, *i.e.,* ratification by acquiescence. However, silence or inaction that would amount to a ratification in favor of third parties may not amount to a ratification in favor of the agent who committed the unauthorized act. If the issue is whether a principal has ratified by conduct an unauthorized act of the agent, the principal's intent to ratify must be shown by unambiguous evidence and must be demonstrated by acts inconsistent with any other theory. *Gates v Bank of America* (1953) 120 CA2d 571, 577, 261 P2d 545. See also *Rakestraw,* 8 C3d at 74 (exoneration of agent by ratification limited to instances when principal has power to rescind at time of his or her "first complete knowledge" of transaction and fails to rescind at that time).

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§2.40 d. Voluntariness Requirement for Ratification

Whether express or implied, ratification must be voluntary. *Rakestraw v Rodrigues* (1972) 8 C3d 67, 73, 104 CR 57. Thus, if the principal simply takes action to minimize losses caused by an agent's unauthorized act or resulting from duress or misrepresentation by the agent, the principal's actions will not amount to ratification. 8 C3d at 73. A principal must ordinarily be apprised of all the facts surrounding a transaction before he or she will be held to have ratified an agent's unauthorized acts. *Reusche v California Pac. Title Ins. Co.* (1965) 231 CA2d 731, 737, 42 CR 262 (principal's failure to make inquiries on learning her endorsement on check had been forged and acceptance of transaction's benefits amounted to ratification). If, however, the principal fails to investigate when circumstances are such as to put a reasonable person on notice, he or she may be held to have ratified despite lack of full knowledge of the act. 231 CA2d at 738.

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§2.41 e. Partial Ratification (CC §2311)

A principal cannot divide an agency transaction and accept the benefits while avoiding the burdens. *Norcal Mut. Ins. Co. v Newton* (2000) 84 CA4th 64, 81, 100 CR2d 683. A principal who ratifies part of a transaction ratifies the whole transaction. CC §2311. See *Navrides v Zurich Ins. Co.* (1971) 5 C3d 698, 704, 97 CR 309. In *Navrides,* an attorney, without authority from his client, negotiated a settlement with the tortfeasor's insurer, took receipt of the settlement check, and misappropriated the funds. The client sued the insurance company in an attempt to recover the settlement, but the court held that by suing the insurance company, the client had ratified the entire transaction—both the settlement and the attorney's receipt of the settlement check. The court noted that because ratification "is approval of a transaction that has already taken place," a principal must ratify the transaction as it in fact occurred. 5 C3d at 704. See also *Patterson v Crowell* (1910) 15 CA 105, 108, 113 P 700 (principal whose agent exceeded authority by paying higher price than authorized could not reap benefit of transaction without ratifying all its terms, including price).

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§2.42 2. Ratifications That Prejudice Third Persons (CC §2313)

A ratification is invalid if it prejudices third persons without their consent. CC §2313. When, for example, a broker canceled a personal injury liability policy without authority, the insured could not impliedly ratify the cancellation after an injury-causing accident had occurred because this would prejudice the rights of third parties whose causes of action had already accrued. *Hooker v American Indem. Co.* (1936) 12 CA2d 116, 123, 54 P2d 1158.

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§2.43 3. Rescission of Ratification (CC §2314)

A principal may rescind a ratification only if it was made without his or her consent or "with an imperfect knowledge of the material facts of the transaction ratified." CC §2314. See *Willey v Clements* (1905) 146 C 91, 99, 79 P 850 (principal could rescind ratification of exchange of deeds based on agent's failure to impart material facts that would not be disclosed by examining property). The party seeking to avoid the transaction has the burden of showing lack of consent or imperfect knowledge of material facts under CC §2314. For example, the principal could not rescind its ratification of a purchase of land on the ground that its agent also represented the seller when the principal did not prove it was unaware of the dual agency when the transaction was ratified. *Blood v La Serena Land & Water Co.* (1896) 113 C 221, 236, 45 P 252.

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§2.44 F. Notices to Principal or Agent (CC §2332)

Civil Code §2332 provides that, as against the principal, both the principal and the agent are deemed to have notice of what the other has notice of and "ought, in good faith and the exercise of ordinary care and diligence, to communicate to the other." See, *e.g., Zurich Ins. Co. (U.S. Branch) v Killer Music, Inc.* (9th Cir 1993) 998 F2d 674 (insurance broker's knowledge of insured's claim imputed to insurer); *Marriage of Cloney* (2001) 91 CA4th 429, 110 CR2d 615 (escrow agent's actual knowledge of vendor's full name imputed to real property purchaser). Civil Code §2332 has been interpreted as being limited to imputation of an agent's knowledge to the principal only; it does not concern imputation of a principal's knowledge to the agent. Further, there is no principle of agency law that imputes knowledge of one agent to other agents. *Godwin v City of Bellflower* (1992) 5 CA4th 1625, 7 CR2d 524.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.45 G. Termination of Agency Relationship (CC §2355)

§2.45 G. Termination of Agency Relationship (CC §2355)

Civil Code §2355 enumerates the circumstances in which an agency relationship is terminated "as to every person having notice thereof":

- Expiration of its term;
- Extinction of its subject;
- Death or incapacity of the agent; or
- The agent's renunciation of the agency relationship.

Further, unless the agent's power is "coupled with an interest in the subject of the agency" (CC §2356(a)), *i.e.*, is irrevocable, an agency relationship is terminated by:

- Revocation by the principal; or
- Death or incapacity of the principal.

In *Pacific Landmark Hotel, Ltd. v Marriott Hotels, Inc.* (1993) 19 CA4th 615, 625, 23 CR2d 555 (citations omitted), the court explained what "coupled with an interest" means:

> For an agency to be coupled with an interest the agent must have a "specific, present and coexisting" beneficial interest in the subject matter of the agency.... The agency must be created for the benefit of the agent in order to protect some title or right in the subject of the agency or secure some performance to him. ... Monetary compensation, in whatever form it may take, does not create a power coupled with an interest so as to make the agency irrevocable.

Notwithstanding a revocation by, or death or incapacity of, the principal, any good faith transaction entered into with the agent by a person acting without actual knowledge of the revocation, death, or incapacity is binding on the principal and his or her successors in interest. CC §2356(b).

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VI. POWERS OF ATTORNEY (Prob C §§4000-4545)

§2.46 A. Generally (Prob C §4022)

A power of attorney is a written instrument, executed by a natural person with capacity to contract (*i.e.,* the principal), that grants actual authority to an attorney-in-fact, sometimes also known as an agent. Prob C §4022. See Prob C §4026 (defining principal as "a natural person who executes a power of attorney"). The attorney-in-fact is the person granted authority to act for the principal. That person may be called an attorney-in-fact or an agent, and may include a successor, an alternate attorney-in-fact, or a person delegated authority by an attorney-in-fact. Prob C §4014. Subject to certain limitations, an attorney-in-fact acts in place of the principal, and a third party must accord the attorney-in-fact the same rights and privileges as would be accorded the principal. Prob C §4300. For further discussion of third party dealings with an attorney-in-fact, see §2.65.

In California, powers of attorney are governed by the Power of Attorney Law (Prob C §§4000-4545), which is a detailed, comprehensive, and essentially self-contained statutory scheme. The general law of agency applies when the Power of Attorney Law does not provide a specific rule. Prob C §§4051, 4054. For a review of California law governing agency relationships not created under the Power of Attorney Law, see §§2.30-2.45. Sections 2.47-2.68 summarize the provisions of the Power of Attorney Law most relevant to contract formation.

NOTE: For a comprehensive review and analysis of governing law and practice relating to the use of powers of attorney in California, practitioners should consult California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.47 B. Application of Power of Attorney Law (Prob C §4050)

§2.47 B. Application of Power of Attorney Law (Prob C §4050)

In general, the Power of Attorney Law applies to (Prob C §4050(a)):

- Durable powers of attorney, other than powers of attorney for health care (see Prob C §§4600-4805);
- Statutory form powers of attorney (which can be durable or nondurable; see Prob C §§4400-4465); and
- Any other powers of attorney that incorporate or refer to the Power of Attorney Law or its provisions.

The Power of Attorney Law does not apply to (Prob C §4050(b)):

- Powers of attorney in which the attorney-in-fact also has an interest in the subject matter (which are governed by CC §2356);
- Reciprocal or inter-insurance exchanges and their contracts, subscribers, attorneys-in-fact, agents, and representatives; and
- A proxy that an attorney-in-fact gives to another to exercise voting rights.

Probate Code §4050 does not affect the validity of powers of attorney or agencies to which the Power of Attorney Law does not apply. Prob C §4050(c). Thus, a power of attorney that does not meet the execution requirements of the Power of Attorney Law may nonetheless be held valid under general agency law or other principles. See Comment to Prob C §4050(c). See also §§2.30-2.46.

Unless a statutory exception applies, a principal may limit the application of one or more provisions of the Power of Attorney Law by "an express statement in the power of attorney or by providing an inconsistent rule in the power of attorney." Prob C §4101(a). There are several exceptions to this general rule, however. A principal may not limit provisions of the Power of Attorney Law concerning:

- Warnings or notices required to be included in the power of attorney;
- Operative dates of statutory enactments or amendments;
- Execution formalities;
- Qualifications of witnesses;
- Qualifications of attorneys in fact; or
- Protection of third persons from liability.

Prob C §4101(b). Further, the principal may not limit application of a statutory provision that states that it is not subject to limitation by the power of attorney. Prob C §4101(b).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.48 C. Execution of Power of Attorney (Prob C §4120)

§2.48 C. Execution of Power of Attorney (Prob C §4120)

A power of attorney may be executed by any natural person having the capacity to contract. Prob C §4120. See Prob C §4022 (defining power of attorney as written instrument executed by natural person with capacity to contract). To be legally sufficient, a power of attorney must (Prob C §4121):

- Contain the date of its execution;
- Be signed by the principal, or in the principal's name by another adult at the principal's direction and in the principal's presence; and
- Be acknowledged by a notary public or signed by at least two witnesses.

Any meaningful expression of the principal's intent will suffice to create a power of attorney; an "X" can be a clear expression of the principal's intent. *Torres v Torres* (2006) 135 CA4th 870, 37 CR3d 754. If the power of attorney is signed by witnesses, they must be adults, and each witness must witness the principal signing the instrument or must witness the principal's acknowledgment of the signature or the power of attorney. The attorney-in-fact may not be a witness. Prob C §4122. The requirements of §§4121 and 4122 cannot be limited by the principal in the power of attorney. Prob C §4101(b)(3)-(4).

Only a power of attorney that gives the attorney-in-fact power to execute a real estate deed or mortgage need be recorded. See CC §2933. If a power of attorney is recorded, it can only be revoked by recording a revocation of the power of attorney. CC §1216.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.49 D. Durable and Nondurable Power of Attorney (Prob C §§4022, 4124)

§2.49 D. Durable and Nondurable Power of Attorney (Prob C §§4022, 4124)

A power of attorney may be durable or nondurable. Prob C §4022. If the power of attorney is durable, the authority granted to the attorney-in-fact may be exercised even if the principal later becomes incapacitated. Prob C §4124. A durable power of attorney must contain language showing the principal's intent that the authority granted may be exercised despite the principal's later incapacity. Prob C §§4124, 4404. In a nondurable power of attorney, the authority granted the attorney-in-fact is terminated if the principal becomes incapacitated. Prob C §4155(a). For a comprehensive review and analysis of durable powers of attorney, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

A durable power of attorney, *i.e.,* one in which the authority of the attorney-in-fact does not terminate when the principal becomes incapacitated, must contain one of the following statements (Prob C §4124):

- "This power of attorney shall not be affected by subsequent incapacity of the principal."
- "This power of attorney shall become effective upon the incapacity of the principal."
- Similar words showing the intent of the principal that the authority conferred will be exercisable regardless of the principal's subsequent incapacity.

See, *e.g.,* Prob C §§4401 (Uniform Statutory Form Power of Attorney), 4404.

Normally, a printed form may be used for a durable power of attorney as long as the form complies with Prob C §4128, which specifies the requirements for printed forms. Prob C §4102(b). For a statutory form of power of attorney, see §2.68.

If a principal creates and grants authority under a durable power of attorney, the principal's subsequent incapacity does not affect the agency because acts performed by an attorney-in-fact under a durable power of attorney while the principal is incapacitated have the same effect and benefit and bind the principal and the principal's successors in interest just as if the principal had capacity. Prob C §4125.

In contrast, if the power of attorney is nondurable, the authority of the attorney-in-fact is terminated by the principal's incapacity. Prob C §4155(a). The application of §4155 cannot be limited by language in the power of attorney. Prob C §4155(a). If, however, an attorney-in-fact or third party acts in good faith under a nondurable power of attorney without actual knowledge of the principal's incapacity, the incapacity does not revoke or terminate the agency, and actions taken under it, unless otherwise invalid or unenforceable, bind the principal and the principal's successors in interest. Prob C §4304(b). See also §4155(b) (attorney-in-fact or third person with no notice of principal's incapacity is protected from liability).

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§2.50 E. Springing Power of Attorney (Prob C §§4030, 4129)

Powers of attorney can also be designed to become effective at a specified future time or on the occurrence of a specified future event or contingency, including the principal's incapacity. Prob C §4030. These are known as "springing" powers of attorney. A springing power of attorney may be durable or nondurable. Prob C §4030. If a power of attorney becomes effective on the incapacity of the principal, it is necessarily a durable power of attorney. See Prob C §4124(b); Comment to Prob C §4129. A power of attorney may be nondurable if it takes effect on an event other than the incapacity of the principal, such as the principal's failure to return from a trip by a certain date. Prob C §4030; Comment to Prob C §4129.

To eliminate potential issues concerning whether a springing power of attorney has become effective, §4129 contains a mechanism for conclusively determining that a triggering event or contingency has occurred. The principal may designate in a springing power of attorney "one or more persons who, by a written declaration under penalty of perjury, have the power to determine conclusively that the specified event or contingency has occurred. The principal may designate the attorney-in-fact or someone else to perform this function, either alone or jointly with other persons." Prob C §4129(a). When the designated person executes a written declaration under penalty of perjury that the triggering event has occurred, the power of attorney becomes effective. Any person may act in reliance on the written declaration, whether or not the specified event has in fact occurred. Prob C §4129(b).

Probate Code §4129 does not apply if the power of attorney sets forth a different method for determining whether a triggering event has occurred. Prob C §4129(d); Comment to Prob C §4129. Nevertheless, to avoid court involvement, it is prudent for the principal to designate someone to determine that the triggering event or contingency has occurred and the manner in which the determination should be made. See California Powers of Attorney and Health Care Directives §§4.11-4.13 (Cal CEB 2008). This is particularly true when the triggering event is the incapacity of the principal, because incapacity may occur over time and can be difficult to determine.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.51 F. Scope of Authority Granted in Power of Attorney (Prob C §4123)

§2.51 F. Scope of Authority Granted in Power of Attorney (Prob C §4123)

A principal may grant authority for an attorney-in-fact to act on the principal's behalf in regard to all lawful subjects and purposes (a grant of a general power) or with respect to one or more express subjects or purposes (a grant of a limited or special power). Prob C §4123(a). The authority granted the attorney-in-fact under a grant of either general or limited power may encompass (Prob C §4123(a)-(c)):

- The principal's property, including all real and personal property wherever located and whenever acquired;
- The principal's care, including determining where the principal will live, providing meals, hiring household employees, providing transportation, handling mail, and arranging recreation and entertainment; or
- Any other matter (except the principal's will; see Prob C §4265).

A power of attorney may also grant authority to the attorney-in-fact by incorporating powers by reference to another statute. Prob C §4263(b). See also *Garrison v Superior Court* (2005) 132 CA4th 253, 266, 33 CR3d 350 (attorney-in-fact, acting on authority granted in durable power of attorney, may enter into binding arbitration agreements on behalf of principal).

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§2.52 1. Limited or Special Powers of Attorney (Prob C §4262)

If the power of attorney grants limited authority, the attorney-in-fact has the authority granted in the power of attorney, as limited with regard to permissible action, subject, or purpose. In addition, the attorney-in-fact will have any authority that is incidental, necessary, or proper to carry out the granted authority. Prob C §4262.

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§2.53 2. General Powers of Attorney (Prob C §4261)

Under Prob C §§4260-4266, governing authority of attorneys-in-fact, if general authority is granted in the power of attorney, the attorney-in-fact has "all the authority to act that a person having the capacity to contract may carry out through an attorney-in-fact specifically authorized to take the action." Prob C §4261. Section 4261 provides the broadest possible authority for one holding a general power of attorney. Comment to Prob C §4261.

NOTE: Probate Code §§4261-4266 do not apply to statutory form powers of attorney. Prob C §4260. Rather, the Uniform Statutory Form Power of Attorney Act (Prob C §§4400-4465) has its own specific provisions regarding authority granted in a statutory form power of attorney. See §§2.66-2.69.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.54 3. When Express Authority Is Required (Prob C §4264)

§2.54 3. When Express Authority Is Required (Prob C §4264)

Certain acts must be expressly authorized in the power of attorney, *i.e.,* a general power of attorney will not be construed to include them. A power of attorney must expressly authorize an attorney-in-fact to:

- Create, modify, or revoke a trust;
- Fund a trust not created by the principal with the principal's property;
- Make or revoke a gift of the principal's property in trust or otherwise;
- Exercise the right to make a disclaimer on the principal's behalf;
- Create or change survivorship interests in the principal's property;
- Designate beneficiaries to receive any property, benefit, or contract right on the principal's death; or
- Make a loan to the attorney-in-fact.

Prob C §4264. See, *e.g., Schubert v Reynolds* (2002) 95 CA4th 100, 103, 115 CR2d 285.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.55 G. Modification of Power of Attorney (Prob C §§4121, 4150)

§2.55 G. Modification of Power of Attorney (Prob C §§4121, 4150)

A principal may modify a power of attorney either in accordance with the terms of the power itself or by an instrument executed in the same manner as a power of attorney, *i.e.,* an instrument that is dated, signed by the principal or by another adult at the principal's direction, and acknowledged by a notary public or signed by at least two adult witnesses. Prob C §§4121, 4150(a). On execution formalities for powers of attorney, see §2.48. Attorneys-in-fact or third persons without notice of the modification are protected from liability. Prob C §4150(b). See also Prob C §4304. Application of §4150 can be limited by the power of attorney. Prob C §4150(b).

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§2.56 H. Revocation or Termination of Power of Attorney (Prob C §4151)

The principal may revoke a power of attorney either in accordance with its terms or simply "by a writing" (as distinct from a formal instrument required to modify a power of attorney; see §2.55). Prob C §4151(a). The revocation provided for in §4151 is a revocation of the power of attorney in its entirety. In contrast, §§4152 and 4153 permit termination or revocation of the *authority* of the attorney-in-fact. See §§2.62-2.64. Attorneys-in-fact or third persons without notice of revocation or termination of the power of attorney are protected from liability. Prob C §§4151(b), 4303. A power of attorney does not terminate through lapse of time unless the power of attorney states a time of termination. Prob C §4127.

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I. Attorneys-in-Fact

§2.57 1. Qualifications (Prob C §4200)

An attorney-in-fact must have the capacity to contract. Prob C §4200. Although the principal who executes a power of attorney must be a "natural person" (Prob C §4026; see §2.46), there is no such requirement for the attorney-in-fact. See Prob C §56 ("person" defined to include entities as well as individuals). Because capacity to contract is required, minors, persons of unsound mind, and prisoners (under certain circumstances) may not serve as attorneys-in-fact. CC §1556. However, designating an unqualified person as an attorney-in-fact does not relieve the unqualified person of duties to the principal, nor does it affect a third person's immunity from liability. Prob C §4201. See §2.35 for discussion of the principal's liability to third parties who rely in good faith on the ostensible authority of an agent. An attorney-in-fact is entitled to reasonable compensation and reimbursement for the expenses of providing services to the principal. Prob C §4204.

NOTE: "Any person may be authorized to act as an agent, including an adverse party to a transaction." *Michelson v Hamada* (1994) 29 CA4th 1566, 1579, 36 CR2d 343. See CC §2295.

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§2.58 2. Multiple Attorneys-in-Fact; Successors (Prob C §4202)

The principal may designate more than one attorney-in-fact in one or more powers of attorney. Prob C §4202(a). Unless the power of attorney provides otherwise, multiple attorneys-in-fact may exercise the authority granted to them only by unanimous action. Prob C §4202(b). Because application of §4202 may be limited in the power of attorney, however, the unanimous action requirement is merely a "default rule." Comment to Prob C §4202. See also Prob C §4101. Indeed, the "power of attorney may provide that the authority conferred on two or more attorneys-in-fact shall or may be exercised either jointly or severally or in a manner, with the priority, and with respect to particular subjects, provided in the power of attorney." Comment to Prob C §4202. Probate Code §4202 also addresses the issue of the unavailability of one attorney-in-fact if more than one has been appointed.

A principal may designate one or more successor attorneys-in-fact to act if the authority of a predecessor attorney-in fact terminates. Prob C §4203(a). The principal may also grant authority to another person to designate successor attorneys-in-fact. Prob C §4203(b). A successor attorney-in-fact is not liable for the predecessor's actions. Prob C §4203(c). If there are inconsistent grants of authority to one or more attorneys-in-fact in two or more powers of attorney, the authority granted last controls to the extent of the inconsistency. Prob C §4130(a).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.59 3. Delegation of Authority by Attorney-in-Fact (Prob C §4205)

§2.59 3. Delegation of Authority by Attorney-in-Fact (Prob C §4205)

An attorney-in-fact may delegate authority to perform "mechanical acts" to qualified persons. Prob C §4205(a). Delegating authority does not relieve the attorney-in-fact of responsibility, however. The attorney-in-fact remains accountable to the principal for the exercise or nonexercise of the authority delegated. Prob C §4205(b).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.60 4. Resignation of Attorney-in-Fact (Prob C §4207)

§2.60 4. Resignation of Attorney-in-Fact (Prob C §4207)

An attorney-in-fact may resign under the following circumstances (Prob C §4207(a)):

- By giving notice to the principal, if the principal is competent;
- If a conservator is appointed, by giving notice to the conservator;
- By written agreement of the successor attorney-in-fact designated in the power of attorney; or
- Pursuant to a court order.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.61 5. Duties of Attorney-in-Fact (Prob C §4230)

§2.61 5. Duties of Attorney-in-Fact (Prob C §4230)

In general, a person designated as an attorney-in-fact has no duty to exercise the authority granted in the power of attorney and is not subject to other duties of an attorney-in-fact, even if the principal is incapacitated, missing, or otherwise unable to act. Prob C §4230(a). There are some exceptions, however. Although acting for the principal in one transaction does not obligate the attorney-in-fact to act for the principal in a subsequent transaction, the attorney-in-fact has a duty to complete a transaction he or she has begun. Prob C §4230(b). If an attorney-in-fact expressly agrees in writing to act for the principal, the attorney-in-fact has a duty to the principal to act according to the terms of that agreement. Prob C §4230(c).

In general, an attorney-in-fact is a fiduciary and must observe the "prudent person" standard in dealing with property of the principal. Prob C §4231(a). For further discussion of the duties of attorneys-in-fact, see California Powers of Attorney and Health Care Directives, chap 4 (Cal CEB 2008).

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6. Revocation or Termination of Authority of Attorney-in-Fact

§2.62 a. Revocation of Authority (Prob C §4153)

As distinct from revocation of the power of attorney itself, the *authority* of an attorney-in-fact may be revoked in one of three ways (Prob C §4153(a)):

- According to the terms of the power of attorney;
- When the principal informs the attorney-in-fact orally or in writing that the attorney-in-fact's authority is revoked; or
- When the principal's legal representative, with approval of the court, informs the attorney-in-fact in writing that his or her authority is revoked.

An attorney-in-fact or third person without notice of the revocation is protected from liability. Prob C §4153(b). See also Prob C §4304.

If a principal executes a power of attorney designating his or her spouse as the attorney-in-fact, the spouse's authority is revoked by dissolution or annulment of the marriage, but may be revived by remarriage of the spouses. Prob C §4154(a).

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b. Termination of Authority

§2.63 (1) Terminating Events (Prob C §4152)

The authority of an attorney-in-fact may be terminated (Prob C §4152(a)):

- By the terms of the power of attorney;
- When the subject of the power of attorney is extinct or the purpose of the power of attorney is fulfilled;
- When the attorney-in-fact's authority is revoked under Prob C §4153 (see §2.62);
- By the death of the principal (except for authority to perform certain specific acts authorized by statute);
- By removal of the attorney-in-fact;
- By resignation of the attorney-in-fact;
- By incapacity of the attorney-in-fact, unless the incapacity is temporary, in which event the power of attorney is suspended only for the duration of the incapacity;
- By dissolution or annulment of the marriage of the attorney-in-fact and the principal; or
- By the death of the attorney-in-fact.

A third person with no notice of the terminating event is protected from liability. Prob C §4152(b). See also Prob C §4304. In addition, the authority of an attorney-in-fact under a nondurable power of attorney is terminated by the incapacity of the principal to contract. Prob C §4155(a). However, an attorney-in-fact or third person who does not have notice of the principal's incapacity is protected from liability. Prob C §4155(b). For further discussion of nondurable powers of attorney, see §2.49.

When an attorney-in-fact or third party acts in good faith under a durable or nondurable power of attorney without actual knowledge of the death of the principal, the principal's death does not revoke or terminate the agency in regard to those acts, and the acts, unless otherwise invalid or unenforceable, are binding on the principal's successors in interest. Prob C §4304(a).

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§2.64 (2) Affidavit of Lack of Actual Knowledge (Prob C §§4305-4306)

With respect to acts taken in good faith reliance of the attorney-in-fact's exercise of authority, an affidavit executed by an attorney-in-fact under a power of attorney is conclusive proof of the nonrevocation or nontermination of the power. The affidavit must state that, at the time the acts were taken, the attorney-in-fact did not have actual knowledge of the termination of the power of attorney by revocation or of the principal's death or incapacity. Prob C §4305(a).

A third person furnished with such an affidavit is liable for attorney fees if the person refuses to accept the exercise of the attorney-in-fact's authority. Prob C §4306. An exception is made, however, for third persons whom a court determines believed in good faith that the attorney-in-fact was not qualified or was attempting to exceed or improperly exercise his or her authority. Prob C §4306(a).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.65 7. Third Persons Dealing With Attorney-in-Fact (Prob C §§4300, 4302-4303, 4309-4310)

§2.65 7. Third Persons Dealing With Attorney-in-Fact (Prob C §§4300, 4302-4303, 4309-4310)

Third persons dealing with attorneys-in-fact acting under a power of attorney must accord them the same rights and privileges they would accord the principal. Prob C §4300. If the principal could not require the third person to act in the same circumstances, however, the third person is not required to do business with the attorney-in-fact. Prob C §4300.

A third person is not required to do business with an attorney-in-fact who previously breached an agreement with the third person. Prob C §4309. In addition, a financial institution is not required to open a deposit account or make a loan on behalf of a principal on the request of an attorney-in-fact if the principal is not currently a depositor or borrower of the financial institution. Prob C §4310.

Third persons may require the attorney-in-fact to furnish identification, sample signatures of the principal and the attorney-in-fact, the addressees of the principal, and any other information reasonably necessary for the third person's ability to transact business with the attorney-in-fact. Prob C §4302.

A third person who acts in good faith reliance on a power of attorney is not liable to the principal or any other person if the power of attorney (Prob C §4303(a)):

- Is presented by the attorney-in-fact;
- Appears valid on its face; and
- Includes a notary public's certificate of acknowledgment or is signed by two witnesses.

A third person who does not satisfy the conditions stated above may still be immune from liability. Prob C §4303(b). Indeed, the statute expressly states that it is not the exclusive means for providing immunity to third persons, and that any other immunities that may exist continue to apply. Prob C §4303(b). See also Comment to Prob C §4303. The purpose of §4303 is to ensure that powers of attorney will be accepted and relied on by third persons. Comment to Prob C §4303.

NOTE: There is one exception to the immunity provided to third persons by §4303. The person presenting the power of attorney must actually be the designated attorney-in-fact. The immunity does not apply if the person purporting to be the attorney-in-fact is an impostor. Comment to Prob C §4303. Thus, persons dealing with attorneys-in-fact must be careful to require sufficient identification.

With respect to third persons, a copy of a power of attorney has the same force and effect as the original power of attorney if it is certified by a licensed California attorney, a notary public, or a government official authorized to make certifications. Prob C §4307(a)-(b). Certification under §4307, however, is not a prerequisite to immunities afforded a third person who relies in good faith reliance on a copy or a power of attorney. See Prob C §4307(d). See also Comment to Prob C §4307(d).

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J. Uniform Statutory Form Power of Attorney

§2.66 1. Use of Form (Prob C §§4401-4402)

California's Uniform Statutory Form Power of Attorney Act is found in Prob C §§4400-4465. The form power of attorney is set forth in §4401. The power of attorney provided in the form is durable, remaining in effect after the incapacity of the principal, unless the language in the form that makes the instrument a durable power of attorney is stricken. Comment to Prob C §4401. See §2.49 for further discussion of durable powers of attorney. Use of the statutory form in §4401 is both sufficient and necessary to bring the provisions of the Uniform Statutory Form Power of Attorney Act into play. Comment to Prob C §4401. The statutory form can be used in whole or part instead of individually drafted forms or forms adapted from a form book.

The statutory form power of attorney is legally sufficient if three requirements are met (Prob C §4402):

- The wording of the form substantially complies with the language of the form set forth in §4401. However, the form need not include the provisions set forth in §4401 regarding the designation of co-agents.
- The form must be "properly completed." "Properly completed" is not defined by statute or in the case law.
- The principal's signature must be acknowledged.

PRACTICE TIP: Despite the "substantial compliance" language of Prob C §4402, because the form in §4401 is specifically provided for and approved by statute, attorneys are advised to use it without alteration (with the exception of any "special instructions"—see §2.67) to avoid the issue of whether the Uniform Statutory Form Power of Attorney Act applies. This is the true despite the Law Revision Commission comment that "[m]inor variances in wording will not take it out of the scope of the [Act]." Comment to Prob C §4401. The point is to avoid having to litigate whether the variations are "minor" or otherwise.

Note that the term "agent" is used throughout the Uniform Statutory Form Power of Attorney Act and in the form instead of "attorney-in-fact." This is an effort by the legislature to make the language of the Act informal. Comment to Prob C §4401.

For a comprehensive discussion of the application of the Uniform Statutory Form Power of Attorney Act, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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§2.67 2. Form Provisions (Prob C §4401)

The statutory power of attorney form in Prob C §4401 contains a list of powers that relate to various classes of activities. (Health care matters are not included, however. See Prob C §4701.) The statutory form provides space for "Special Instructions." Here, the principal may include specific provisions limiting or extending the powers granted to the agent. Because the statutory form contains a limited list of powers, a principal who wishes to give the agent the broadest possible powers should add the following language in the Special Instructions portion of the form (Comment to Prob C §4401):

> **In addition to all of the powers listed in lines (A) to (M) above, I grant to my agent full power and authority to act for me, in any way which I myself could act if I were personally present and able to act, with respect to all other matters and affairs not listed in lines (A) to (M) above, but this authority does not include authority to make health care decisions.**

The last paragraph of the statutory form expressly protects a third party who receives a copy of the form and acts in reliance on it in conformance with general protections for third parties throughout the general Power of Attorney Law (Prob C §§4000-4545). See Prob C §§4300 (third persons required to respect agent's authority), 4301 (immunities of third person), 4303 (protection of person who relies in good faith reliance on power of attorney when specified requirements satisfied), 4304 (good faith reliance on power of attorney without actual knowledge of death or incapacity of principal), and 4305 (affidavit of lack of knowledge of termination of power). The protection provided by these sections and other immunities apply to a statutory form power of attorney. See Prob C §§4100 (application of division to statutory form power of attorney), 4407 (general provisions applicable to statutory form power of attorney). Comment to Prob C §4401.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.68 3. Form: Uniform Statutory Form Power of Attorney

§2.68 3. Form: Uniform Statutory Form Power of Attorney

UNIFORM STATUTORY FORM POWER OF ATTORNEY

(California Probate Code Section 4401)

NOTICE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE UNIFORM STATUTORY FORM POWER OF ATTORNEY ACT (CALIFORNIA PROBATE CODE SECTIONS 4400-4465). IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.

I _____ (your name and address) appoint _____ (name and address of the person appointed, or of each person appointed if you want to designate more than one) as my agent (attorney-in-fact) to act for me in any lawful way with respect to the following initialed subjects:

TO GRANT ALL OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF (N) AND IGNORE THE LINES IN FRONT OF THE OTHER POWERS.

TO GRANT ONE OR MORE, BUT FEWER THAN ALL, OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF EACH POWER YOU ARE GRANTING.

TO WITHHOLD A POWER, DO NOT INITIAL THE LINE IN FRONT OF IT. YOU MAY, BUT NEED NOT, CROSS OUT EACH POWER WITHHELD.

INITIAL

____ (A) Real property transactions.

____ (B) Tangible personal property transactions.

____ (C) Stock and bond transactions.

____ (D) Commodity and option transactions.

____ (E) Banking and other financial institution transactions.

____ (F) Business operating transactions.

____ (G) Insurance and annuity transactions.

____ (H) Estate, trust, and other beneficiary transactions.

____ (I) Claims and litigation.

____ (J) Personal and family maintenance.

____ (K) Benefits from social security, Medicare, Medicaid, or other governmental programs, or civil or military service.

____ (L) Retirement plan transactions.

____ (M) Tax matters.

____ (N) ALL OF THE POWERS LISTED ABOVE.

YOU NEED NOT INITIAL ANY OTHER LINES IF YOU INITIAL LINE (N).

SPECIAL INSTRUCTIONS:

ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

_____

_____

_____

_____

_____

_____

_____

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.

This power of attorney will continue to be effective even though I become incapacitated.

STRIKE THE PRECEDING SENTENCE IF YOU DO NOT WANT THIS POWER OF ATTORNEY TO CONTINUE IF YOU BECOME INCAPACITATED.

EXERCISE OF POWER OF ATTORNEY WHEN MORE THAN ONE AGENT DESIGNATED:

If I have designated more than one agent, the agents are to act _____ .

IF YOU APPOINTED MORE THAN ONE AGENT AND YOU WANT EACH AGENT TO BE ABLE TO ACT ALONE WITHOUT THE OTHER AGENT JOINING, WRITE THE WORD "SEPARATELY" IN THE BLANK SPACE ABOVE. IF YOU DO NOT INSERT ANY WORD IN THE BLANK SPACE, OR IF YOU INSERT THE WORD "JOINTLY," THEN ALL OF YOUR AGENTS MUST ACT OR SIGN TOGETHER.

I agree that any third party who receives a copy of this document may act under it. Revocation of the power of attorney is not effective as to a third party until the third party has actual knowledge of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

Signed this ___ day of _____, 20___

_____
(your signature)

State of _____

County of _____

BY ACCEPTING OR ACTING UNDER THE APPOINTMENT, THE AGENT ASSUMES THE FIDUCIARY AND OTHER LEGAL RESPONSIBILITIES OF AN AGENT.

[*Include certificate of acknowledgment of notary public in compliance with CC §1189 or other applicable law.*]

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VII. AUTHORITY OF ENTITIES TO CONTRACT

A. Corporations

§2.69 1. Contracts With Other Entities (Corp C §§207, 7140)

Both nonprofit and business corporations have all of the powers of natural persons in carrying out their activities, including the power to contract. *ECC Constr., Inc. v Ganson* (2000) 82 CA4th 572, 576, 98 CR2d 292. See Corp C §§207(g) (powers of corporation), 7140 (powers of nonprofit mutual benefit corporations).

Contracts in the corporate name that are authorized or ratified by the board of directors or done within an officer's actual or apparent authority bind the corporation, and the corporation acquires rights under the contract, whether it is fully performed or is executory. Corp C §§208(b), 7141(b). See *ECC Constr. Inc. v Ganson*, *supra*.

NOTE: The common law doctrine of ultra vires, which could nullify a contract outside the scope of the powers conferred on a corporation by its charter, has been circumscribed by statute and by the courts—particularly for private corporations as distinct from governmental entities. The doctrine is disfavored and has been partially abolished. See Corp C §208. See, *e.g., Sammis v Stafford* (1996) 48 CA4th 1935, 1942, 56 CR2d 589; *Marsili v PG&E* (1975) 51 CA3d 313, 322, 124 CR 313.

In general, an instrument entered into by a corporation is not invalidated by any lack of authority on the part of the officers executing the instrument, provided that (Corp C §313):

- It has been executed by the designated officers; and
- The other party does not have actual knowledge that the signing officers lacked authority to execute the instrument.

Corporations Code §313 precludes an instrument entered into by a corporation from being invalidated, despite evidence demonstrating that the signing officers lacked authority to execute the instrument on its behalf. It sets forth a conclusive, rather than a merely rebuttable, presumption of authority to enter into the agreement on the part of the specified corporate officers. It applies as long as the other party does not have actual knowledge that the signing officers lacked authority and limits the burden of proof to a showing that the other party did not have actual knowledge of any lack of authority on the part of the signing officers. The purpose of the statute is to permit third parties to rely on the asserted authority of a corporation's officers. *Snukal v Flightways Mfg., Inc.* (2000) 23 C4th 754, 782, 98 CR2d 1.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.70 2. Contracts With Directors or Other Entity in Which Director Has an Interest (Corp C §310)

§2.70 2. Contracts With Directors or Other Entity in Which Director Has an Interest (Corp C §310)

A contract between a corporation and one or more of its directors, or between a corporation and another entity in which one or more of its directors has a material financial interest, is not void or voidable if the transaction is (Corp C §310):

- Approved in good faith by the shareholders after they have been fully informed about the material facts of the transaction including the director's interest;
- Approved in good faith of the board (or a board committee) if the material facts of the transaction and the director's interest are fully disclosed or known to the board or committee, and the contract is just and reasonable as to the corporation when it is approved; or
- If the person asserting the contract's validity meets the burden of proof that the transaction was just and reasonable concerning the corporation when it was approved.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.70A 3. Preincorporation Contracts

§2.70A 3. Preincorporation Contracts

A preorganization contract made for the benefit of a corporation can be enforced by the corporation, provided that the corporation adopts or ratifies the contract or otherwise succeeds to it. *02 Dev., LLC v 607 South Park, LLC* (2008) 159 CA4th 609, 71 CR3d 608 (applying same rule to limited liability company).

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B. General Partnerships

§2.71 1. Mutual Agency Relationship (Corp C §16301)

A mutual agency relationship exists among the partners of a partnership. Each partner is an agent of the partnership for purposes of its business. Corp C §16301(1). A partner's act, including executing an instrument in the partnership name, performed apparently for carrying on the ordinary course of the partnership business, is binding on the partnership, unless the partner had no authority to act, and the person dealing with the partner knew or received notification (see Corp C §16102) that the partner lacked authority. Corp C §16301(1). In addition, a partner's act that is not apparently for carrying on the partnership business only binds the partnership if the other partners authorize the act. Corp C §16301(2).

All partners are liable jointly and severally for all obligations of the partnership. Corp C §16306(a). The statement of partnership authority may vary these rules, however.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.72 2. Transfers of Partnership Property (Corp C §16302)

§2.72 2. Transfers of Partnership Property (Corp C §16302)

Special rules govern the authority to transfer partnership property (Corp C §16302(a)):

- Partnership property held in the name of the partnership may be transferred by an instrument of transfer executed by a partner in the partnership name, subject to the effect of a statement of partnership authority. Corp C §16302(a)(1).
- Partnership property held in the name of one or more partners may be transferred by an instrument of transfer executed by the persons in whose name the property is held if the instrument transferring the property to them indicates their capacity as partners or the existence of a partnership, but does not indicate the name of the partnership. Corp C §16302(a)(2).
- Partnership property held in the name of one or more persons other than the partnership may be transferred by an instrument of transfer executed by the persons in whose name the property is held if the instrument transferring the property to them does not indicate their capacity as partners or the existence of a partnership. Corp C §16302(a)(3).

A partnership may limit a partner's ability to bind the partnership by filing a statement of partnership authority. Corp C §16303. See §2.73.

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§2.73 3. Statement of Partnership Authority (Corp C §16303)

A partnership may limit the partners' ability to bind the partnership by filing a Statement of Partnership Authority (Secretary of State Form GP-1) with the California Secretary of State containing the information specified in Corp C §16303. See generally Advising California Partnerships, chap 4 (3d ed Cal CEB 1999). A filed statement of partnership authority provides certain conclusive presumptions regarding the grant of authority in favor of purchasers of personal and real property and constructive notice in favor of nonpartners regarding limitations on the authority of a partner to transfer partnership real property. Corp C §16303(d)-(e). Subject to these provisions and to Corp C §§16704 and 16805, a nonpartner is not considered to have knowledge of a limitation on a partner's authority merely because the limitation is set forth in the statement of partnership authority. Corp C §16303(f).

A certified copy of a statement filed with the Secretary of State may be recorded with the county recorder. Any grant of authority to convey partnership real property contained in a recorded statement of authority is conclusive in favor of a person who gives value without knowledge to the contrary, provided that there is no limitation on such authority of record. Corp C §16303(d)(2).

NOTE: Merely being listed by another as a partner in a statement of authority does not mean that the named person is liable as a partner. Corp C §16308(c). In addition, the failure to correct an inaccurate or outdated statement does not mean that a person named in a statement of authority continues to be liable as a partner. Corp C §16308(d). A former partner's apparent authority to bind the partnership expires after 2 years. Corp C §16702(a).

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§2.74 4. Authority of Former Partners to Bind Partnership (Corp C §16702)

A partner who has dissociated from a partnership may bind the partnership for up to two years after the dissociation. During this time, the partnership is bound by an act of the dissociated partner taken apparently for carrying on the ordinary course of the partnership business if, at the time of the transaction (Corp C §16702(a)(1)-(3)):

- The other party to the transaction reasonably believed that the dissociated partner was still a partner;
- The other party did not have notice of the dissociation; and
- The other party is not considered to have had constructive notice as a result of the filing of a Statement of Dissociation or a statement that limits the partner's authority to transfer real property (see Corp C §§16303(e), 16704(c)).

Filing a Statement of Dissociation can shorten the 2-year period. Ninety days after the filing of a Statement of Dissociation, all persons are considered to have constructive notice that the dissociated partner no longer has authority to bind the partnership. Corp C §16704. Not only does the prompt filing of a Statement of Dissociation limit the liability of a dissociated partner for partnership obligations created after dissociation has occurred, but it also limits the liability of the partnership for the acts of the dissociated partner after dissociation. Corp C §§16702(a)(3), 16704(c). Thus, by promptly filing a Statement of Dissociation, the remaining partners can quickly cut off the dissociating partner's ability to bind the partnership and the remaining partners to additional contractual obligations.

PRACTICE TIP: A Statement of Dissociation cuts off the apparent authority of the dissociated partner not only with respect to creditors who had not previously granted credit to the partnership, but also to those who were creditors before the date of dissociation. A partnership should routinely file the Statement of Dissociation in every case, even if actual notice is given to all known creditors.

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§2.75 5. Liability of Dissociated Partner (Corp C §16703)

Except for limited liability partnerships (see §2.78) and foreign limited liability partnerships, a partner who dissociates is liable for a transaction entered into by the partnership for up to 2 years after the partner's dissociation, if (Corp C §16703(b)(1)-(3)):

- The other party to the transaction reasonably believed that the dissociated partner was still a partner;
- The other party did not have notice of the dissociation; and
- The other party is not considered to have had constructive notice as a result of the filing of a Statement of Dissociation or a statement that limits the partner's authority to transfer real property (see Corp C §§16303(e), 16704(c)).

A dissociating partner may file a Statement of Dissociation (see §2.74), which provides notice of the termination of the partner's status as a partner in the general partnership. The Statement of Dissociation limits the partner's authority to enter into transactions on behalf of the partnership (Corp C §§16303(d), 16704(b)) and also serves to provide constructive notice to those dealing with the partnership that the dissociated partner no longer has the apparent authority to act on behalf of the partnership. Corp C §16704(c). The partnership's continued use of the partnership name or the dissociated partner's name as a part of the partnership name does not by itself make the dissociated partner liable for partnership obligations. Corp C §16705.

A dissociated partner may be released from liability for a partnership obligation by agreement with the partnership creditor and the partners continuing the business. Corp C §16703(c). A dissociated partner is also released from liability for a partnership obligation if a creditor, with notice of the partner's dissociation, but without the partner's consent, agrees to a material alteration in the nature or time of payment of a partnership obligation. Corp C §16703(d).

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C. Limited Partnerships

§2.76 1. Authority of General Partners to Contract (Corp C §§15904.02, 15904.04, 15904.06)

In general, the rights and obligations of a general partner in a limited partnership with respect to the partnership and the other partners are the same as those of a partner in a general partnership. Corp C §§15904.02(a), 15904.04, 15904.06. See §§2.71-2.75. Thus, a general partner of a limited partnership has authority to bind a limited partnership to the same extent as a partner in a general partnership (see Corp C §§15904.02(a), 16301(1)) and has unlimited personal liability for all partnership obligations, except for obligations incurred before the person became a general partner (Corp C §§15904.04, 16306). See Corp C §15906.06(a) for the circumstances when a person who has been dissociated as a general partner before dissolution of the limited partnership can nonetheless bind the partnership.

After dissolution of a limited partnership, a general partner can bind the partnership as follows (Corp C §15908.04(a)):

- By any act appropriate for winding up the limited partnership's activities; or
- By any act that would have bound the limited partnership under Corp C §15904.02 before dissolution if the other party to the transaction did not have notice of the dissolution at the time that party entered into the transaction.

See Corp C §15908.04(b) for the circumstances when a person who has been dissociated as a general partner will bind a limited partnership by an act occurring after dissolution of the partnership.

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§2.77 2. Authority of Limited Partners to Contract (Corp C §§15903.02, 15903.03)

A limited partner does not have any right or power to act for or to bind the limited partnership. Corp C §15903.02. Nor is a limited partner personally liable for the obligations of the limited partnership, unless named as a general partner in the certificate of limited partnership or, in limited circumstances, unless the limited partner participates in control of the business. Corp C §15903.03(a). See Corp C §15903.03(b) for a nonexclusive list of actions by a limited partner that do not constitute participation in control of the business. See also *Gruendl v Oewel Partnership, Inc.* (1997) 55 CA4th 654, 64 CR2d 217; Advising California Partnerships, chap 5 (3d ed Cal CEB 1999). A limited partner may be required, however, to return distributions received from the limited partnership at a time when the limited partnership did not have sufficient assets to satisfy its liabilities. See Corp C §15905.09(b). In addition, a limited partner may be held liable by the limited partnership or a third party creditor for payment of his or her agreed capital contribution. Corp C §§15905.02(c), 15905.02(d).

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§2.78 D. Limited Liability Partnerships (Corp C §16306)

A limited liability partnership (LLP) is an entity available in California for partnerships (1) engaged in the practice of architecture, public accountancy, or law, and (2) affiliated partnerships that either provide services related or complementary to the LLP or provide facilities to the LLP. Corp C §16101(6).

In an LLP, there is generally no liability for the obligations of the partnership or the other partners (Corp C §16306(c)). Liability protection extends to vicarious liability for both another partner's negligence or other tortious conduct and the partnership's contractual obligations (*e.g.,* trade debt, loans, and leases). This shield against personal liability is very broad and equivalent to the protection extended to shareholders of a corporation.

There are five significant exceptions to the rule of nonliability, however (see Corp C §16306(c)-(h)):

- Liabilities incurred when the partnership is not an LLP;
- Liability imposed by agreement;
- Liability for one's own tortious conduct;
- Liability for errors and omissions in rendering legal advice; and
- Liability as a guarantor.

For detailed discussion of the exceptions to liability for a partner in a limited liability partnership, see Advising California Partnerships, chap 6 (3d ed Cal CEB 1999).

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§2.79 E. Limited Liability Companies (Corp C §17157)

A limited liability company (LLC) has all the powers of a natural person in carrying out its business activities, including the power to make contracts and guarantees, incur liabilities, sell assets, or purchase real or personal property. See Corp C §17003(d)-(f).

Authority of individual members of the LLC to bind the LLC depends on how the LLC is structured under its operating agreement. An LLC may be managed either by all the members (a "member-managed LLC") or by one or more managers (a "manager-managed LLC"). See Corp C §§17150, 17151(b). In a member-managed LLC, each member is an agent of the LLC, and any act of a member for the apparent purpose of carrying on in the usual way the affairs of the member-managed LLC binds the LLC. Corp C §17157(a). Although the members may agree that a member has no authority to act, either generally or with respect to a particular matter, third parties are not bound by that agreement absent their actual knowledge that the member lacks authority to act. Corp C §17157(a). The rules in this regard are similar to the rules that apply to general partnerships. See §§2.71-2.75.

In a manager-managed LLC, no member is an agent of the LLC by virtue of being a member. Corp C §17157(b)(1). Instead, every manager is an agent of the LLC, and any act of a manager for the apparent purpose of carrying on in the usual way the affairs of the LLC binds the LLC. Corp C §17157(b)(2). A manager's lack of authority to act is not binding on third parties without actual knowledge of the lack of authority. Corp C §17157(b)(2). The rules in this regard are similar to the rules that apply to limited partnerships (a manager corresponds to a general partner, and a member corresponds to a limited partner; see §§2.76-2.77) except that the active participation by a member in the management and control of an LLC will not create liability for the member. See Corp C §§17101, 17150; compare Corp C §15632(a) with Corp C §§17101, 17150.

For more detailed discussion of authority to bind limited liability companies, see Forming and Operating California Limited Liability Companies, chap 6 (2d ed Cal CEB 2007).

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.80 F. Trusts (Prob C §16200)

§2.80 F. Trusts (Prob C §16200)

Unlike corporations, trusts are not distinct legal entities. Legal title to trust property is held by the trustee. *Galdjie v Darwish* (2003) 113 CA4th 1331, 7 CR3d 178. The trustee's authority to contract on behalf of the trust and to bind trust property is governed by the Probate Code. Probate Code §16200 provides that a trustee has the powers conferred by the trust instrument, the powers conferred by statute (*e.g.*, Prob C §§16220-16249) unless limited by the trust instrument, and the power to perform any act that a trustee would perform for the purposes of the trust in exercise of the trustee's standard of care (see Prob C §16040) unless limited by the trust instrument. Probate Code §§16220-16249 enumerate a series of specific powers, such as the power to continue to operate a business that is part of the trust property and the power to develop land, most of which would necessarily entail the trustee's entering into contracts on behalf of the trust.

Probate Code §18000 provides that, for contracts entered into on or after July 1, 1987, "a trustee is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administration of the trust unless the trustee fails to reveal the trustee's representative capacity or identify the trust in the contract."

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§2.81 G. Municipalities

The capacity of a city to contract is governed by statute. *South Bay Sr. Hous. Corp. v City of Hawthorne* (1997) 56 CA4th 1231, 1236, 66 CR2d 99. Cities are either "chartered cities" (organized under a charter; see Govt C §§34101, 34450) or "general law cities" (organized under the general law of the state; see Govt C §§34100-34102).

- A general law city must comply with state statutes that specify requirements for entering into contracts. *South Bay Sr. Hous. Corp. v City of Hawthorne, supra*. See Govt C §§34000-45345. The powers of a general law city include only the powers expressly conferred on it by the legislature, together with powers necessarily incident to those expressly granted or essential to their declared purpose. A contract entered into by a local government without legal authority is void and unenforceable. *Midway Orchards v County of Butte* (1990) 220 CA3d 765, 783, 269 CR 796. See, *e.g., Authority for Cal. Cities Excess Liability v City of Los Altos* (2006) 136 CA4th 1207, 1212, 39 CR3d 571 (document at issue not contract under which city was liable). Thus, for example, in *G.L. Mezzetta, Inc. v City of Am. Canyon* (2000) 78 CA4th 1087, 93 CR2d 292, a general law city's oral agreement to provide a plaintiff with a wastewater discharge system was invalid because the relevant statutes and ordinances required the mayor and city manager to sign all written contracts and the city attorney to prepare or approve all contracts, implying (when all the statutes were read together) that contracts with the city must be in writing, approved by the city council and the city attorney, and signed by the mayor or city manager. Restrictions on a municipality's power to contract should be strictly construed, and the statutes in this case specifically provided for the ways the city could enter into contracts. Therefore, any other methods of contract formation, even though not explicitly forbidden, are invalid.
- A chartered city remains subject to state statutes, except for "municipal affairs" governed by the charter. Cal Const art XI, §5. The manner in which a city may form a contract is considered a municipal affair, which can be controlled by the terms of the city's charter. Moreover, a contract made without regard to the method prescribed by the city charter is unenforceable. *First St. Plaza Partners v City of Los Angeles* (1998) 65 CA4th 650, 76 CR2d 626. In the absence of a conflicting charter or ordinance provision, however, the Public Contract Code applies to charter cities. Pub Cont C §1100.7.

A city may be held liable under an implied contract theory for benefits received on express contracts entered into under its general power if the contracts are later rendered invalid because of an irregularity in their execution, rather than because of any statutory restriction. See *South Bay Sr. Hous. Corp. v City of Hawthorne,* 56 CA4th at 1236.

Although the rule is that contracts beyond the powers of a municipality are void, cannot be ratified, and are not subject to estoppel to deny their validity, some courts have found this rule to be unduly harsh and have abandoned it when the party contracting with the city acted in good faith, the contract in question was invalid because it was beyond the city's powers to contract for an otherwise legitimate purpose, and the city received consideration that could be returned to the private party in kind. See *Trimont Land Co. v Truckee Sanitary Dist.* (1983) 145 CA3d 330, 356, 193 CR 568.

Contracts between the government and a private party that are within the government's power are construed according to the same rules that apply to contracts between private parties. See *Trimont Land Co. v Truckee Sanitary Dist., supra*; *Sawyer v City of San Diego* (1956) 138 CA2d 652, 661, 292 P2d 233. Thus, when a government contract has several distinct objects, one of which is unlawful in whole or in part, the contract is void as regards that object, but valid as to the rest. 145 CA3d at 355.

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Source: Business Law/California Law of Contracts/2 Contract Formation: Capacity to Contract/§2.82 H. State; State and Local Agencies

§2.82 H. State; State and Local Agencies

Contracts with the State of California or its agencies are governed by the State Contract Act (Pub Cont C §§10100-19102). Contracts with local agencies are subject to different statutory requirements that are usually specific to the type of agency involved. Pub Cont C §§20100-22300. The statutes may create contractual provisions not found in the text of the contract. Further, the California Code of Regulations has extensive rules and regulations governing public contracts. Further discussion of government contracting is beyond the scope of this title.

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3

Contract Formation: Consent, Legality, Consideration

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§3.1 I. INTRODUCTION (CC §1550)

Under the California Civil Code, there are four essential elements to the existence of a contract:

- Parties capable of contracting;
- Their consent;
- A lawful object; and
- Sufficient cause or consideration.

CC §1550; *ASP Props. Group, L.P. v Fard, Inc.* (2005) 133 CA4th 1257, 1268, 35 CR3d 343; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1230, 13 CR3d 544. The first element—parties with the capacity to contract—is discussed in chap 2. This chapter addresses the other three elements—consent, legality, and consideration.

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II. CONSENT

§3.2 A. Generally (CC §1550(2))

In general, consent of the parties, or mutual assent, is an essential element of any valid contract. *ASP Props. Group, L.P. v Fard,* (2005) 133 CA4th 1257, 1269, 35 CR3d 343; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1230, 13 CR3d 544. Consent must be (1) free, (2) mutual, and (3) communicated by each party to the other. CC §1565. These three aspects of consent are not treated equally, however. It is important to distinguish consent that was not freely given because it was obtained by duress, menace, fraud, undue influence, or mistake (see CC §1567) from consent that is not mutual because the parties did not agree on the same thing in the same sense (see CC §1580). *Chakmak v H.J. Lucas Masonry, Inc.* (1976) 55 CA3d 124, 129, 127 CR 404. If consent is not freely given, the contract is *voidable,* not absolutely void, and may be rescinded. CC §1566. If there is no mutual assent, however, no contract is formed, so there is no contract. *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645. Further, a contract cannot be formed unless the parties communicate their consent to one another. *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807; *Lopez v Charles Schwab & Co., supra*. In sum, if there is no mutual consent or if one or both parties do not communicate their consent effectively, there is no contract at all, but, if consent is not free, a contract is formed but it is voidable.

The concept of consent is expanded in the Uniform Commercial Code rules governing contracts for the sale or lease of goods. Formation of contracts for the sale of goods is discussed more fully in §§4.36-4.38. See also California UCC Sales and Leases, chap 2 (Cal CEB 2002).

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B. Mutual Consent

§3.3 1. Generally (CC §1580)

Subject to the statutory rules of contract interpretation discussed in chap 5 and the special Commercial Code rule in Com C §2204 discussed in §4.36, "[c]onsent is not mutual, unless the parties all agree upon the same thing in the same sense." CC §1580. See also *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 208, 45 CR3d 692; *Weddington Prods., Inc. v Flick* (1998) 60 CA4th 793, 811, 71 CR2d 265. The law will not enforce the terms of a contract or give a remedy for its breach without evidence of mutual consent. "One cannot be made to stand on a contract to which he has never consented." *Khajavi v Feather River Anesthesia Med. Group* (2000) 84 CA4th 32, 60, 100 CR2d 627. See also Restatement (Second) of Contracts §23 (1981). Mutual consent has two basic components: (1) a "meeting of the minds" between the parties (see *Banner Entertainment, Inc. v Superior Court* (1998) 62 CA4th 348, 359, 72 CR2d 598), and (2) knowledge (actual or constructive) of and assent to a contract's terms (*Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645). These components are discussed in §§3.4-3.5.

It is important to note that in cases where contract formation is in dispute, mutual consent (or the lack thereof) will often be at issue along with other formation defenses, such as fraud, undue influence, or incapacity. For example, in *Lever v Garoogian* (1974) 41 CA3d 37, 115 CR 856, there was evidence that the defendant signed a promissory note because the plaintiff misrepresented to him that it was merely a receipt, and this supported the trial court's finding that there was no mutual consent to form a contract. Further, the same evidence could be considered evidence of fraud, an affirmative defense in the action brought on the note.

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.4 2. Meeting of the Minds

§3.4 2. Meeting of the Minds

For there to be a meeting of the minds between the parties, the parties must agree on all material contract terms. *Elyaoudayan v Hoffman* (2003) 104 CA4th 1421, 129 CR2d 41. "[T]he failure to reach a meeting of the minds on all material points prevents the formation of a contract *even though the parties have orally agreed upon some of the terms, or have taken some action related to the contract*." *Banner Entertainment, Inc. v Superior Court* (1998) 62 CA4th 348, 359, 72 CR2d 598 (emphasis in original). If there is no evidence to establish the parties' manifestation of assent to the same subject matter, there is no mutual consent and no contract formation. *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 208, 45 CR3d 692. See, *e.g., Winter v Window Fashions Profs., Inc.* (2008) 166 CA4th 943, 950, 83 CR3d 89 (no meeting of minds on arbitration where franchise agreement specified arbitration in Texas under Texas law, and offering circular stated that arbitration clause "may not be enforceable under California law").

NOTE: The Commercial Code rule for contracts for the sale of goods differs. Under Com C §2204(3), a meeting of the minds on all material points is not required. Division 2 of the Commercial Code includes a series of rules intended to guide courts in completing any terms and provisions left open by the parties. These gap-filling rules are discussed in §§5.60-5.69.

The issue of whether a meeting of the minds has occurred often arises in the context of contract negotiations, letters of intent, or oral agreements preliminary to a written contract. In *Banner Entertainment,* the trial court's order compelling arbitration based on an unsigned contract containing an arbitration clause was vacated. Although the parties had orally agreed to certain business dealings, there was no evidence that during negotiations the parties discussed, let alone agreed, that disputes would be resolved by arbitration. Moreover, the unsigned contract itself provided that it would become operative only when signed by the parties. In contrast, if the parties orally agree on the material terms and conditions of a proposed written agreement with the mutual intent that it should thereupon become binding, the fact that the written agreement is not signed does not affect the validity of the oral agreement. *Magness Petroleum Co. v Warren Resources of Cal., Inc.* (2002) 103 CA4th 901, 127 CR2d 159; *Columbia Pictures Corp. v DeToth* (1948) 87 CA2d 620, 629, 197 P2d 580. For further discussion of contract formation in the context of negotiations, including offer and acceptance, and letters of intent, see chap 4.

In general, whether mutual assent exists—whether there has been a meeting of the minds—is determined by objective rather than subjective criteria. *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 208, 45 CR3d 692; *ASP Props. Group, L.P. v Fard, Inc.* (2005) 133 CA4th 1257, 1269, 35 CR3d 343; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 13 CR3d 544. The test is whether a reasonable person would conclude from the outward conduct of the parties that there was mutual agreement. *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645; *Weddington Prods., Inc. v Flick* (1998) 60 CA4th 793, 811, 71 CR2d 265. In determining whether there is mutual consent, the principal focus is on the acts of the parties as distinct from their unspoken thoughts. *Meyer v Benko* (1976) 55 CA3d 937, 943, 127 CR 846. This approach conforms with the objective theory of contract generally followed in California. See, *e.g., Stewart v Preston Pipeline, Inc.* (2005) 134 CA4th 1565, 1587, 36 CR3d 901. See generally §5.1. In *Beard v Goodrich* (2003) 110 CA4th 1031, 2 CR3d 160, the court found that an attorney's unsubstantiated assertion regarding his subjective intent was insufficient to establish that there had *not* been a meeting of the minds regarding a contingency fee agreement. Further, in *Patel v Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366, the court held that a post-formation dispute over the terms of a real estate option contract did not indicate that there had been no meeting of the minds.

NOTE: Under the parol evidence rule, evidence of the parties' subjective understandings and intent in taking the actions they did is admissible for purposes of determining whether a binding agreement was ever reached. What each party intended is a question of fact, to be determined by the trial court from the surrounding facts and circumstances. *Banner Entertainment,* 62 CA4th at 359. See CCP §1856. The parol evidence rule is discussed in §§5.33-5.43.

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§3.5 3. Knowledge of and Assent to Contract Terms

The other component of mutual consent concerns whether a party had, or is deemed to have had, knowledge of the terms and provisions of a contract and has assented to them. *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645. This issue typically arises in the context of written contracts, particularly printed form contracts. It is not necessary that all contract terms be expressly negotiated to be part of a binding contract. "[O]rdinarily one who signs an instrument which on its face is a contract is deemed to assent to all its terms." 89 CA4th at 1049. In general, a party cannot avoid the terms of a contract on the grounds that he or she failed to read it before signing it. In *Marin Storage,* a document entitled "Work Authorization and Contract" contained the phrase, "This is a contract which includes all terms and conditions stated on the reverse side." 89 CA4th at 1049. The defendant company was deemed to have assented to an indemnification provision set forth on the reverse side even though its agent did not read the provision before signing the document. See also *Stewart v Preston Pipeline, Inc.* (2005) 134 CA4th 1565, 1588, 36 CR3d 901; *Tarpy v County of San Diego* (2003) 110 CA4th 267, 276, 1 CR3d 607; *Hernandez v Badger Constr. Equip. Co.* (1994) 28 CA4th 1791, 1816, 34 CR2d 732.

In contrast, if the document does not appear to be a contract and the terms are not called to the attention of the signing party, he or she is not bound, and no contract is formed with respect to the undisclosed terms. *Metters v Ralphs Grocery Co.* (2008) 161 CA4th 696, 74 CR3d 210 (arbitration clause on form employee was directed to fill out to submit grievance was invalid because form did not look like a contract and did not alert employee he was agreeing to arbitration); *Cory v Golden State Bank* (1979) 95 CA3d 360, 157 CR 538 (service charge provision on reverse of money order). See also *Rodriguez v American Technol., Inc.* (2006) 136 CA4th 1110, 1123, 39 CR3d 437. In *Carnival Cruise Lines, Inc. v Superior Court* (1991) 234 CA3d 1019, 286 CR 323, the court found that there had been no mutual assent, and therefore no valid contract, with respect to a forum selection clause because the plaintiff had not received sufficient notice of the clause before entering into the contract for passage.

The question whether a party has adequate notice of a contract's terms and conditions often arises in the context of the Internet. See, *e.g., Specht v Netscape Communications Corp.* (2d Cir 2002) 306 F3d 17, 29 (applying California common law, court ruled that "clicking on a download button does not communicate assent to contractual terms if the offer did not make clear to the customer that clicking on the download button would signify assent to those terms"). See also the discussion of electronic contracting in §§4.54-4.66.

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§3.6 4. Fraud in the Execution

Fraud in the execution refers to a situation when a party has been deceived into signing an agreement and as a consequence does not know what he or she has signed. If there is "fraud [that] goes to the inception or execution of the agreement, so that the promisor is deceived as to the nature of his act, and actually does not know what he is signing, or does not intend to enter into a contract at all, mutual assent is lacking, and [the contract] is void." *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 415, 58 CR2d 875. See also *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 85 CR3d 817; *Hotels Nevada v L.A. Pacific Ctr., Inc.* (2006) 144 CA4th 754, 50 CR3d 700. In such cases, the court may disregard the contract without need for formal rescission.

NOTE: Fraud in the execution must be distinguished from fraud in the inducement, when the promisor knows what he or she has signed but his or her consent has been induced by fraud. Fraud in the inducement negates freedom of consent and renders a contract voidable rather than wholly void. As the court explained in *Brown v Wells Fargo Bank N.A.*, 168 CA4th at 958:

> When a plaintiff alleges fraud in the inducement, the plaintiff is asserting that it understood the contract it was signing, but that its consent to the contract was induced by fraud. In contrast, when a plaintiff alleges fraud in the execution, the plaintiff is asserting that it was deceived as to the very nature of contract execution and did not know what it was signing. A contract fraudulently induced is voidable; but a contract fraudulently executed is void, because there never was an agreement.

For further discussion of fraud in the inducement, see §3.11.

If a plaintiff seeks a judicial determination that a contract is void for fraud in the execution, the plaintiff must establish that he or she did not act in an objectively unreasonable manner by failing to acquaint himself or herself with the contents of the agreement before signing it. For example, if the plaintiff has a physical disability, the plaintiff might not have had a reasonable opportunity to learn the terms of the contract. See *Brown,* 168 CA4th at 959 (defendant investment company was fiduciary with duty to explain material terms of contract to disabled plaintiff); *Jones v Adams Fin. Servs.* (1999) 71 CA4th 831, 84 CR2d 151. If, however, the plaintiff's failure to read the agreement before signing it was the result of the plaintiff's *unreasonable* reliance on the other party's misrepresentations, the contract is not void and will be enforced. *Rosenthal,* 14 C4th at 423. Citing the Restatement (Second) of Contracts §163 (1981), the court in *Rosenthal* stated (14 C4th at 423):

> One party's misrepresentations as to the nature or character of the writing do not negate the other party's apparent manifestation of assent, if the second party had "reasonable opportunity to know of the character or essential terms of the proposed contract." [Citation.] If a party, with such reasonable opportunity, fails to learn the nature of the document he or she signs, such "negligence" precludes a finding the contract is void for fraud in the execution.

The *Rosenthal* court noted that California law is clear that a misrepresentation will not render the contract *void* unless the misled party lacked a reasonable opportunity to learn the contract terms before signing it. 14 C4th at 421. See also *Larian v Larian* (2004) 123 CA4th 751, 763, 19 CR3d 916.

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§3.7 C. Communication of Consent (CC §§1565, 1581-1583)

Parties must communicate their consent in order to form a contract. CC §1565; *Rennick v O.P.T.I.O.N. Care, Inc.* (9th Cir 1996) 77 F3d 309, 315, cert denied (1996) 519 US 865. In most cases, consent is manifested in the form of an offer communicated to the offeree and an acceptance communicated to the offeror. *Donovan v RRL Corp.* (2001) 26 C4th 261, 270, 109 CR2d 807; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 13 CR3d 544. Thus, the requirement stated in CC §1565 that consent be communicated by each party to the other is essentially the same as the common law requirement for an effective offer and acceptance. See Restatement (Second) of Contracts §22(1) (1981). For a detailed discussion of offer and acceptance as different aspects of mutual consent, see §§4.1-4.38. The Civil Code includes three sections addressing communication of consent, as follows:

- CC §1581: "Communicated Consent or Acceptance. Consent can be communicated with effect, only by some act or omission of the party contracting, by which he intends to communicate it, or which necessarily tends to such communication."
- CC §1582: "Conditional. If a proposal prescribes any conditions concerning the communication of its acceptance, the proposer is not bound unless they are conformed to; but in other cases any reasonable and usual mode may be adopted."
- CC §1583: "Time Computed. Consent is deemed to be fully communicated between the parties as soon as the party accepting a proposal has put his acceptance in the course of transmission to the proposer, in conformity to the last section."

Consent may be communicated expressly by written or spoken words, or implied from a party's conduct. *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 850, 89 CR2d 540. See CC §1581 (consent can be communicated by an "act or omission" that "necessarily tends to such communication"); Restatement (Second) of Contracts §19 (1981) (when conduct will be effective as a manifestation of assent). The distinction between express or implied contracts does not involve a difference in their legal effectiveness, but rather lies simply in the manner in which the parties have manifested assent. Assent may be manifested in words or by implication from the parties' conduct, including course of dealing, usage of trade, or course of performance. 75 CA4th at 850; Restatement (Second) of Contracts §4 (1981), Comment a. See also CC §1621 ("An implied contract is one, the existence and terms of which are manifested by conduct"). To determine whether the parties have reached agreement and what the parties have impliedly agreed to, the court must examine the circumstances in which the implied agreement arose and the conduct that gave rise to it. 75 CA4th at 855.

Ordinarily, silence or inaction is not sufficient to communicate consent unless there is a duty to speak or a relationship or course of dealing between the parties such that silence would reasonably be understood as acceptance. *Circuit City Stores, Inc. v Najd* (9th Cir 2002) 294 F3d 1104, 1109; *Southern Cal. Acoustics Co. v C.V. Holder, Inc.* (1969) 71 C2d 719, 722, 79 CR 319. For further discussion of the question of when silence constitutes acceptance of a contract, see §4.32.

As a general rule, under CC §1582, any reasonable and usual mode of communication may be used to communicate consent to an offer, unless the offer specified that a particular manner of communication should be used. *Gray v Stewart* (2002) 97 CA4th 1394, 1397, 119 CR2d 217. See also *Palo Alto Town & Country Village, Inc. v BBTC Co.* (1974) 11 C3d 494, 113 CR 705 (ordinary mail was reasonable means of communicating acceptance in absence of any provision for other means of communication in lease document); *Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 2 CR2d 288. If, however, an offer provides, *e.g.,* that it can be accepted only in writing, there is no contract under CC §1582 unless the offeree does in fact accept the offer in writing.

Civil Code §1583 expresses the common law "mailbox rule" that a party's acceptance is effective on transmittal, and is discussed more fully in §4.27.

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§3.8 D. Freedom of Consent (CC §§1566-1568)

"A consent which is not free is nevertheless not absolutely void, but may be rescinded by the parties." CC §1566. Thus, if consent is not freely given, a contract is still formed, but the contract is voidable. Civil Code §1567 provides that consent obtained through duress, menace, fraud, undue influence, or mistake, is not free. If it appears, however, that consent would have been given despite the presence of duress, menace, fraud, undue influence, or mistake, the contract may not be rescinded. See CC §1568 ("Consent is deemed to have been obtained through one of the causes mentioned in [§1567] only when it would not have been given had such cause not existed"); *In re Cheryl E.* (1984) 161 CA3d 587, 207 CR 728. See also CC §1689(b)(1) (contract may be rescinded when consent was given by mistake or obtained through duress, menace, fraud, or undue influence). For further discussion of the remedy of rescission, see §§11.46-11.58.

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.9 1. Duress (CC §1569)

§3.9 1. Duress (CC §1569)

Statutory duress. California law recognizes two kinds of duress: statutory duress and economic duress. Statutory duress is based on CC §1569 (see also CC §§1567-1568), and is present when a person is induced by the unlawful act of another person to enter into a contract or to perform some other act in a context that deprives him or her of the exercise of free will. *Tarpy v County of San Diego* (2003) 110 CA4th 267, 276, 1 CR3d 607; *Lewis v Fahn* (1952) 113 CA2d 95, 98, 247 P2d 831. Civil Code §1569 sets out three types of statutory duress:

- Unlawful confinement of the person of the party, or of the husband or wife of such party, or of an ancestor, descendant, or adopted child of such party, husband, or wife;
- Unlawful detention of the property of any such person; or
- Confinement of such person, lawful in form, but fraudulently obtained, or fraudulently made unjustly harassing or oppressive.

For purposes of statutory duress, "unlawful" means "resulting from a tortious or criminal act." *Tarpy,* 110 CA4th at 276 (plaintiff failed to show that county's detention of his unlicensed dog found wandering streets twice within month was unlawful); *Louisville Title Ins. Co. v Surety Title & Guar. Co.* (1976) 60 CA3d 781, 806, 132 CR 63 (threat to do what one is legally entitled to do cannot give rise to duress); *Keithley v Civil Serv. Bd.* (1970) 11 CA3d 443, 89 CR 809 (no evidence of duress when there was no evidence of unlawful conduct). In *Alderson v Alderson* (1986) 180 CA3d 450, 465, 225 CR 610, the court found that evidence of a man's threat of violence against a woman if she did not sign certain quitclaim deeds, together with evidence of actual incidents of violence between the couple both before and after the signing, provided sufficient evidence to support the trial court's implied finding of duress and its cancellation of the deeds in question. Restatement (Second) of Contracts §174 (1981) recognizes that compulsion by physical force is duress, which renders a contract void.

Economic duress. In addition to statutory duress, economic duress may serve as a basis for defeating consent. *Tarpy,* 110 CA4th at 276. Economic duress is an equitable doctrine that represents an expansion of common law and statutory duress in that it does not require an unlawful act such as a tort or a crime. Instead, economic duress may be present if there is a wrongful act that is so coercive that a reasonably prudent person without any reasonable alternative has given in to the perpetrator's pressure and agreed to an unfavorable contract. *Rich & Whillock, Inc. v Ashton Dev., Inc.* (1984) 157 CA3d 1154, 1158, 204 CR 86 (for economic duress to lie, coercive act must be "wrongful"). See also *Tarpy,* 110 CA4th at 276; *Krantz v BT Visual Images L.L.C.* (2001) 89 CA4th 164, 176, 107 CR2d 209; *CrossTalk Prods., Inc. v Jacobson* (1998) 65 CA4th 631, 644, 76 CR2d 615. "Under modern law duress is not limited to threats against the person. It may also consist of threats to business or property interests." *Leeper v Beltrami* (1959) 53 C2d 195, 203, 1 CR 12. Examples of wrongful acts include assertion of a knowingly false claim, a threat made in bad faith to breach a contract, or a threat to withhold a payment due. *CrossTalk Prods., Inc.,* 65 CA4th at 645; *Philippine Export & Foreign Loan Guar. Corp. v Chuidian* (1990) 218 CA3d 1058, 1077, 267 CR 457. See also Restatement (Second) of Contracts §176 (1981) (when threats are improper).

An important element of economic duress is that the party seeking to avoid the contract must have had no reasonable alternative. Economic duress is not present if the party did have a reasonable alternative, and therefore did not have a compelling need to submit to the coercive demands of the other party. Whether a person asserting economic duress had a reasonable alternative is a question of fact, and is "determined by examining whether a reasonably prudent person would follow the alternative course, or whether a reasonably prudent person might submit." *CrossTalk Prods., Inc.,* 65 CA4th at 644 (doctrine of economic duress can be asserted offensively as well as defensively). See also *Johnson v IBM Corp.* (ND Cal 1995) 891 F Supp 522 (release not subject to rescission for economic duress because employee was not facing financial ruin or excessive pressure when he selected from various alternative severance arrangements); *Philippine Export & Foreign Loan Guar. Corp.*, 218 CA3d at 1078; Restatement (Second) of Contracts §175 (1981), Comment b. The court in *Rich & Whillock, Inc. v Ashton Dev., Inc.* (1984) 157 CA3d 1154, 1159, 204 CR 86, explained:

> The underlying concern of the economic duress doctrine is the enforcement in the marketplace of certain minimal standards of business ethics.… They include equitable notions of fairness and propriety which preclude the wrongful exploitation of business exigencies to obtain disproportionate exchanges of value. Such exchanges make a mockery of freedom of contract and undermine the proper functioning of our economic system. The economic duress doctrine serves as a last resort to correct these aberrations when conventional alternatives and remedies are unavailing.

In *Rich & Whillock,* the court found that a compromise and release proposed by defendants in bad faith was an unenforceable product of economic duress. The defendants knew that the plaintiff was a new company, overextended to its creditors, and that it would face imminent bankruptcy if it did not receive the full amount owed by the defendants. The plaintiff agreed to the defendants' coercive tactics only to avoid economic disaster to itself and its own creditors. 157 CA3d at 1160.

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.10 2. Menace (CC §1570)

§3.10 2. Menace (CC §1570)

Menace and duress are closely related and are sometimes pleaded together. See, *e.g., Goldstein v Enoch* (1967) 248 CA2d 891, 894, 57 CR 19. See also *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 128, 54 CR 533 (noting that terms "duress" and "menace" are often used interchangeably). Menace, however, is more accurately a *threat* of duress or of injury to the person, property, or character of another. 246 CA2d at 128. Civil Code §1570 defines menace as a threat:

- Of such duress as is specified in CC §1569(1) and (3) (see §3.9);
- Of unlawful and violent injury to the person or property of any such person as is specified in CC §1569; or
- Of injury to the character of any such person.

A contract obtained under a threat of criminal prosecution constitutes menace and is unenforceable as against public policy. *Bayscene Resident Negotiators v Bayscene Mobilehome Pa*rk (1993) 15 CA4th 119, 127, 18 CR2d 626 (arbitration agreement was unenforceable because it was signed under threat of criminal prosecution from city attorney for failure to comply with ordinance later ruled unconstitutional). See also *Tiffany & Co. v Spreckels* (1927) 202 C 778, 262 P 742.

Like statutory duress, which requires an unlawful act (see *Tarpy v County of San Diego* (2003) 110 CA4th 267, 276, 1 CR3d 607), menace under CC §1570 requires an unlawful threat. In *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 128, 54 CR 533, the court found that a teacher's resignation could not be rescinded on the grounds of duress or menace based on the school board's announcement that it intended to file suspension and dismissal proceedings against him. The board had the legal right and a duty to file such proceedings based on the teacher's criminal conduct and was acting in good faith. The court held that a threat to take legal action is not unlawful unless the party making the threat knows the falsity of his or her claim. Restatement (Second) of Contracts §176 (1981) includes a list of the type of threats that are deemed to be improper, including threats of a crime, a tort, a criminal prosecution, or a bad faith use of civil process, or a threat that constitutes a breach of the covenant of good faith and fair dealing.

Further, to establish menace, unlawful pressure must have been exerted on the injured party with the result that the injured party has been deprived of contractual volition and induced to act to his or her own detriment. A simple request is not enough. "[A]n action for duress and menace cannot be sustained when the voluntary action of the apprehensive party is induced by his speculation upon or anticipation of a future event suggested to him by the defendant but not threatened to induce his conduct." *Goldstein v Enoch* (1967) 248 CA2d 891, 894, 57 CR 19. In *Goldstein,* the minority owner of a corporation sold his stock to the majority owner at a price that was below fair market value after the majority owner disclosed a scheme to sell the corporation using a false financial statement. The court found that the plaintiff was not being induced to participate in the fraudulent scheme through unlawful pressure exerted by the defendant. Rather, the plaintiff was simply acting to avoid the plan.

NOTE: Apparently, few published California cases over the last 40 years have addressed menace as an independent ground for avoiding a contract. Most recent published cases involving threats have been analyzed in the context of economic duress. As discussed in §3.9, economic duress may result from threats as well as from coercive actions. See *Tarpy v County of San Diego* (2003) 110 CA4th 267, 276, 1 CR3d 607. See also *Leeper v Beltrami* (1959) 53 C2d 195, 203, 1 CR 12 (economic duress may "consist of threats to business or property interests"); *Rich & Whillock, Inc. v Ashton Dev., Inc.* (1984) 157 CA3d 1154, 1158, 204 CR 86 (bad faith threat to breach contract may constitute wrongful act for purposes of economic duress). There is no separate doctrine of "economic menace."

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3. Fraud

§3.11 a. Generally; Fraud in the Inducement (CC §§1571-1574)

Fraud that defeats freedom of consent is often referred to as "fraud in the inducement," as distinguished from fraud in the inception or execution, which vitiates mutual consent and renders a contract wholly void. Fraud in the execution is discussed in §3.6. With fraud in the inducement, "the promisor knows what he is signing but his consent is *induced* by fraud, mutual assent is present and a contract is formed, which, by reason of the fraud, is *voidable*," and to escape its obligations, the promisor must rescind by prompt notice and offer to return any consideration received. *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 415, 58 CR2d 875 (emphasis in original); *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 85 CR3d 817; *Hotels Nevada v L.A. Pacific Ctr., Inc.* (2006) 144 CA4th 754, 50 CR3d 700. See also *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 294, 37 CR3d 364. For a detailed discussion of the remedy of rescission, see §§11.46-11.58.

NOTE: A party that discovers an alleged fraud but then ratifies the original contract by entering into a new agreement, gaining substantial benefits with respect to the same subject matter, will be deemed to have waived the right to claim fraud in the inducement. *Oakland Raiders v Oakland-Alameda County Coliseum, Inc.* (2006) 144 CA4th 1175, 1185, 51 CR3d 144.

For purposes of freedom of consent, the Civil Code divides fraud into two categories: actual fraud and constructive fraud. See CC §1571. Civil Code §1572 lists five types of actual fraud, including:

- Intentional misrepresentation;
- Negligent misrepresentation;
- Suppression of fact (also known as concealment);
- A promise made without any intent to perform; and
- "Any other act fitted to deceive."

See *Masters v San Bernardino County Employees Retirement Ass'n* (1995) 32 CA4th 30, 41, 37 CR2d 860.

Actual fraud requires an "intent to deceive another party [to the contract], or to induce him to enter into the contract." CC §1572. See also *David v Herman* (2005) 129 CA4th 672, 28 CR3d 622. Civil Code §1574 provides that actual fraud is always a question of fact. This does not mean, however, that allegations of fraud are never subject to summary judgment. See, *e.g., Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 977, 64 CR2d 843 (whether fact is material is itself question of fact unless "fact misrepresented is so obviously unimportant that the jury could not reasonably find that a reasonable man would have been influenced by it" (quoting Restatement (Second) of Torts §538, Comment e)). Actual fraud is discussed more fully in §§3.12-3.19.

Constructive fraud "arises on a breach of duty by one in a confidential or fiduciary relationship to another which induces justifiable reliance by the latter to his prejudice." *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 129, 54 CR 533. See also *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 960, 23 CR3d 233 (it is essential to operation of doctrine of constructive fraud that there exist fiduciary or special relationship); *Tyler v Children's Home Soc'y* (1994) 29 CA4th 511, 548, 35 CR2d 291. Civil Code §1573 generally provides that constructive fraud is (1) any breach of duty by which a person (without an actual fraudulent intent) gains an advantage by misleading another to his or her prejudice or (2) any other act or omission that the law declares to be fraudulent, without regard to actual fraud. Constructive fraud is discussed more fully in §3.20.

NOTE: One material misrepresentation may be sufficient grounds for rescission of the contract in a proper case. *Wilke v Coinway, Inc.* (1967) 257 CA2d 126, 138, 64 CR 845.

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/ b. Actual Fraud/ (1) Intentional Misrepresentation (CC §1572(1))/§3.12 (a) Elements; False Representation; Scienter

b. Actual Fraud

(1) Intentional Misrepresentation (CC §1572(1))

§3.12 (a) Elements; False Representation; Scienter

The elements of actual fraud based on intentional misrepresentation are:

- Misrepresentation;
- Knowledge of falsity or scienter;
- Intent to deceive or induce reliance; and
- Justifiable reliance.

There is no requirement to show damages if fraud is asserted as a defense to enforcement of a contract, rather than as a basis for a tort action for damages. *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 974, 64 CR2d 843 (rescission of arbitration agreement warranted when defendant misrepresented efficiency of its arbitration process to induce persons, including plaintiff's employer, to subscribe to its health maintenance plan). See also *Agosta v Astor* (2004) 120 CA4th 596, 603, 15 CR3d 565; *Anderson v Deloitte & Touche LLP* (1997) 56 CA4th 1468, 66 CR2d 512.

The first element, a false statement, is usually not in dispute. The second element, scienter, generally requires evidence that the defendant either knew or believed that the statement was not true. 56 CA4th at 1476. Scienter will also be present, however, if a false representation was made recklessly and without regard for its truth for the purpose of inducing action by the other party. *Engalla v Permanente Med. Group, Inc., supra*; *Yellow Creek Logging Corp. v Dare* (1963) 216 CA2d 50, 55, 30 CR 629. In *Engalla,* the court found that the defendant's statements regarding the efficiency of its arbitration program were made either with knowledge that it would not comply with its contractual arbitration deadlines or with reckless indifference as to whether it would comply with those deadlines, and were therefore actionable.

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§3.13 (b) Misrepresentations of Fact; Statements of Opinion

Ordinarily, there must be an intentional misrepresentation of *fact*. Thus, an expression of opinion will not normally provide a basis for rescission because reliance on an opinion is normally not justified. See *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 295, 37 CR3d 364; *Borba v Thomas* (1977) 70 CA3d 144, 138 CR 565. In *Borba,* the court found that the seller's assertion that there would be no problem getting Bureau of Reclamation approval for water rights on the land sold was merely an expression of opinion about the future conduct of a governmental agency, and the buyer could not justifiably rely on it. The court refused to rescind the sale, finding that there was no relationship of special trust or confidence between the parties and the buyer had the same means as the seller to verify the underlying facts. See also *Hauter v Zogarts* (1975) 14 C3d 104, 111, 120 CR 681 (defendants would not be liable in tort for statements of opinion that amount to mere "puffing"); *Wilke v Coinway, Inc.* (1967) 257 CA2d 126, 136, 64 CR 845 (person cannot justifiably rely on mere statements of opinion unless person giving opinion purports to have knowledge concerning matter or stands in position of trust and confidence to other). In *Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 291, 17 CR3d 26, the court of appeal ruled that statements made by an attorney to opposing counsel and their client that the transaction being negotiated was "standard" and "nothing unusual" were not actionable misrepresentations. The court noted that although expressions of professional opinion are sometimes treated as representations of fact, a "casual expression of belief" is not so treated. 121 CA4th at 291.

In some circumstances, however, an expression of opinion may be treated as a representation of fact for purposes of a fraud claim. A professional opinion that is not merely a casual expression of belief but rather a deliberate affirmation of the matters stated may be regarded as a positive assertion of fact. *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 11 CR2d 51. See *Wilson v Century 21 Great W. Realty* (1993) 15 CA4th 298, 18 CR2d 779 (alleged misrepresentations by real estate agent that he was unaware of any foundation problems were too remote for "positive assertion" requirement).

An opinion may also serve as the basis for fraud if the person expressing the opinion either "does not honestly entertain that opinion" or has "superior knowledge or special information" about the matter. *Ogier v Pacific Oil & Gas Dev. Corp.* (1955) 132 CA2d 496, 506, 282 P2d 574 (both exceptions satisfied if person who held himself out as in business of selling oil securities knowingly gave false opinion to older woman that "there is a strong possibility of securing oil" from land at issue). 132 CA2d at 505. As the California Supreme Court stated in *Bily,* 3 C4th at 408:

> [W]hen a party possesses or holds itself out as possessing superior knowledge or special information or expertise regarding the subject matter and a plaintiff is so situated that it may reasonably rely on such supposed knowledge, information, or expertise, the defendant's representation may be treated as one of material fact.

See also *Wilke v Coinway, Inc.* (1967) 257 CA2d 126, 136, 64 CR 845 (representations by seller of coin-operated testing machines that machines would be source of supplemental income for inexperienced elderly buyers were not merely predictions of future income but rather assertions of material fact made without reasonable grounds for believing them to be true).

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§3.14 (c) Intent to Deceive

Actual intent to deceive is a sufficient but not a necessary element; it is enough if the party making the misrepresentation intended to induce the other party to act in reliance on it. *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 974, 64 CR2d 843. See also CC §1572; *David v Herman* (2005) 129 CA4th 672, 685, 28 CR3d 622; *Lovejoy v AT&T Corp.* (2004) 119 CA4th 151, 160, 14 CR3d 117 (evidence that long distance carrier switched customer's service without his consent would support inference of intent to defraud). If the element of intent is present, however, the fraud is actionable, irrespective of any fiduciary or contractual obligation that one party might owe to the other. *Agricultural Ins. Co. v Superior Court* (1999) 70 CA4th 385, 402, 82 CR2d 594.

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§3.15 (d) Justifiable Reliance; Materiality

Actual, justifiable reliance. A party seeking to rescind must show that he or she actually relied on the misrepresentation, and that such reliance was justified. *Mirkin v Wasserman* (1993) 5 C4th 1082, 23 CR2d 101; *Gawara v United States Brass Corp.* (1998) 63 CA4th 1341, 74 CR2d 663. Reliance is ordinarily a question of fact. "Reliance exists when the misrepresentation or nondisclosure was an immediate cause of the plaintiff's conduct which altered his or her legal relations, and when without such misrepresentation or nondisclosure he or she would not, in all reasonable probability, have entered into the contract or other transaction." *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1239, 44 CR2d 352.

NOTE: The misrepresentation need not be made directly to the person who relies and acts on it. "Indirect communications fraud" involves a chain of fraudulent representations that are repeated by one victim to another. It is sufficient if the defendant made a misrepresentation or omission to one victim, intending or reasonably expecting that it would be repeated or otherwise communicated to another who would justifiably rely on it. *Boeken v Phillip Morris Inc.* (2005) 127 CA4th 1640, 1659, 26 CR3d 638; *Gawara,* 63 CA4th at 1358. Similarly, a plaintiff is not required "to demonstrate individualized reliance on specific misrepresentations to satisfy the reliance requirement." *In re Tobacco II Cases* (2009) 46 C4th 298, 327, 93 CR3d 559 (plaintiffs exposed to long-term advertising campaign by tobacco companies).

It must be shown that the plaintiff believed that the representation was true and that it played a substantial role in inducing him or her to act or to refrain from acting. The misrepresentation need not be the sole or predominant factor in inducing the plaintiff to act; it is sufficient if it was a substantial factor. *Conroy v Regents of Univ. of Cal.* (2009) 45 C4th 1244, 1256, 91 CR3d 532 (when deceased had signed agreement donating his body to defendant, deceased's widow could not demonstrate reliance on defendant's alleged misrepresentations regarding how decedent's body would be used); *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 974, 64 CR2d 843. See also *In re Tobacco II Cases, supra*; *Vasquez v Superior Court* (1971) 4 C3d 800, 814 n9, 94 CR 796.

Presumption of reliance, when. There is a presumption, or at least an inference, of actual reliance when the misrepresentation is material. *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 977, 64 CR2d 843. See also *In re Tobacco II Cases*, 46 C4th at 327. A misrepresentation is material if a reasonable person would "attach importance to its existence or nonexistence in determining his choice of action in the transaction in question." *Engalla,* 15 C4th at 977 (quoting Restatement (Second) of Torts §538(2)(a) (1981)). See also *In re Tobacco II Cases*, 46 C4th at 327; *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 37 CR3d 364 (representation to commercial shopping center lessee that "name brand" stores would be in close proximity was material, but justifiable reliance was not shown); *Wilke v Coinway, Inc.* (1967) 257 CA2d 126, 136, 64 CR 845 (representation made to prospective purchasers of business that they could make a profit was of utmost materiality and was primary inducement for them to enter into contract). Materiality is not an essential element of fraud based on an intentional misrepresentation if the misrepresentation produces the results sought by the defendant. In contrast, if the misrepresentation is innocent, it is in the nature of a mistake and must be material in order to warrant rescission of the contract. *Wood v Kalbaugh* (1974) 39 CA3d 926, 930, 114 CR 673.

Reliance justified if misrepresentation intentional. If a party relies on an *intentional* misrepresentation, that reliance is ordinarily justified, even if an investigation would have revealed that the representation was false. *Balfour, Guthrie & Co. v Hansen* (1964) 227 CA2d 173, 196, 38 CR 525 (party's agent who was regularly on job site for brief periods was justified in relying on defendant's intentional misrepresentation that grain silos were properly constructed according to specifications). The plaintiff's reliance is unjustified only if the representation was "preposterous" or "obviously false" based on known facts. 227 CA2d at 198. When one party intentionally misleads another, he or she cannot complain that the true facts would have become known if the plaintiff had made a reasonable inquiry. If, however, the plaintiff did in fact undertake his or her own investigation, the plaintiff may be found not to have relied on the defendant, and any facts that the plaintiff discovers will bear on whether his or her reliance was justified. 227 CA2d

at 196.

Representations about the law. The issue of justifiable reliance is reflected in the general rule that a false representation or opinion about the law made by a nonlawyer cannot serve as the basis of fraud, unless the person making the misrepresentation (1) "purports to have expert knowledge concerning the matter" and (2) "having had superior means of information, possesses a knowledge of the law and thereby gains an unconscionable advantage over one who is ignorant and has not been in a situation to become informed." *Regus v Schartkoff* (1957) 156 CA2d 382, 388, 319 P2d 721 (both exceptions satisfied when insurance adjuster with "knowledge far superior to that of plaintiff" erroneously informed plaintiff that she had 3 years, rather than 1 year, before her claim would be barred by statute of limitations). If both parties know the facts on which a lay opinion of law is based, and there is no confidential relationship between them, the person to whom the opinion is directed is not justified in relying on it. *Watt v Patterson* (1954) 125 CA2d 788, 793, 271 P2d 200. In contrast, a plaintiff's reliance on the legal opinion of a nonlawyer may be deemed reasonable if the parties have a relationship of trust and confidence, or if the plaintiff reasonably believes that the person giving the opinion has special knowledge or skill concerning its subject matter. Thus, a plaintiff's reliance may be considered reasonable when a real estate or insurance agent gives an opinion of law on a routine matter within the agent's competence. *Lynch v Cruttenden & Co.* (1993) 18 CA4th 802, 808, 22 CR2d 636; Restatement (Second) of Contracts §§169-170 (1981).

Representations about value of real estate. Similarly, general statements or opinions regarding the value of real property are usually not deemed reliable and therefore do not normally support an action for fraud. As in the case of opinions about the law, however, there is an exception if the opinion is made with an intent to deceive and in a setting where the plaintiff has been persuaded not to make an independent investigation or cannot reasonably do so. See *Palm v Smither* (1942) 52 CA2d 500, 126 P2d 428. See also §3.13. See generally California Real Property Sales Transactions (4th ed Cal CEB 2007).

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.16 (2) Negligent Misrepresentation (CC §1572(2))

§3.16 (2) Negligent Misrepresentation (CC §1572(2))

Elements. The elements of fraud based on negligent misrepresentation are as follows:

- The defendant must have made a representation regarding a present or past material fact;
- The representation must have been untrue;
- The defendant must have made the representation without any reasonable grounds for believing it to be true;
- The representation must have been made with the intent to induce the plaintiff to rely on it; and
- The plaintiff must have been unaware of the falsity of the representation, must have acted in reliance on the truth of the representation, and must have been justified in relying on it; and
- As a result of the plaintiff's reliance, the plaintiff must have sustained damage.

Friedman v Merck & Co. (2003) 107 CA4th 454, 476, 131 CR2d 885. See also *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 407, 11 CR2d 51; *Anderson v Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1476, 66 CR2d 512.

Scienter not required. Actual knowledge by the defendant of the falsity of the representation is not required. *Gagne v Bertran* (1954) 43 C2d 481, 487, 275 P2d 15. Further, actual intent to defraud (scienter) is not required. *Agosta v Astor* (2004) 120 CA4th 596, 603, 15 CR3d 565; *Anderson,* 56 CA4th at 1476. Civil Code §1572(2) provides that actual fraud includes "[t]he 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." In *Pohl v Mills* (1933) 218 C 641, 653, 24 P2d 476, the court found that the defendant's incorrect statement that he held a structure copyright to a series of lemon-shaped juice stands when he held only a copyright to a photograph of the stands supported rescission of leases to operate the stands. The defendant did not have a reasonable basis for his belief that the two types of copyright were the same. 218 C at 654.

Who may rely. The class of persons entitled to rely on the representations is restricted to those to whom or for whom the misrepresentations were made. "Even though the defendant should have anticipated that the misinformation might reach others, he is not liable to them." *Friedman v Merck & Co.* (2003) 107 CA4th 454, 476, 131 CR2d 885. See also *Conroy v Regents of Univ. of Cal.* (2009) 45 C4th 1244, 1256, 91 CR3d 532 (when deceased had signed agreement donating his body to defendant, deceased's widow could not demonstrate reliance on defendant's alleged misrepresentations regarding use of body because they were made to deceased, not widow-plaintiff).

Professional opinions. Allegations of negligent misrepresentation often arise in the context of professional opinions or opinions by those with a particular skill. See, *e.g., Bily v Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51 (audit opinion); *Anderson*, 56 CA4th at 1476 (independent accountants' reports for confidential offering memoranda); *Soderberg v McKinney* (1996) 44 CA4th 1760, 52 CR2d 635 (real estate appraisal); *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901 (legal opinion). In *Anderson v Deloitte & Touche LLP, supra,* the court held that a professional accountant's opinion was made without reasonable grounds for believing it to be true because the accountants failed to obtain or examine the information necessary to support their opinion delivered to prospective investors, and therefore fell below the applicable standard of care for the profession. To the extent that a statement, although cast as an opinion, is actually a "deliberate affirmation of the matters stated," rather than a "casual expression of belief," it may be regarded as a positive assertion of fact and will support rescission on the basis of negligent misrepresentation. *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51. See §3.13. Further, a representation will be treated as one of material fact when a party has or holds itself out as having special expertise or superior knowledge about the subject matter and it is reasonable for the other party to rely on the first party's knowledge or expertise. *Bily,* 3 C4th at 408; *Balfour, Guthrie & Co. v Hansen* (1964) 227 CA2d 173, 196, 38 CR 525.

Intent. The element of intent to induce reliance will be satisfied if the party making the representation knows with substantial certainty that the other person (or the class of persons to which he or she belongs) will rely on the representation in the course of the transaction. *Anderson v Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1477, 66 CR2d 512. The test for reliance is the same as in cases of intentional misrepresentation. See §3.15.

Reliance must be justified. Like intentional misrepresentation, negligent misrepresentation also requires proof that the plaintiff's reliance was justified. *Agosta v Astor* (2004) 120 CA4th 596, 603, 15 CR3d 565. On the issue of whether

there was justifiable reliance, many cases make the point that the plaintiff's negligence in failing to discover the falsity is no defense if the defendant's misrepresentation was intentional as distinct from negligent. See, *e.g., Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1239, 44 CR2d 352; *Balfour, Guthrie & Co. v Hansen* (1964) 227 CA2d 173, 196, 38 CR 525. Yet, even if the defendant's misrepresentation was negligent (*i.e.,* made without reasonable grounds to believe that it was true), the plaintiff is not held to a hypothetical reasonable person standard when determining whether his or her reliance was justified. Instead, the focus is the plaintiff's own knowledge and experience—whether the plaintiff was justified in relying on the defendant's statement in the light of the plaintiff's personal knowledge and experience. *Gray v Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 503, 198 CR 551. This standard is substantially the same as the standard for justifiable reliance when the misrepresentation was intentional. See *Alliance Mortgage Co.,* 10 C4th at 1240 (no justifiable reliance if plaintiff's conduct was manifestly unreasonable in view of his own intelligence and information).

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§3.17 (3) Concealment, Suppression of Fact (CC §1572(3))

Generally, no duty of disclosure; exceptions. In general, there is no common law duty to disclose material facts unless there is a special confidential relationship between the parties. *Cicone v URS Corp.* (1986) 183 CA3d 194, 201, 227 CR 887. See also *Goodman v Kennedy* (1976) 18 C3d 335, 346, 134 CR 375; *Alfaro v Community Hous. Improvement Sys. & Planning Ass'n* (2009) 171 CA4th 1356, 1382, 89 CR3d 659. (For discussion of confidential relationships, see §§3.22-3.30.) Statutory exceptions to this general rule exist for offers or sales of securities and in real estate transactions (see below). Moreover, the intentional concealment or suppression of a material fact may be equivalent to an affirmative misrepresentation, even if made by a person who does not occupy a fiduciary or other special position towards the other party. *Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 294, 17 CR3d 26. See also *Goodman, supra*.

Elements. The elements of actual fraud based on nondisclosure or concealment are (1) active concealment or suppression of a material fact, (2) by someone with a duty to disclose that fact to the other party, (3) done with an intent to defraud the other party, and (4) the other party is unaware of the fact concealed and would not have acted as he or she did had he or she known about it. *Lovejoy v AT&T Corp.* (2004) 119 CA4th 151, 157, 14 CR3d 117; *Roddenberry v Roddenberry* (1996) 44 CA4th 634, 665, 51 CR2d 907. Even if there is no fiduciary or confidential relationship between the parties, a concealment claim arises when one person makes representations to another but does not disclose additional facts that materially qualify the facts disclosed or that render the disclosure likely to be misleading. *Warner Constr. Corp. v. City of Los Angeles* (1970) 2 C3d 285, 294, 85 CR 444. "Even where no duty to disclose would otherwise exist, 'where one does speak he must speak the whole truth to the end that he does not conceal any facts which materially qualify those stated.… One who is asked for or volunteers information must be truthful, and the telling of a half-truth calculated to deceive is fraud.'" *Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 292, 17 CR3d 26 (citations omitted). In *Vega,* the court held that the plaintiff's allegations that the defendant law firm prepared two versions of a disclosure schedule, one with and the other without certain material terms, and delivered only the "sanitized" version to the opposing parties, stated a claim for active concealment or suppression of facts. Because the law firm specifically undertook to disclose the transaction and did so, it was not at liberty to conceal material provisions. In *Stevens v Superior Court* (1986) 180 CA3d 605, 225 CR 624, the court ruled that allegations that a hospital had intentionally concealed from patients the fact that unlicensed foreign physicians were serving as hospital staff physicians without supervision required by statute were sufficient to plead a cause of action for fraud by intentional concealment.

Materiality. As in cases involving other types of actual fraud, a fact is material if a reasonable person would "attach importance to its existence or nonexistence in determining his choice of action in the transaction in question." *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 977, 64 CR2d 843 (quoting Restatement (Second) of Torts §538(2)(a) (1981)). See also *In re Tobacco II Cases* (2009) 46 C4th 298, 327, 93 CR3d 559. For further discussion of materiality as an aspect of justifiable reliance, see §3.15.

Information in public domain. In a concealment case, the fact that the information allegedly concealed by the defendant is available somewhere in the public domain will not necessarily defeat the plaintiff's claim. The question is whether the defendant knew of material facts and also knew that those facts were neither known nor readily accessible to the plaintiff. *Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 295, 17 CR3d 26. The plaintiff is not barred by constructive notice of a public record, such as a filing with the Securities and Exchange Commission. In contrast, fraudulent concealment claims may be rejected if the information at issue is readily accessible or if the plaintiff had inquiry notice of the allegedly concealed information. See, *e.g., Clayton v Landsing Pac. Fund, Inc.* (ND Cal, May 16, 2002, No. C01-03110 WHA) 2002 US Dist Lexis 9446 (no claim for fraudulent concealment of decline in value of plaintiff's investment; value of shares was publicly available and defendants' letter to plaintiff disclosed decrease in value); *Stevenson v Baum* (1998) 65 CA4th 159, 75 CR2d 904 (no cause of action for fraudulent nondisclosure of pipeline easement because purchase contract put plaintiffs on notice that they took title subject to easements of record). See also *Alfaro v Community Hous. Improvement Sys. & Planning Ass'n* (2009) 171 CA4th 1356, 1384, 89

CR3d 659 (collecting and analyzing cases).

Exception for offers and sales of securities. An exception to the common law rule that there is no duty to disclose material facts is codified in federal and state securities laws. Under §10(b) of the Securities Exchange Act of 1934 (15 USC §78j(b)) and Rule 10b-5 (17 CFR §240.10b-5), and corresponding state laws (see Corp C §§25500-25504.2), it is unlawful (among other things) to omit to state any material facts necessary to make statements made in connection with the offer or sale of a security not misleading. See Financing and Protecting California Businesses §6A.2 (Cal CEB 2006). Further discussion of disclosure obligations in securities transactions is beyond the scope of this title.

Exception for real estate transactions. Another exception to the rule exists for California real estate transactions. In all real estate transactions, whether residential or commercial, a common law duty of disclosure arises when:

- The seller knows of facts materially affecting the value or desirability of the property;
- The facts are known or accessible only to the seller; and
- The seller knows that the facts are not known to the buyer and not reasonably discoverable by the buyer on diligent inspection.

Calemine v Samuelson (2009) 171 CA4th 153, 89 CR3d 495; *Shapiro v Sutherland* (1998) 64 CA4th 1534, 1544, 76 CR2d 101. This duty has been expanded and codified in numerous federal and state statutes and local ordinances. See, *e.g.,* CC §1102.6. For further discussion of a real estate seller's disclosure obligations, see California Real Property Sales Transactions §§6.29-6.70 (4th ed Cal CEB 2007).

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§3.18 (4) Promissory Fraud (CC §1572(4))

Promissory fraud is a "subspecies" of actual fraud. *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 974, 64 CR2d 843; *Agosta v Astor* (2004) 120 CA4th 596, 603, 15 CR3d 565. Under CC §1572(4), actual fraud includes "a promise made without any intention of performing it" with an intent to deceive another party to the contract or to induce him or her to enter into the contract. "A promise to do something necessarily implies the intention to perform; hence, where a promise is made without such intention, there is an implied misrepresentation of fact that may be actionable fraud." *Lazar v Superior Court* (1996) 12 C4th 631, 638, 49 CR2d 377. A contract may be rescinded based on promissory fraud when a party to the contract (1) makes a promise regarding a material fact, (2) knowing that he or she will not perform the promise or with reckless disregard as to whether he or she will perform, (3) with the intent to deceive, or induce reliance, and (4) the other party justifiably relies on the promise. *Engalla,* 15 C4th at 974. Essentially, the defendant has fraudulently induced the plaintiff to enter into the contract. *Lazar,* 12 C4th at 638. See, *e.g., Manson v Reed* (1986) 186 CA3d 1493, 231 CR 446 (evidence that defendant signed promissory note with no intention of making payments under it and no intention of using note proceeds as represented supported finding of promissory fraud under CC §1572(4)). For discussion of the elements of intent to induce reliance and justifiable reliance, see §§3.13-3.16.

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§3.19 (5) "Any Other Act Fitted to Deceive" (CC §1572(5))

Civil Code §1572(5) is a "catch-all" fraud provision, which encompasses "[a]ny other act fitted to deceive" made with an intent to deceive another party to the contract or to induce him or her to enter into the contract. As one court has stated, it is difficult to understand precisely what types of conduct are encompassed by §1572(5) that differ from the types of fraudulent conduct previously described in CC §1572. *Masters v San Bernardino County Employees Retirement Ass'n* (1995) 32 CA4th 30, 41 n7, 37 CR2d 860. Nonetheless, courts have used §1572(5) in a variety of circumstances, often without detailed discussion of the elements of actual fraud. See, *e.g., Earl v Saks & Co.* (1951) 36 C2d 602, 613, 226 P2d 340, in which the court ruled that the donor was entitled to rescind a gift of a fur coat. A department store led the donor to believe that the purchase price for the coat was $4000—the maximum amount the donor was willing to pay—when in fact the donee had paid $1000 towards an actual purchase price of $5000. The defendant's act was an act "fitted to deceive." See also *Architects & Contractors Estimating Serv., Inc. v Smith* (1985) 164 CA3d 1001, 1007, 211 CR 45 (holding that subcontract was voidable because contractor's suppression of hidden costs when he knew the subcontractor was "a babe in the woods" was an "act fitted to deceive").

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§3.20 c. Constructive Fraud (CC §1573)

Civil Code §1573 defines constructive fraud as consisting:

> 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.

Constructive fraud is usually asserted against a fiduciary by someone to whom a fiduciary duty is owed and often involves a nondisclosure of material facts. It permits conduct that does not constitute actual fraud to be treated as such when there is a fiduciary or confidential relationship between the parties. *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 981 n13, 64 CR2d 843; *Estate of Gump* (1991) 1 CA4th 582, 601, 2 CR2d 269. See *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 85 CR3d 817. Constructive fraud "arises on a breach of duty by one in a confidential or fiduciary relationship to another which induces justifiable reliance by the latter to his prejudice." *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 129, 54 CR 533. Confidential and fiduciary relationships are discussed in §§3.22-3.30.

NOTE: The relationship between the parties need not be a formal fiduciary relationship to constitute a basis for a constructive fraud claim. Constructive fraud may also arise in the context of nonfiduciary "confidential" relationships. A confidential relationship may be present whenever someone justifiably places trust and confidence in the good faith and integrity of another person. *Tyler v Children's Home Soc'y* (1994) 29 CA4th 511, 549, 35 CR2d 291; *Odorizzi,* 246 CA2d at 129. For further discussion of confidential relationships, see §3.22.

A contract may be rescinded on the basis of constructive fraud even if there is no evidence of intent to deceive or induce reliance, as is required to show actual fraud (see §§3.12-3.19), or to gain an unfair advantage, as is required to show undue influence (see §3.21). *Tyler,* 29 CA4th at 547. The element of intent is presumed from the nature of the parties' relationship and their course of dealing. See *Byrum v Brand* (1990) 219 CA3d 926, 938, 268 CR 609.

A party seeking rescission based on constructive fraud must show justifiable reliance as well as resulting prejudice. *Tyler,* 29 CA4th at 549 (even if confidential relationship existed between adoption agency and birth parents, relinquishment of child could not be rescinded based on constructive fraud because birth parents could not show they were misled to their prejudice by agency's mere negligent omissions of regulatory requirements). However, the element of reliance may be relaxed in constructive fraud cases. As long as there is no direct evidence that the plaintiff did *not* rely on the defendant's misrepresentation or nondisclosure, reasonable reliance may be presumed, again based on the parties' fiduciary or confidential relationship. *Estate of Gump* (1991) 1 CA4th 582, 601, 2 CR2d 269.

In *Barrett v Bank of America* (1986) 183 CA3d 1362, 229 CR 16, the court found evidence of constructive fraud when the plaintiff-guarantors, in proceeding with a merger of their corporation, had relied on a bank loan officer's advice that the bank would release their personal guaranties. Without the plaintiffs' knowledge, the loan officer had concurrently assured a consultant for the corporation's merger partner that the bank would never agree to release the guarantors. See also *Montoya v McLeod* (1985) 176 CA3d 57, 221 CR 353 (constructive fraud by real estate saleswoman acting in dual agency capacity).

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/ 4. Undue Influence (CC §1575)/§3.21 a. Generally

4. Undue Influence (CC §1575)

§3.21 a. Generally

Civil Code §1575 defines undue influence as consisting:

1. In the use, by one in whom a confidence is reposed by another, or who holds real or apparent authority over him, of such confidence or authority for the purpose of obtaining an unfair advantage over him;
2. In taking an unfair advantage of another's weakness of mind; or,
3. In taking a grossly oppressive and unfair advantage of another's necessities or distress.

Undue influence refers to persuasion that is coercive in nature, that operates on another person's mental weakness and overcomes his or her will. *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 133, 54 CR 533. It consists of "the use of excessive pressure by a dominant person over a servient person resulting in the apparent will of the servient person being in fact the will of the dominant person." *Robison v City of Manteca* (2000) 78 CA4th 452, 457, 92 CR2d 748 (quoting *Keithley v Civil Serv. Bd.* (1970) 11 CA3d 443, 451, 89 CR 809). See also *Odorizzi,* 246 CA2d at 131 (consent vitiated based on undue influence where school officials exerted excessive pressure on distraught school teacher to resign immediately after he was arrested). The hallmark of undue influence is "high pressure, a pressure which works on mental, moral, or emotional weakness to such an extent that it approaches the boundaries of coercion." Undue influence has therefore been called "overpersuasion." 246 CA2d at 130.

Although many cases of undue influence involve persons in a confidential or fiduciary relationship toward one another, such a relationship is not required to show undue influence under the second and third subsections of CC §1575 if the defendant has taken unfair advantage of the plaintiff's distress or weakness. See *Odorizzi,* 246 CA2d at 130.

Direct evidence of undue influence is usually not obtainable; courts are therefore "*often obliged* to infer undue influence from the totality of the circumstances." *In re Cheryl E.* (1984) 161 CA3d 587, 601, 207 CR 728 (italics in original) (mother could rescind adoption based on undue influence where she was physically and emotionally overwhelmed and adoption worker was in position of dominance and trust). See also *Keithley v Civil Serv. Bd.* (1970) 11 CA3d 443, 451, 89 CR 809, in which the court noted that "there are no fixed definitions or inflexible formulas" for determining whether there was undue influence. Instead, the court must look at the entire context and determine whether "it appears that one's will was overborne and he was induced to do or forbear to do an act which he would not do, or would do, if left to act freely." 11 CA3d at 451.

The elements of excessive pressure, on the one hand, and the plaintiff's susceptibility, on the other, are interrelated. Both elements are generally present in some degree in cases involving undue influence, and more of one may compensate for less of the other. *Johnson v IBM Corp.* (ND Cal 1995) 891 F Supp 522, 530. See also *Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 132, 54 CR 533 ("[u]ndue influence involves a type of mismatch which our statute calls unfair advantage"). The court in *Odorizzi* identified elements of a pattern of behavior that may characterize excessive pressure. A defendant's conduct will be considered excessive if a number of these elements are present at the same time (246 CA2d at 133):

- Discussion of the transaction at an unusual or inappropriate time;
- Consummation of the transaction in an unusual place;
- Insistent demand that the business be finished at once;
- Extreme emphasis on untoward consequences of delay;
- The use of multiple persuaders by the dominant side against a single servient party;
- Absence of third party advisers to the servient party; and
- Statements that there is no time to consult financial advisers or attorneys.

See also *Robison v City of Manteca* (2000) 78 CA4th 452, 457, 92 CR2d 748; *Keithley v Civil Serv. Bd.* (1970) 11 CA3d 443, 452, 89 CR 809.

Undue susceptibility amounts to a lessened capacity of the subservient person to freely enter into a contract. It may, but need not, consist of a total incapacity or mental weakness. It need not be long-lasting, and may result from advanced age, sickness, injury, senility, mental or emotional anguish, physical or emotional exhaustion, or a combination of factors. *Odorizzi,* 246 CA2d at 131. See also *Keithley,* 11 CA3d at 451.

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§3.22 b. Fiduciary and Confidential Relationships

Although a fiduciary or confidential relationship between contracting parties is not required for undue influence to be present (*Odorizzi v Bloomfield Sch. Dist.* (1966) 246 CA2d 123, 130, 54 CR 533), the presence or absence of such a relationship is significant. See *Stewart v Marvin* (1956) 139 CA2d 769, 294 P2d 114. First, if there is a confidential relationship, the person seeking rescission does not need to show weakness of mind or undue susceptibility. *Sinclair v Weber* (1958) 166 CA2d 452, 465, 333 P2d 158; *Kloehn v Prendiville* (1957) 154 CA2d 156, 161, 316 P2d 17. In addition, if the person in whom trust and confidence is reposed actively participates in a transaction that is advantageous to himself or herself and detrimental to the other party, there is ordinarily a presumption of undue influence. The presumption is rebuttable, however. *Platt v Wells Fargo Bank Am. Trust Co.* (1963) 222 CA2d 658, 667, 35 CR 377; *Faulkner v Beatty* (1958) 161 CA2d 547, 327 P2d 41.

The presence or absence of a confidential relationship is a question of fact. *Richelle L. v Roman Catholic Archbishop* (2003) 106 CA4th 257, 272 n6, 130 CR2d 601; *Platt,* 222 CA2d at 667. A confidential relationship may exist between two people even if they have no formal legal relationship such as attorney-client, husband-wife, or trustee-beneficiary. *Kloehn v Prendiville* (1957) 154 CA2d 156, 160, 316 P2d 17. A confidential relationship may be present even though there is no fiduciary relationship between the parties, and may be founded on a moral, social, domestic, or merely personal relationship. *Richelle L.,* 106 CA4th at 271; *Barbara A. v John G.* (1983) 145 CA3d 369, 383, 193 CR 422. A confidential relationship exists when one person has gained the confidence of another and purports to advise or act with the other person's interest in mind. It is especially likely to exist in a family or friendship setting or, *e.g.,* between priest and penitent. *Davies v Krasna* (1975) 14 C3d 502, 510, 121 CR 705. It may exist whenever one person places trust in the honesty and good faith of another. *Kloehn v Prendiville* (1957) 154 CA2d 156, 160, 316 P2d 17.

In contrast, fiduciary relationships are generally recognized legal relationships, and include, *e.g.,* the relationships of attorney-client and trustee-beneficiary, and relationships among general partners or joint venturers. *Oakland Raiders v National Football League* (2005) 131 CA4th 621, 632, 32 CR3d 266 (cataloguing 12 different types of fiduciary relationships and 11 different situations in which claim of fiduciary relationship was rejected). See §§3.23-3.30. If a fiduciary duty is not imposed on a relationship as a matter of law, one must "knowingly undertake to act on behalf and for the benefit of another" in order for the duty to arise. *City of Hope Nat'l Med. Ctr. v Genentech, Inc.* (2008) 43 C4th 375, 380, 75 CR3d 333 (agreement to develop, patent, and commercially exploit secret scientific discovery in exchange for payment of royalties did not give rise to fiduciary relationship). The essence of both fiduciary and confidential relationships is that "the parties do not deal on equal terms, because the person in whom trust and confidence is reposed and who accepts that trust and confidence is in a superior position to exert unique influence over the dependent party." *Richelle L. v Roman Catholic Archbishop* (2003) 106 CA4th 257, 271, 130 CR2d 601. See also *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 85 CR3d 817. See generally Frankel, *Fiduciary Law*, 71 Cal L Rev 795 (May 1983).

NOTE: It is important to note that parties to a contract do not, simply by the act of contracting, become fiduciaries of one another. Although every contract includes an implied covenant of good faith and fair dealing (see §§6.33-6.36), the implied covenant does not create a fiduciary relationship. *Wolf v Superior Court* (2003) 107 CA4th 25, 31, 130 CR2d 860.

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§3.23 (1) Particular Fiduciary Relationships: Trustee and Beneficiary (Prob C §16004(c))

Probate Code §16004(c) creates a rebuttable presumption of undue influence in any transaction between a trustee and a beneficiary during the existence of the trust or while the trustee has influence over the beneficiary, in which the trustee gained an advantage from the beneficiary. Under the statute, any such transaction is presumed to constitute a violation of the trustee's fiduciary duty and a breach of trust. *Valentine v Read* (1996) 50 CA4th 787, 57 CR2d 836. See generally California Trust and Probate Litigation, chap 21 (Cal CEB 1999). Further, such a transaction is voidable at the option of the beneficiary. *BGJ Assocs., LLC v Wilson* (2003) 113 CA4th 1217, 7 CR3d 140. Whenever a trustee improves his or her position, or obtains a favorable opportunity, or otherwise benefits, gains, or profits in a transaction with a beneficiary, the trustee is deemed to have obtained an advantage. See *Cagnolatti v Guinn* (1983) 140 CA3d 42, 49, 189 CR 151; *Ferrara v La Sala* (1960) 186 CA2d 263, 271, 9 CR 179, overruled on other grounds in *Rader v Thrasher* (1962) 57 C2d 244, 252, 18 CR 736. If it is shown that a trustee gained an advantage in a transaction with a beneficiary, the trustee has the burden to prove that the transaction was nonetheless fair. See *Ortiz v Avila* (1963) 222 CA2d 786, 792, 35 CR 522.

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.24 (2) Particular Fiduciary Relationships: Attorney and Client

§3.24 (2) Particular Fiduciary Relationships: Attorney and Client

The relationship between attorney and client is "one of a strict fiduciary and confidential nature" of the highest character. *Bradner v Vasquez* (1954) 43 C2d 147, 151, 272 P2d 11. See also *Hunniecutt v State Bar* (1988) 44 C3d 362, 372, 243 CR 699; *Frazier v Superior Court* (2002) 97 CA4th 23, 35, 118 CR2d 129; *Zador Corp. v Kwan* (1995) 31 CA4th 1285, 1293, 37 CR2d 754. The fiduciary nature of the attorney-client relationship is reflected in Bus & P C §6068 (duties of attorney) and several of the Rules of Professional Conduct governing California lawyers. See, *e.g.,* Cal Rules of Prof Cond 3-300 (avoiding interests adverse to a client), 3-310 (avoiding representation of adverse interests), 4-100 (preserving identity of client's funds and property). See *BGJ Assocs., LLC v Wilson* (2003) 113 CA4th 1217, 1227, 7 CR3d 140. Rule 3-300 flatly prohibits attorneys from entering into business transactions with clients unless (a) the terms of the transaction are fair and reasonable to the client and are fully disclosed to the client, (b) the client is advised to seek independent counsel, and (c) the client consents in writing.

Whether an attorney-client relationship exists is a question of law. An attorney-client relationship can only be created by express or implied contract. *Koo v Rubio's Restaurants, Inc.* (2003) 109 CA4th 719, 729, 135 CR2d 415. It is important to note, however, that a fiduciary or confidential relationship between an attorney and another person may arise from the factual circumstances of the parties' interactions, even if no formal attorney-client relationship is established or the formal relationship has terminated. *Beery v State Bar* (1987) 43 C3d 802, 812, 239 CR 121. See also *Hunniecutt v State Bar* (1988) 44 C3d 362, 372, 243 CR 699.

Any transactions between an attorney and client, if beneficial to the attorney, are subject to strict scrutiny for unfairness. 44 C3d at 372; *Clancy v State Bar* (1969) 71 C2d 140, 77 CR 657. If an attorney receives a benefit in a transaction involving his or her client other than compensation for legal services rendered, there is a rebuttable presumption of undue influence. *Estate of Auen* (1994) 30 CA4th 300, 311, 35 CR2d 557. See also *Lewin v Anselmo* (1997) 56 CA4th 694, 701, 65 CR2d 682.

NOTE: Probate Code §16004(c) provides that any transaction between a trustee and a beneficiary that occurs during the existence of a trust or while the trustee's influence over the beneficiary continues, and in which the trustee gains an advantage from the beneficiary, is presumed to violate the trustee's fiduciary duties. See §3.23. California courts apply Prob C §16004(c) to the relationship between attorney and client. See *BGJ Assocs., LLC v Wilson* (2003) 113 CA4th 1217, 1227, 7 CR3d 140; *Lewin v Anselmo* (1997) 56 CA4th 694, 65 CR2d 682.

A benefit or advantage is obtained by an attorney when the attorney enters into a transaction with a client in which the attorney's position is improved or the attorney obtains a favorable opportunity or otherwise gains, benefits, or profits. See *Bradner v Vasquez* (1954) 43 C2d 147, 152, 272 P2d 11. Once the presumption of undue influence is established, the burden of going forward to rebut the presumption is on the attorney. See *Hunniecutt v State Bar* (1988) 44 C3d 362, 372, 243 CR 699; *Magee v State Bar* (1962) 58 C2d 423, 430, 24 CR 839. As summarized by the California Supreme Court in *Beery v State Bar* (1987) 43 C3d 802, 812, 239 CR 121:

> While an attorney is not prohibited from having business transactions with his client, yet, inasmuch as the relation of attorney and client is one wherein the attorney is apt to have very great influence over the client, especially in transactions which are a part of or intimately connected with the very business in reference to which the relation exists, such transactions are always scrutinized by courts with jealous care, and are set aside at the mere instance of the client, unless the attorney can show by extrinsic evidence that his client acted with full knowledge of all the facts connected with such transaction, and fully understood their effect; and in any attempt by the attorney to enforce an agreement on the part of the client growing out of such transaction, the burden of proof is always upon the attorney to show that the dealing was fair and just, and that the client was fully advised.

See also *BGJ Assocs., LLC v Wilson* (2003) 113 CA4th 1217, 1227, 7 CR3d 140 (holding that attorney's participation in business transaction with client violated Cal Rules of Prof Cond 3-300 and constituted undue influence under Prob C §16004, rendering agreement at issue voidable).

Any business transaction between an attorney and client must place the client "in a position that enables him to act

meaningfully, voluntarily, and with full legal advice," and the "mere fact that the contract might be fair or even advantageous does not eliminate or nullify the fiduciary duty of the attorney." *Trafton v Youngblood* (1968) 69 C2d 17, 28, 69 CR 568. Similarly, although a client's lack of confidence and trust in his or her attorney may be weighed as one factor in determining whether the attorney exercised undue influence over the client, it cannot lessen the attorney's duties to the client, because those duties arise from assumption of the relationship by the attorney. *Rader v Thrasher* (1962) 57 C2d 244, 250, 18 CR 736.

NOTE: Older cases addressing undue influence in the context of an attorney-client relationship sometimes rely on former CC §2235. This statute was repealed in 1986 with the enactment of the California Probate Code. It is superseded by Prob C §§16002 (trustee's duty of loyalty) and 16004 (trustee's duty to avoid conflict of interest). The repeal "was not intended to alter the rules applied by the courts to fiduciary and confidential relationships," except in cases involving express trusts subject to the Probate Code. Prob C §15003(b).

Perhaps in response to the intense scrutiny that California courts have given business transactions between attorneys and their clients, the legislature enacted Bus & P C §§6175-6177, which creates a safe harbor allowing attorneys to offer certain financial products such long-term care insurance, life insurance, and annuities to their clients, provided that the statutory disclosure requirements are met. See Bus & P C §6175.3.

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§3.25 (3) Particular Fiduciary Relationships: Health Care Provider and Patient

It is well established in California case law that the relationship between physician and patient is a fiduciary one. *Moore v Regents of Univ. of Cal.* (1990) 51 C3d 120, 129, 271 CR 146; *Stafford v Shultz* (1954) 42 C2d 767, 777, 270 P2d 1. Other health care providers, including hospitals (see *Wohlgemuth v Meyer* (1956) 139 CA2d 326, 331, 293 P2d 819), nurses (see *In re Estate of Bliss* (1962) 199 CA2d 630, 640, 18 CR 821), and psychotherapists (see *Hill v National Collegiate Athletic Ass'n* (1994) 7 C4th 1, 27, 26 CR2d 834), have also been recognized as occupying a fiduciary position with respect to their patients, premised on the confidential nature of the relationship. As in the case of attorney-client relationships (see §3.24), the fiduciary duties of a physician or other health care provider to a patient may continue even after the formal relationship has terminated. *Brown v Bleiberg* (1982) 32 C3d 426, 438, 186 CR 228.

Among other things, a physician has an obligation to disclose to the patient all information material to the patient's health care decisions (*Moore v Regents of Univ. of Cal., supra; Wohlgemuth v Meyer, supra*) and to avoid conflicts of interest. "Where there is a duty to disclose, the disclosure must be full and complete, and any material concealment or misrepresentation will amount to fraud sufficient to entitle the party injured thereby to an action." *Stafford,* 42 C2d at 777. The law "demands the strictest good faith and fair dealing" in all transactions between physician and patient; once the relationship is shown to exist, "all dealings between the parties will be closely scrutinized to ascertain if the confidence of the trusting party has been betrayed, or his mind unduly influenced to his prejudice." *Cole v Wolfskill* (1920) 49 CA 52, 54, 192 P 549.

California courts have struck down releases of physician or hospital liability signed by patients as void as against public policy. See, *e.g., Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33; *Belshaw v Feinstein* (1968) 258 CA2d 711, 726, 65 CR 788.

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(4) Particular Fiduciary Relationships: Husband and Wife; Registered Domestic Partners; Unmarried Persons

§3.26 (a) Husband and Wife (Fam C §721(b))

Under Fam C §721(b), a husband and wife have the status of fiduciaries in their dealings with each other, and are subject to all of the general rules governing fiduciary and confidential relationships. The relationship of marriage imposes a statutory duty of "the highest good faith and fair dealing" on each spouse, and each spouse is prohibited from taking any unfair advantage of the other. Fam C §721(b). See generally *Marriage of Mathews* (2005) 133 CA4th 624, 628, 35 CR3d 1; *Marriage of Haines* (1995) 33 CA4th 277, 295, 39 CR2d 673. The fiduciary relationship between spouses is subject to the same rights and obligations as nonmarital business partners as provided in Corp C §§16403 (keeping of books and records; right of partners and their agents and attorneys to access partnership books and records), 16404 (fiduciary duties of partner to partnership and to other partners), and 16503 (transfers of partnership interests). Family Code §721(b) expressly provides that these fiduciary obligations include, without limitation, the following:

- Giving each spouse access at all times, for the purpose of inspection and copying, to any books kept regarding a transaction;
- Providing full and accurate information on request regarding any matters affecting transactions concerning community property;
- Accounting to the spouse (and holding as a trustee) any benefits or profit derived by one spouse without the other spouse's consent from any transaction concerning the community property.

In general, nothing prohibits a spouse from entering into any transaction with the other, or with any other person, just as if that spouse were unmarried. Fam C §721(a). See also *Marriage of Haines*, 33 CA4th at 293. Transactions between spouses, however, must conform with the rules applicable to the conduct of persons in a confidential relationship, and are evaluated according to a fiduciary standard. There is a rebuttable presumption of undue influence if one spouse obtains an advantage over the other in a transaction involving community property. The transaction will be viewed with a "jealous eye" by the reviewing court. 33 CA4th at 293. In general, a spouse obtains an advantage in an interspousal transaction if he or she obtains "a favorable opportunity, or… otherwise gains, benefits, or profits." The burden of rebutting the presumption of undue influence is on the spouse who received the advantage. *Marriage of Lange* (2002) 102 CA4th 360, 364, 125 CR2d 379. If the presumption is not rebutted, the transaction is voidable by the disadvantaged spouse. *Estate of Mader* (1970) 11 CA3d 409, 417, 89 CR 787.

The presumption of undue influence in Fam C §721(b) is a specific presumption that supersedes other, more general evidentiary presumptions such as the presumption in Evid C §662 that beneficial ownership conforms with legal title. This result is consistent with California public policy that seeks to promote the institution of marriage. See *Marriage of Delaney* (2003) 111 CA4th 991, 999, 4 CR3d 378; *Marriage of Haines,* 33 CA4th at 301.

The fiduciary relationship of spouses continues, even after the parties separate. See Fam C §2102. Each party remains subject to the standards set forth in Fam C §721 from the date of the separation until all the community and quasi-community property and liabilities are distributed, with respect to all activities affecting the property and liability of the other party. Fam C §2102(a). See also *Marriage of Modnick* (1983) 33 C3d 897, 906, 191 CR 629 ("The duty of disclosure continues until the marriage has been dissolved and the community property divided by the court"); *Brewer v Federici* (2001) 93 CA4th 1334, 1348, 113 CR2d 849 (marriage settlement held invalid because spouse in superior position to obtain records and information by which certain community property could be valued violated her fiduciary duty to make full and accurate disclosure of that information to her spouse).

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Source: Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.27 (b) Registered Domestic Partners (Fam C §297.5)

§3.27 (b) Registered Domestic Partners (Fam C §297.5)

Domestic partners, as defined in Fam C §297(a), may register their partnership with the State of California in accordance with Fam C §§298-298.6. Once registered, the partners become subject to Fam C §297.5, which provides:

> Registered domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law, whether they derive from statutes, administrative regulations, court rules, government policies, common law, or any other provisions or sources of law, as are granted to and imposed upon spouses.

Although there is no case law on point to date, California courts are likely to conclude, by operation of Fam C §297.5, that registered domestic partners are fiduciaries of one another and that there is a rebuttable presumption of undue influence if one partner takes advantage of the other, as would arise in interspousal transactions under Fam C §721(b) in the same circumstances.

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§3.28 (c) Unmarried Persons

Unmarried parties to an antenuptial agreement generally do not fall within the scope of Fam C §721. There is no presumption of a fiduciary or confidential relationship merely because two individuals are engaged to marry. *Marriage of Dawley* (1976) 17 C3d 342, 355, 131 CR 3. See also *Maglica v Maglica* (1998) 66 CA4th 442, 448, 78 CR2d 101 (no fiduciary relationship between unmarried cohabitants concerning operation of one cohabitant's business). In the absence of a marriage, the burden of proof is on the party claiming the confidential relationship to prove that the relationship in fact exists. *Marriage of Haines* (1995) 33 CA4th 277, 299, 39 CR2d 673.

When two persons have lived together as husband and wife without being formally married, a confidential relationship may be found. "In some instances a confidential relationship may arise between nonmarital partners, and economic transactions between them should be governed by the principles applicable to such relationships." *Marvin v Marvin* (1976) 18 C3d 660, 682 n22, 134 CR 815. Before any presumption of undue influence can arise, however, the facts must first show that there was a confidential relationship between the couple. Second, it must be shown that the confidential relationship was violated and one party used the relationship to obtain an unfair advantage over the other. *Patterson v Davis* (1953) 121 CA2d 152, 159, 262 P2d 601.

NOTE: A formal *fiduciary* relationship cannot arise between two unmarried persons living together unless one entrusts property to the other or the two agree to purchase property together, no matter how "confidential" the relationship is between them*. Maglica v Maglica (1998) 66 CA4th 442, 448, 78 CR2d 101.*

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.29 (5) Particular Fiduciary Relationships: Partnerships, LLCs (Corp C §§16404, 17153)*

§3.29 (5) Particular Fiduciary Relationships: Partnerships, LLCs (Corp C §§16404, 17153)

Partners in a general partnership or a joint venture have fiduciary obligations to one another as provided by the California Uniform Partnership Act of 1994 (CUPA) (Corp C §§16100-16962). See generally Gartenberg & King, Fiduciary Duties in Partnerships and Limited Liability Companies Under California Law, 18 CEB Cal Bus L Prac 93 (Fall 2003). Corporations Code §16404 sets forth the fiduciary duties that a partner owes to the partnership and the other partners. These include, as an aspect of the duty of loyalty, a duty "[t]o account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property or information, including the appropriation of a partnership opportunity" and a duty to refrain from conflict-of-interest transactions with the partnership. Corp C §16404(b)(1)-(2).

Before CUPA, partners were held to the standards of a trustee in their dealings with each other and with the partnership. See, e.g., Leff v Gunter (1983) 33 C3d 508, 514, 189 CR 377; BT-I v Equitable Life Assur. Soc'y (1999) 75 CA4th 1406, 89 CR2d 811 (pre-CUPA partnership agreement). Citing Leff, the court in BT-I stated (75 CA4th at 1410, citations omitted):

> *Partners are trustees for each other, and in all proceedings connected with the conduct of the partnership every partner is bound to act in the highest good faith to his copartner and may not obtain any advantage over him in the partnership affairs by the slightest misrepresentation, concealment, threat or adverse pressure of any kind.… Moreover, this duty extends to all aspects of the relationship and all transactions between the partners. Each [partner] occupie[s] the position of a trustee to the other with regard to all the partnership transactions, including the transactions contemplated by the firm and constituting the object or purpose for which the partnership was formed.*

In an effort to limit the broad common law fiduciary standards, the Uniform Partnership Act on which CUPA was based provided that the fiduciary duties specified in the Act were exclusive. Gartenberg & King, 18 CEB Cal Bus L Prac at 94. CUPA omitted the Uniform Act's exclusivity provision, however. Thus, in California, common law fiduciary duties in addition to those enumerated in Corp C §16404 survive to some extent. Gartenberg & King, 18 CEB Cal Bus L Prac at 94. Importantly, cases decided after BT-I have carried forward the principle that partners are held to the standards and duties of trustees in their dealings with one another and other broad language from the earlier cases. See, e.g., Enea v Superior Court (2005) 132 CA4th 1559, 1564, 34 CR3d 513; Bardis v Oates (2004) 119 CA4th 1, 12, 14 CR3d 89; Everest Investors 8 v McNeil Partners (2003) 114 CA4th 411, 424, 8 CR3d 31.

CUPA nevertheless includes some important restrictions on the common law fiduciary duties of partners, as follows:

- *If not manifestly unreasonable, the partnership agreement may specify particular types of activities that do not violate the duty of loyalty, and further may specify a number or percentage of partners that may authorize or ratify (after full disclosure of all material facts) a specific act or transaction that would otherwise violate the duty of loyalty. Corp C §16103(b)(3).*
- *A partner does not violate a fiduciary duty to the partnership or the other partners merely because the partner's conduct furthers the partner's self-interest. Corp C §16404(e).*
- *A partner may lend money to, and otherwise transact business with, the partnership, and subject to other applicable law, the partner's rights and obligations regarding performance or enforcement are the same as those of someone who is not a partner. Corp C §16404(f).*

CUPA also specifies the extent to which a partner's fiduciary duties continue after the partner has withdrawn (now referred to as "dissociation") from the partnership. Corporations Code §16603(3) provides that a partner's fiduciary duty to account for profits and to avoid conflicts of interest in Corp C §16404(b)(1)-(2) (as well as the partner's duty of care in Corp C §16404(c)) continue "only with regard to matters arising and events occurring before the partner's dissociation."

General partners of limited partnerships are subject to the same restrictions, and have the same fiduciary duties to the partnership and the other partners, as in a general partnership. 114 CA4th at 424. See Corp C §15904.08. Similarly, a manager of a limited liability company has the same fiduciary duties to the limited liability company and its

members as a general partner has to the partnership and the other partners. Corp C §17153.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.30 (6) Other Fiduciary Relationships*

§3.30 (6) Other Fiduciary Relationships

The law recognizes a number of other legal relationships as fiduciary relationships, including the following:

- *Real estate brokers and salespersons toward their clients. Fragale v Faulkner (2003) 110 CA4th 229, 232, 1 CR3d 616. See also Skopp v Weaver (1976) 16 C3d 432, 128 CR 19; Smith v Zak (1971) 20 CA3d 785, 792, 98 CR 242.*
- *Accountants toward their clients. Richard B. LeVine, Inc. v Higashi (2005) 131 CA4th 566, 583, 32 CR3d 244 (but stating that law gives confidential relationship between accountant and client less protection than attorney-client relationship).*
- *Mortgage loan brokers toward their clients. Wyatt v Union Mortgage Co. (1979) 24 C3d 773, 782, 157 CR 392.*
- *Securities brokers toward their clients. Rosenthal v Great W. Fin. Sec. Corp. (1996) 14 C4th 394, 425, 58 CR2d 875; Brown v Wells Fargo Bank, N.A. (2008) 168 CA4th 938, 85 CR3d 817; Duffy v Cavalier (1989) 215 CA3d 1517, 1535, 264 CR 740.*
- *Corporate directors toward the corporation's shareholders. See Corp C §309; Advising and Defending Corporate Directors and Officers, chaps 3-4 (Cal CEB 1998).*
- *Escrow agents toward the other parties in an escrow transaction. Amen v Merced County Title Co. (1962) 58 C2d 528, 534, 25 CR 65.*
- *A guardian toward his or her ward; a conservator towards the conservatee. Prob C §2101. See also Prob C §39.*
- *A personal representative, custodian under the California Uniform Transfer to Minors Act, or "other legal representative" subject to the Probate Code, toward the beneficiary or beneficiaries of the fiduciary estate. See Prob C §39.*
- *An attorney-in-fact under a power of attorney, toward the grantor of the power of attorney. See Prob C §39.*
- *The governing board of a county retirement system towards county employees. McIntyre v Santa Barbara County Employees' Retirement Sys. (2001) 91 CA4th 730, 734, 110 CR2d 565.*
- *Priest and penitent. See Richelle L. v Roman Catholic Archbishop (2003) 106 CA4th 257, 275, 130 CR2d 601.*

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.31 (7) Legal Relationships That Are Not Fiduciary Relationships*

§3.31 (7) Legal Relationships That Are Not Fiduciary Relationships

A number of other legal relationships have been held not to constitute fiduciary relationships, including:

- *An insurance company toward its insured. Vu v Prudential Prop. & Cas. Ins. Co. (2001) 26 C4th 1142, 1150, 113 CR2d 70 (insurer-insured relationship not true fiduciary relationship, although insurer has special, heightened duties arising from the unique nature of insurance contract).*
- *A creditor-debtor relationship. Jones v Wells Fargo Bank (2003) 112 CA4th 1527, 1540 n5, 5 CR3d 835.*
- *The relationship of an employer toward its employees. O'Byrne v Santa Monica-UCLA Med. Ctr. (2001) 94 CA4th 797, 811, 114 CR2d 575; Odorizzi v Bloomfield Sch. Dist. (1966) 246 CA2d 123, 129, 54 CR 533.*

See also Oakland Raiders v National Football League (2005) 131 CA4th 621, 633, 32 CR3d 266 (listing 11 types of relationships that do not constitute fiduciary relationships).

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5. Mistake (CC §§1567(5), 1576-1579)

§3.32 a. Generally

Mistake is another factor that may defeat consent and nullify a contract. See CC §1567(5). Thus, a party may rescind a contract if his or her consent was given by mistake. CC §1689(b)(1). For further discussion of the remedy of rescission, see §11.46-11.58. Mistake may also be grounds for reformation (or, as it is termed under the Civil Code, "revision") of a written contract. See CC §3399. For further discussion of the remedy of reformation or revision, see §§11.62-11.64.

A mistake supporting rescission or revision may be one of fact or one of law. CC §1576. See generally Guthrie v Times-Mirror Co. (1975) 51 CA3d 879, 884, 124 CR 577 ("Mistake is said to fall generally into two categories: (1) A person may know the specific facts upon which his rights depend but be ignorant of the rules of law the courts will apply to those facts, or (2) a person may know the applicable legal rules but be mistaken as to the specific facts to which the rules are to be applied") (collecting cases); Odorizzi v Bloomfield Sch. Dist. (1966) 246 CA2d 123, 130, 54 CR 533 ("the doctrine of mistake customarily involves such errors as the nature of the transaction, the identity of the parties, the identity of the things to which the contract relates, or the occurrence of collateral happenings"). Whether the mistake is one of law or one of fact, however, to constitute grounds for rescission or reformation of the contract, the mistake must "materially affect an essential element of the contract." Guthrie, 51 CA3d at 886. For further discussion of the element of materiality, see §§3.33-3.34.

Mistake must be distinguished from assumption of the risk of a doubtful issue. "Where parties are aware at the time the contract is entered into that a doubt exists in regard to a certain matter and contract on that assumption, the risk of the existence of the doubtful matter is assumed as an element of the bargain." Guthrie, 51 CA3d at 885. In other words, "the kind of mistake which renders a contract voidable does not include 'mistakes as to matters which the contracting parties had in mind as possibilities and as to the existence of which they took the risk.'" 51 CA3d at 885 (citations omitted).

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.33 b. Mistake of Fact (CC §§1577, 1579)*

§3.33 b. Mistake of Fact (CC §§1577, 1579)

A mistake of fact is defined in CC §1577 as follows:

> *Mistake of fact is a mistake, not caused by the neglect of a legal duty on the part of the person making the mistake, and consisting in:*
> *1. An unconscious ignorance or forgetfulness of a fact past or present, material to the contract; or,*
> *2. Belief in the present existence of a thing material to the contract, which does not exist, or in the past existence of such a thing, which has not existed.*

The Civil Code also treats a mistake of foreign law as a mistake of fact. See CC §1579.

In general, a mistake of fact occurs when a person's assumption or belief does not accord with existing facts and that person's erroneous belief is material to his or her decision to enter into the contract. Schultz v County of Contra Costa (1984) 157 CA3d 242, 248, 203 CR 760. For purposes of considering whether a mistake of fact has occurred, the outward conduct or manifestations of assent that led to formation of the contract are not controlling. What is relevant is a party's subjective belief. See 157 CA3d at 248. Nonetheless, to constitute a basis for rescission or reformation of the contract, the mistake must not have been caused by the "neglect of a legal duty" of the party seeking to avoid the contract. See CC §1577; Mercury Ins. Co. v Pearson (2008) 169 CA4th 1064, 1074, 487 CR 310. Thus, a person with the capacity of reading and understanding a contract is bound by its contents on signing, in the absence of fraud or undue influence, and cannot avoid its terms merely by asserting that it is contrary to his or her subjective understanding. Tarpy v County of San Diego (2003) 110 CA4th 267, 1 CR3d 607; Jefferson v California Dep't of Youth Auth. (2002) 28 C4th 299, 121 CR2d 391. A person cannot avoid a contract on the grounds that he or she did not read it before signing. Stewart v Preston Pipeline, Inc. (2005) 134 CA4th 1565, 1588, 36 CR3d 901; Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc. (2001) 89 CA4th 1042, 107 CR2d 645.

NOTE: *Although a contracting party has a duty to read the written contract before signing it, and failure to do so will not constitute grounds for rescission, there are limited exceptions to this general rule. For example, rescission may be obtained if the party can show that he or she did not know that what he or she was signing was a contract at all (see Saint Agnes Med. Ctr. v PacifiCare of Cal. (2003) 31 C4th 1187, 8 CR3d 517; Rosenthal v Great W. Fin. Sec. Corp. (1996) 14 C4th 394, 58 CR2d 875), or if there is unusual or unfair language that is not brought to the attention of, and explained to, the party signing (see Williams v California Physicians' Serv. (1999) 72 CA4th 722, 85 CR2d 497).*

The "neglect of a legal duty" referred to in CC §1577 does not mean ordinary negligence. Donovan v RRL Corp. (2001) 26 C4th 261, 285, 109 CR2d 807. The simple negligence of a party in failing to learn the true facts will not prevent that party from obtaining rescission for mistake of fact. To bar rescission, the "neglect of a legal duty" must amount to gross negligence. Harris v Rudin, Richman & Appel (2002) 95 CA4th 1332, 1342, 116 CR2d 552.

A mistake of fact may be either mutual or unilateral. When both parties have entered into a contract under a mistake of fact, the mistake is mutual, and if the mistake is material, it is grounds for rescission. CC §1689(b)(1); Merced County Mut. Fire Ins. Co. v State (1991) 233 CA3d 765, 771, 284 CR 680; Crocker-Anglo Nat'l Bank v Kuchman (1964) 224 CA2d 490, 496, 36 CR 806. See Stewart, 134 CA4th at 1587. To determine whether a mutual mistake has occurred, the court may admit parol evidence, even if the parties intended the writing to be a complete expression of their agreement. Hess v Ford Motor Co. (2002) 27 C4th 516, 525, 117 CR2d 220. The parol evidence rule is discussed in §§5.33-5.42.

NOTE: *Materiality is a key requirement in any action for rescission based on a mistake of fact, whether mutual or unilateral. See CC §1577; Merced County Mut. Fire Ins. Co. v State (1991) 233 CA3d 765, 772, 284 CR 680; Edwards v Lang (1961) 198 CA2d 5, 18 CR 60. The mistake must be one that "animated and controlled the conduct of the party; go to the essence of the object in view and not be merely incidental. The court must be satisfied that but for the mistake the complainant would not have assumed the obligation from which he seeks to be relieved." Reid v Landon (1958) 166 CA2d 476, 483, 333 P2d 432 (rescission warranted when defendant*

signed option-to-purchase agreement under mistaken belief, known to plaintiffs, that she was signing right of first refusal). See also Guthrie v Times-Mirror Co. (1975) 51 CA3d 879, 885, 124 CR 577, discussed in §3.34.

If only one party is mistaken, the mistake is unilateral, and rescission is not automatically available. If a party's unilateral mistake of fact is due to fault of the other party or if the other party knew or had reason to know of the mistake, then the contract may be rescinded. Hernandez v Badger Constr. Equip. Co. (1994) 28 CA4th 1791, 34 CR2d 732. See also CC §1689(b)(1) (rescission available for mistake "exercised by or with the connivance" of other party). Under this rule, an innocent misrepresentation, if material, may be grounds for rescission or revision based on mistake, even in the absence of constructive fraud. See Merced County Mut. Fire Ins. Co. v State (1991) 233 CA3d 765, 284 CR 680; Crocker-Anglo Nat'l Bank v Kuchman (1964) 224 CA2d 490, 496, 36 CR 806 (plaintiffs had claim for rescission of stock purchase contract when, because of defendant's representations, they believed stock to be worth substantially more than its actual value).

A different rule applies, however, in cases where the other party is not responsible for the first party's unilateral mistake of fact. In Donovan v RRL Corp. (2001) 26 C4th 261, 109 CR2d 807, the California Supreme Court adopted the rule of the Restatement (Second) of Contracts §153(a) (1981), authorizing rescission of a contract for a unilateral mistake of fact in situations when the party seeking to enforce the contract is not responsible for the other party's mistaken belief, if enforcement of the contract would be unconscionable. In Donovan, a car dealer's advertisement mistakenly listed a price for a used Jaguar ($25,995) that was significantly less than the dealer's intended sales price ($37,995). The court ruled that the ad constituted a valid offer that had been accepted by the plaintiff's tender of the advertised purchase price, so that a contract was formed. The contract was subject to rescission, however, under the rule stated by the California Supreme Court as follows (26 C4th at 282):

> *Where the plaintiff [the party seeking to enforce the contract] has no reason to know of and does not cause the defendant's unilateral mistake of fact, the defendant [the party seeking rescission] must establish the following facts to obtain rescission of the contract: (1) the defendant made a mistake regarding a basic assumption upon which the defendant made the contract; (2) the mistake has a material effect upon the agreed exchange of performances that is adverse to the defendant; (3) the defendant does not bear the risk of the mistake; and (4) the effect of the mistake is such that enforcement of the contract would be unconscionable.*

Conversely, in Grenall v United of Omaha Life Ins. Co. (2008) 165 CA4th 188, 80 CR3d 609, the court held an annuity could not be rescinded based on the decedent's unilateral mistaken belief at the time she entered the contract that she was in good health and had a reasonable life expectancy, because she bore the risk of this mistake.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.34 c. Mistake of Law (CC §1578)*

§3.34 c. Mistake of Law (CC §1578)

Under CC §1578, a mistake of law is sufficient to negate consent to a contract only when it derives from:

> *1. A misapprehension of the law by all parties, all supposing that they knew and understood it, and all making substantially the same mistake as to the law; or,*
> *2. A misapprehension of the law by one party, of which the others are aware at the time of contracting, but which they do not rectify.*

In general, "[a] mistake of law is when a person knows the facts as they really are, but has a mistaken belief as to the legal consequences of those facts." Hedging Concepts, Inc. v First Alliance Mortgage Co. (1996) 41 CA4th 1410, 1421 n9, 49 CR2d 191. See also Harris v Rudin, Richman & Appel (2002) 95 CA4th 1332, 1342, 116 CR2d 552.

In Guthrie v Times-Mirror Co. (1975) 51 CA3d 879, 885, 124 CR 577, plaintiffs sought rescission of a contract for sale of a San Bernardino newspaper to defendant Times-Mirror, on grounds that both parties were under a mutual mistake of law (based on an opinion of counsel) that the sale would not violate the federal antitrust laws. Shortly after the sale, a federal court ruled the transaction in violation of §7 of the Clayton Act, and Times-Mirror resold the newspaper to a third party. The court of appeal ruled that the plaintiffs' complaint was sufficient to plead a mistake of law, but nevertheless dismissed the complaint because the plaintiffs failed to show that they were injured by the mistake. 51 CA3d at 886. In so holding, the court emphasized that to void a contract for mutual mistake—whether of fact or law—the mistake must affect an "essential element of the contract" and be "harmful" to the party seeking rescission. 51 CA3d at 884. A "necessary corollary of the principle that the mistake, whether of law or fact, must materially affect an essential element of the contract" is that the "contract is voidable for mistake only if enforcement would be materially harmful or more onerous to the party seeking avoidance than it would have been had the law or the facts been as believed." 51 CA3d at 886.

In Stermer v Board of Dental Exam'rs (2002) 95 CA4th 128, 115 CR2d 294, the court of appeal affirmed that a dentist could not rescind his stipulation to a disciplinary order of the California Board of Dental Examiners after his criminal conviction (which had motivated his stipulation) was vacated. The court found that the parties had contemplated the possibility that the dentist's conviction would be set aside, but the Board refused to provide for that possibility. By proceeding to enter into the stipulation, the dentist assumed the risk (see §3.32) that his conviction might be vacated and therefore could not rescind the stipulation based on a mistake of law.

Like a mistake of fact, a mistake of law can be either mutual or unilateral. A mutual mistake, i.e., "when… all parties think they know and understand the law but all are mistaken in the same way" (Hedging Concepts, Inc. v First Alliance Mortgage Co. (1996) 41 CA4th 1410, 1421, 49 CR2d 191), is sufficient to negate consent under CC §1578(1) if the materiality requirement is met. See Guthrie v Times-Mirror Co. (1975) 51 CA3d 879, 885, 124 CR 577, discussed above. For example, in Adams v Heinsch (1948) 89 CA2d 300, 200 P2d 796, the court allowed rescission of a commercial real estate lease based on the mistaken belief shared by both parties that rent control regulations were not applicable to the lease in question.

If the mistake is unilateral, it will not be sufficient to avoid the contract—even if it satisfies the materiality requirement—unless it was known to or caused by the other party and that party did nothing to rectify the misunderstanding of the party seeking rescission. See CC §1578(2); Hedging Concepts, Inc., 41 CA4th at 1421. One party's subjective misunderstanding of the legal effect of a contract does not constitute a mistake of law. "[T]he courts will not set aside contractual obligations… merely because one of the parties claims to have been ignorant of, or to have misunderstood, the provisions of the contract." 41 CA4th at 1421 (broker's subjective misunderstanding of conditions that would entitle him to commission under his contract with mortgage company was not mistake of law supporting rescission).

NOTE: *Unlike claims for rescission based on a unilateral mistake of fact, there is no requirement that a party seeking rescission of a contract based on a unilateral mistake of law be free from negligence (that is, "neglect of a legal duty" under CC §1577; see §3.33). The absence of "neglect of a legal duty" is only required in cases involving a mistake of fact. Harris v Rudin, Richman & Appel (2002) 95 CA4th 1332, 1342, 116 CR2d 552.*

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.35 E. Ratification of Voidable Contract (CC §1588)*

§3.35 E. Ratification of Voidable Contract (CC §1588)

Civil Code §1588 provides that "[a] contract which is voidable solely for want of due consent, may be ratified by a subsequent consent." Ratification is a question of the ratifying party's intent, as shown by his or her words or conduct. Esau v Briggs (1948) 89 CA2d 427, 201 P2d 25. Further, the ratifying party must have full knowledge of all material facts. "The fundamental test of ratification by conduct is whether the releasor, with full knowledge of the material facts entitling him to rescind, has engaged in some unequivocal conduct giving rise to a reasonable inference that he intended the conduct to amount to a ratification." Union Pac. R.R. Co. v Zimmer (1948) 87 CA2d 524, 532, 197 P2d 363. In BGJ Assocs., LLC v Wilson (2003) 113 CA4th 1217, 7 CR3d 140, the court found that a party's conduct in tendering, subject to conditions, an initial capital contribution to a joint venture to be formed and signing a tenancy-in-common agreement between a third party and the joint venture did not constitute a ratification of the terms of the proposed operating agreement for the joint venture. In the BGJ case, it was clear that the tender was made, and the tenancy-in-common agreement signed, to preserve a purchase option with a third party not to accept the operating agreement.

NOTE: *Contracts that are void, rather than merely voidable, cannot be ratified. Black Hills Invs., Inc. v Albertson's, Inc. (2007) 146 CA4th 883, 53 CR3d 263.*

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III. LEGALITY

§3.36 A. Generally (CC §§1550(3), 1595-1596, 1667)

The third essential element to the existence of a contract under CC §1550 is a lawful object. See §3.1. As the court in Copeland v Baskin Robbins U.S.A. (2002) 96 CA4th 1251, 1257, 117 CR2d 875, observed: "Persons are free to contract to do just about anything that is not illegal or immoral."

Legality as a prerequisite for contract formation is addressed in several provisions of the Civil Code. Civil Code §1595 defines the object of a contract as "the thing which it is agreed, on the part of the party receiving the consideration, to do or not to do." Civil Code §1596 requires that "[t]he object of a contract must be lawful when the contract is made, and possible and ascertainable by the time the contract is to be performed." Civil Code §1667 recognizes three distinct types of illegality. It defines unlawfulness as:

1. *Contrary to an express provision of law;*
2. *Contrary to the policy of express law, though not expressly prohibited; or,*
3. *Otherwise contrary to good morals.*

These three types of unlawful contracts are discussed in §§3.37 and 3.40-3.41. The extent to which contracts with illegal elements may be enforceable is addressed in §§3.38-3.39.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.37 B. Contracts Contrary to Express Provision of Law (CC §1667(1))*

§3.37 B. Contracts Contrary to Express Provision of Law (CC §1667(1))

Contracts that are illegal based on an express provision of law (see CC §1667(1)), such as a statute, have been referred to as "malum prohibitum" contracts. See Yoo v Jho (2007) 147 CA4th 1249, 55 CR3d 243; McIntosh v Mills (2004) 121 CA4th 333, 344 n10, 17 CR3d 66. As a general rule, contracts to perform acts prohibited by statute or regulation are void from inception and not enforceable. MW Erectors, Inc. v Niederhauser Ornamental & Metal Works Co. (2005) 36 C4th 412, 435, 30 CR3d 755; Sixells, LLC v Cannery Bus. Park (2008) 170 CA4th 648, 88 CR3d 235 (contract for sale of property that allowed plaintiff to waive filing of final map violated Subdivision Map Act (Govt C §§66410-66499.37) and thus was void at inception); Espinoza v Calva (2008) 169 CA4th 1393, 87 CR3d 492 (lease for building lacking certificate of occupancy required by law was illegal, unenforceable contract); Yoo v Robi (2005) 126 CA4th 1089, 24 CR3d 740. (Possible equitable exceptions to this rule are discussed in §3.39.) Moreover, a party to an illegal contract cannot render it enforceable by ratification. Black Hills Invs., Inc. v Albertson's, Inc. (2007) 146 CA4th 883, 53 CR3d 263.

Noncompete covenants are a classic example of contracts that may be illegal under CC §1667(1), because Bus & P C §16600 declares noncompete covenants void unless made in connection with the sale of a business or interest in a business or dissolution of a partnership or limited liability company (see Bus & P C §§16601-16602.5). See, e.g., Edwards v Arthur Andersen LLP (2008) 44 C4th 937, 81 CR3d 282; VL Sys., Inc. v Unisen, Inc. (2007) 152 CA4th 708, 61 CR3d 818. The courts hold that overbroad, and therefore illegal, noncompete agreements will not be reformed but will simply be struck down in their entirety. See Dowell v Biosense Webster, Inc. (2009) 179 CA4th 564, 102 CR3d 1; Strategix Ltd. v Infocrossing W., Inc. (2006) 142 CA4th 1068, 48 CR3d 614. Covenants not to compete are discussed further in §6.38.

In Kashani v Tsann Kuen China Enters. Co. (2004) 118 CA4th 531, 13 CR 3d 174, the court ruled that a contract between American and Chinese manufacturers under which the American company was to build a plant in Iran for assembly of the Chinese company's computer products to be sold in Iran was illegal under several federal statutes and regulations, and therefore unenforceable. In Homami v Iranzadi (1989) 211 CA3d 1104, 260 CR 6, the court found that an alleged oral agreement to pay interest on a loan, which was contrary to the terms of a written agreement for a no-interest loan, was illegal and unenforceable because the purpose of the no-interest provision was to enable the lender to avoid federal and state tax laws.

Another example of a contract provision that may be illegal under CC §1667(1) is a clause restricting the assignment or transfer, or creation of a security interest, of rights in the contract, to the extent that the clause would impair creation, attachment, or perfection of a security interest, or cause a default under the agreement. See Com C §9408(a), discussed in §7.26. Still another example of provisions that are void for illegality are loan provisions that violate the usury law. WRI Opportunity Loans II, LLC v Cooper (2007) 154 CA4th 525, 542, 65 CR3d 205.

Yet another type of illegality may result from the failure of a contract to comply with a statute that expressly requires certain terms to be included in particular types of contracts or to be conspicuously displayed in the contract. The terms of contracts used by many specific types of California businesses (mainly, but not exclusively, involving consumer transactions) are regulated by the Civil Code or other California statutes. See §6.38 for further discussion and a nonexclusive list of businesses subject to such regulation. Contracts used by these businesses will be illegal to the extent that they do not conform with statutory requirements. For example, at issue in Malek v Blue Cross of Cal. (2004) 121 CA4th 44, 71, 16 CR3d 687, was Health & S C §1363.1, which requires health care service plans with provisions for binding arbitration to include certain disclosures relating to a patient's waiver of the right to a jury trial on medical malpractice claims. The court ruled that the arbitration provision in the defendant's plan was unenforceable because it did not comply with Health & S C §1363.1. In Timney v Lin (2003) 106 CA4th 1121, 131 CR2d 387, the court invalidated a liquidated damages provision that failed to comply with the requirements of CC §1675(d), which caps the amount of allowable liquidated damages in residential real estate contracts. Another example of a statute that regulates the contents of contracts is Bus & P C §7191, which requires arbitration provisions in contracts for work on residential property of one to four units to satisfy certain disclosure requirements, including a notice to the consumer that he or she

is forgoing the right to a jury trial.

Finally, certain professions and occupations are regulated under state law licensing requirements. An individual offering or performing services within the scope of a regulated profession or occupation is required to be licensed, and any contract of an unlicensed person to perform such services will not be enforceable. MW Erectors, Inc. v Niederhauser Ornamental & Metal Works Co. (2005) 36 C4th 412, 435, 30 CR3d 755; Selten v Hyon (2007) 152 CA4th 463, 60 CR3d 896. See, e.g., Bus & P C §7031 (barring enforcement of contracts of unlicensed contractors); White v Cridlebaugh (2009) 178 CA4th 506, 100 CR3d 434 (recovery under §7031 may not be offset by materials and services provided by unlicensed contractor); Great W. Contractors, Inc. v WSS Indus. Constr. (2008) 162 CA4th 581, 76 CR3d 8 (subcontractor unlicensed for portion of performance under contract cannot recover at all under that contract).

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§3.38 C. How Many Illegal Objects? (CC §§1598-1599)

Civil Code §§1598-1599 address the effect of illegality on contracts with either one object or multiple objects. Civil Code §1598 provides: "Where a contract has but a single object, and such object is unlawful, whether in whole or in part, or wholly impossible of performance, or so vaguely expressed as to be wholly unascertainable, the entire contract is void." For example, in Abramson v Juniper Networks, Inc. (2004) 115 CA4th 638, 9 CR3d 422, the court held that the cost-sharing provision of arbitration agreement, which required the employee to pay half, was illegal and unenforceable. Because, the taint of illegality and unconscionability could not be removed through severance of the offending provision, the agreement in Abramson was wholly unenforceable as matter of law. See also Sanchez v Western Pizza Enters. (2009) 172 CA4th 154, 181, 90 CR3d 818 (arbitration agreement "permeated by an unlawful purpose" was unenforceable when (1) unconscionable arbitrator selection clause designated "panel" of arbitrators comprising only one arbitrator selected by employer and (2) class arbitration waiver that interfered with unwaivable statutory rights to reimbursement of job expenses and receipt of minimum wage was contrary to public policy).

Related to CC §1598 is CC §1608, which provides: "If any part of a single consideration for one or more objects, or of several considerations for a single object, is unlawful, the entire contract is void." Consideration, as one of the essential elements for contract formation, is discussed in §§3.42-3.52.

In contrast to CC §1598, CC §1599 provides: "Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest." Civil Code §1599 contemplates severance of the unlawful provision and enforcement of the remainder of the contract. See Little v Auto Stiegler, Inc. (2003) 29 C4th 1064, 130 CR2d 892 (allowing severance if illegal provision is collateral to the main purpose of the agreement). The remedy of severance is discussed more fully in §§5.70-5.71. In Marathon Entertainment, Inc. v Blasi (2008) 42 C4th 974, 70 CR3d 727, the California Supreme Court held that portions of a personal management contract that pertained to services required to be performed by a licensed talent agent (soliciting and procuring employment) could be severed from portions pertaining to services (advice and counseling) that did not require a license, allowing an unlicensed talent manager to partially enforce the contract. In Birbrower, Montalbano, Condon & Frank, P.C. v Superior Court (1998) 17 C4th 119, 70 CR2d 304, a New York attorney who was not licensed to practice in California rendered legal services under a fee agreement partly in California and partly out of state. Because the agreement violated Bus & P C §6125 to the extent it covered legal services rendered in California, the California Supreme Court invalidated that part of the fee agreement but allowed enforcement of the rest. In Maudlin v Pacific Decision Sciences Corp. (2006) 137 CA4th 1001, 1015 n5, 40 CR3d 724, the court found that the stock redemption agreement at issue had at least one lawful object (redemption of the plaintiff's stock), and that the illegality in question (failure to meet the retained earnings test of Corp C §500) was curable by filing an amended tax return. The court allowed the agreement to be enforced.

A usurious interest rate provision is an example of an unlawful provision that is void and can be severed under CC §1599. See, e.g., Keene v Harling (1964) 61 C2d 318, 38 CR 513. Because a usurious interest rate is contrary to public policy and statutory law, it cannot be waived. WRI Opportunity Loans II, LLC v Cooper (2007) 154 CA4th 525, 65 CR3d 205.

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§3.39 D. Balancing Test for Unenforceability

Notwithstanding the express language of CC §§1598-1599, which appears to mandate voiding illegal contract provisions in all cases, California courts have allowed equitable principles to influence their decisions and may use a balancing test to determine whether and to what extent an illegal contract should be enforced. See, e.g., Tri-Q, Inc. v Sta-Hi Corp. (1965) 63 C2d 199, 218, 45 CR 878; Maudlin v Pacific Decision Sciences Corp. (2006) 137 CA4th 1001, 1013, 40 CR3d 724; McIntosh v Mills (2004) 121 CA4th 333, 344 n10, 17 CR3d 66 ("malum prohibitum contracts may be enforceable despite their illegality if the parties were not in pari delicto").

In general, contracts in violation of regulatory statutes are void, but this rule is not inflexible and is not applied in all circumstances. The so-called "in pari delicto" exception permits an illegal contract to be enforced "so long as the party seeking its enforcement is less morally blameworthy than the party against whom the contract is being asserted, and there is no overriding public interest to be served by voiding the agreement." McIntosh v Mills, 121 CA4th at 347. See also Maudlin v Pacific Decision Sciences Corp., supra. "In compelling cases, illegal contracts will be enforced in order to 'avoid unjust enrichment to a defendant and a disproportionately harsh penalty upon the plaintiff.'… In each case, the extent of enforceability and the kind of remedy granted depend upon a variety of factors, including the policy of the transgressed law, the kind of illegality and the particular facts." Malek v Blue Cross of Cal. (2004) 121 CA4th 44, 70, 16 CR3d 687.

In some cases, a court's refusal to enforce all or part of a contract based on an illegality may cause a forfeiture that would be "disproportionately harsh considering the nature of the illegality." Kashani v Tsann Kuen China Enters. Co. (2004) 118 CA4th 531, 557, 13 CR 3d 174; Yuba Cypress Hous. Partners, Ltd. v Area Developers (2002) 98 CA4th 1077, 1082, 120 CR2d 273. In Maudlin v Pacific Decision Sciences Corp., supra, the court allowed enforcement of a stock redemption agreement that was alleged to be illegal for noncompliance with the retained earnings test of Corp C §500. The court found that a failure to enforce the agreement would result in unjust enrichment of the corporation and a substantial forfeiture by the redeeming stockholder. Similarly, in Yuba Cypress, the plaintiff sought to rescind a real estate contract after he learned that the contract violated the California Subdivided Lands Act (Bus & P C §11000-11200). The court allowed the plaintiff to recover his attorney fees and costs under the prevailing party clause of the contract even though the rest of the contract was unenforceable, because otherwise the defendant would have benefited from the illegality that it created. See also Residential Capital, LLC v Cal-Western Reconveyance Corp. (2003) 108 CA4th 807, 814, 134 CR2d 162.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.40 E. Contracts Contrary to Public Policy (CC §§1667(2), 1668, 1669.7)*

§3.40 E. Contracts Contrary to Public Policy (CC §§1667(2), 1668, 1669.7)

A contractual provision that violates public policy is unlawful under CC §1667(2) and may be declared void. Farmers Ins. Exch. v Hurley (1999) 76 CA4th 797, 90 CR2d 697. California courts have found many different types of contractual provisions unenforceable as against public policy. In addition, certain Civil Code provisions declare that certain types of contracts violate public policy. For example, CC §1668 renders certain exculpatory clauses unenforceable. It provides:

> *All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law.*

See §5.92 for further discussion of CC §1668. Moreover, CC §1669.7 provides that any contract for the payment of money or other consideration in violation of Pen C §132.5 (which prohibits potential witnesses in criminal cases from accepting any payment or other consideration for their testimony) is void as contrary to public policy.

NOTE: *California courts distinguish indemnity agreements, which are generally enforceable, from contracts subject to CC §1668, which purport to exempt a party from liability for his or her own wrongful conduct. See Safeco Ins. Co. v Robert S. (2001) 26 C4th 758, 767, 110 CR2d 844; Lemat Corp. v American Basketball Ass'n (1975) 51 CA3d 267, 279, 124 CR 388. The distinction is based on public policy considerations. "An exemption may deprive a victim of compensation for injuries but an agreement to indemnify a person who may be responsible for a loss is additional assurance that the loss will be compensated." 51 CA3d at 278. Indemnity agreements are discussed in §§6.50-6.58.*

Agreements that California courts have ruled violative of public policy include:

- *A waiver of liability for "any negligent act" in an application for a city-run summer camp (Santa Barbara v Superior Court (2007) 41 C4th 747, 62 CR3d 527; see §5.95);*
- *A class action waiver in a consumer contract of adhesion (Discover Bank v Superior Court (2005) 36 C4th 148, 30 CR3d 76; see §5.78);*
- *A waiver of majority shareholders' and corporate directors' fiduciary duties (Neubauer v Goldfarb (2003) 108 CA4th 47, 133 CR2d 218);*
- *An exculpatory agreement purporting to release a medical center from liability for the negligence of its physician employees (Tunkl v Regents of Univ. of Cal. (1963) 60 C2d 92, 32 CR 33);*
- *Gambling contracts or transactions (Kelly v First Astri Corp. (1999) 72 CA4th 462, 84 CR2d 810; Metropolitan Creditors Serv. v Sadri (1993) 15 CA4th 1821, 19 CR2d 646);*
- *A sperm bank agreement that prohibited disclosure of donor's identity and related information under all circumstances (Johnson v Superior Court (2000) 80 CA4th 1050, 95 CR2d 864);*
- *A hold-harmless agreement purporting to exculpate a stock brokerage firm from liability for its own misrepresentations (Blankenheim v E. F. Hutton & Co. (1990) 217 CA3d 1463, 266 CR 593); and*
- *An exculpatory clause in an aircraft purchase contract, to the extent it purported to cover liability for negligent misrepresentation (Continental Airlines, Inc. v McDonnell Douglas Corp. (1989) 216 CA3d 388, 264 CR 779).*

Conversely, other types of agreements alleged to be contrary to public policy have been ruled not so and therefore enforceable, including:

- *Mandatory forum selection clauses (Schlessinger v Holland America, N.V. (2004) 120 CA4th 552, 16 CR3d 5; Net2Phone, Inc. v Superior Court (2003) 109 CA4th 583, 135 CR2d 149; Intershop Communications, AG v Superior Court (2002) 104 CA4th 191, 127 CR2d 847);*
- *A release agreement concerning skydiving activities (Paralift, Inc. v Superior Court (1993) 23 CA4th 748, 29 CR2d 177);*
- *A release and waiver of liability for future ordinary negligence in favor of a recreational facility (Benedek v PLC*

Santa Monica, LLC (2002) 104 CA4th 1351, 129 CR2d 197; YMCA of Metropolitan Los Angeles v Superior Court (1997) 55 CA4th 22, 63 CR2d 612);

- *A hold-harmless agreement with a title company (Rooz v Kimmel (1997) 55 CA4th 573, 64 CR2d 177); and*
- *A contract of indemnity (Safeco Ins. Co. v Robert S. (2001) 26 C4th 758, 110 CR2d 844).*

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.41 F. Contracts Concerning Marriage, Morals (CC §§1667(3), 1669, 1669.5)*

§3.41 F. Contracts Concerning Marriage, Morals (CC §§1667(3), 1669, 1669.5)

Certain contracts relating to marriage or morality may be unlawful. Civil Code §1667(3) defines unlawfulness to include that which is "contrary to good morals." Contracts that are illegal as contrary to good morals have been referred to as "malum in se" contracts. See McIntosh v Mills (2004) 121 CA4th 333, 344 n10, 17 CR3d 66. This category of unlawful contracts includes agreements for prostitution or (as such agreements are sometimes referred to by the courts) agreements for "meretricious" sexual services. See Della Zoppa v Della Zoppa (2001) 86 CA4th 1144, 103 CR2d 901; Taylor v Fields (1986) 178 CA3d 653, 224 CR 186.

NOTE: *Contracts between unmarried persons are unenforceable only to the extent that they are expressly based on the consideration of meretricious sexual services. In the landmark case of Marvin v Marvin (1976) 18 C3d 660, 670, 134 CR 815, the California Supreme Court held that a contract between unmarried persons who are living together in a sexual relationship is valid and enforceable to the extent that it relates to the parties' earnings, property, or expenses. It is invalid only to the extent that sexual acts are part of the consideration, and any severable part of the contract that is supported by independent consideration will be enforced. 18 C3d at 670, 672. See also Della Zoppa v Della Zoppa, supra; Whorton v Dillingham (1988) 202 CA3d 447, 248 CR 405. Cohabitation is a prerequisite to the Marvin holding, however. Recovery by an unmarried partner requires proof of "a stable and significant relationship arising out of cohabitation." Bergen v Wood (1993) 14 CA4th 854, 857, 18 CR2d 75.*

Contracts for child prostitution are addressed in a special statute, CC §1669.5, which provides (CC §1669.5(a)):

> *Any contract for the payment of money or other consideration to a minor who has been alleged to be the victim of an unlawful sex act, or to his or her legal representative, by the alleged perpetrator of that unlawful sex act, or his or her legal representative, entered into on or after the time of the unlawful sex act, and providing for any payments to be made more than one year after the date of execution of the contract, is void as contrary to public policy.*

The statute excepts child support and payments made from an irrevocable trust for the benefit of the minor. See CC §1669.5(c)-(d).

Contracts that are unlawful because they violate "good morals" historically have included gambling agreements. See Tokar v Redman (1956) 138 CA2d 350, 291 P2d 987. This principle remains in force for contracts concerning illegal types of gambling, but undoubtedly no longer applies to contracts relating to gaming activities that are now legal in California. See Kelly v First Astri Corp. (1999) 72 CA4th 462, 84 CR2d 810; Metropolitan Creditors Serv. v Sadri (1993) 15 CA4th 1821, 19 CR2d 646.

Civil Code §1669 provides that "[e]very contract in restraint of the marriage of any person, other than a minor, is void." For example, in Heaps v Toy (1942) 54 CA2d 178, 128 P2d 813, the court invalidated a contract between a married man and a divorced woman in which the woman agreed to act as the man's companion. The contract included a condition that the woman refrain from marrying anyone else. The court found that this condition was the primary basis for the agreement, and tainted the entire contract.

Some contracts concerning marital relations have been found to violate public policy. See generally §3.40. In Marriage of Merhren & Dargan (2004) 118 CA4th 1167, 13 CR3d 522, the court refused to enforce a marital settlement agreement under which the husband's conduct (a requirement that he refrain from using illegal drugs) affected the division of community property. The agreement violated the no-fault divorce provisions of Fam C §2310, and had an illegal objective under CC §1667. In Marriage of Fell (1997) 55 CA4th 1058, 64 CR2d 522, the court set aside a marital settlement agreement that contained an impermissible waiver of the final declaration of disclosure of assets and liabilities required by Fam C §2105.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/ IV. CONSIDERATION/§3.42 A. Generally (CC §1605)*

IV. CONSIDERATION

§3.42 A. Generally (CC §1605)

The fourth and final essential element to the existence of a contract under CC §1550 is a "a sufficient cause or consideration." See §3.1. "A promise is not enforceable unless consideration was given in exchange for the promise." US Ecology, Inc. v State (2001) 92 CA4th 113, 128, 111 CR2d 689. Civil Code §1605 defines good consideration as:

> *Any benefit conferred, or agreed to be conferred, upon the promisor, by any other person, to which the promisor is not lawfully entitled, or any prejudice suffered, or agreed to be suffered, by such person, other than such as he is at the time of consent lawfully bound to suffer, as an inducement to the promisor, is a good consideration for a promise. (Emphasis added.)*

See also Jara v Suprema Meats, Inc. (2004) 121 CA4th 1238, 1248, 18 CR3d 187; Conservatorship of O'Connor (1996) 48 CA4th 1076, 1102, 56 CR2d 386. The emphasized language is crucial to understanding the requirement that the promise must be bargained for. It is not enough for two parties to an agreement to confer benefits on each other or to each suffer their own detriment; the cross-promises and performances must be bargained-for inducements for one another. See Saks v Charity Mission Baptist Church (2001) 90 CA4th 1116, 1135, 110 CR2d 45. As the court in Saks explained (90 CA4th at 1135, citations omitted, emphasis in original):

> *The consideration for a promise must be an act or a return promise, bargained for and given in exchange for the promise…. In the words of section 75 of the Restatement of Contracts (com. b): "Consideration must actually be bargained for as the exchange for the promise… The existence or non-existence of a bargain where something has been parted with by the promisee or received by the promisor depends upon the manifested intention of the parties.… The fact that the promisee relies on the promise to his injury, or the promisor gains some advantage therefrom, does not establish consideration without the element of bargain or agreed exchange."*

It is not necessary that there be a corresponding separate promise by the other party for each promise made by the first party. One bargained-for promise may constitute consideration for several counter-promises. Alternatively, as is quite common, several promises on one side taken together may support a group of promises on the other side of the bargain. Martin v World Sav. & Loan Ass'n (2001) 92 CA4th 803, 809, 112 CR2d 225. Moreover, under CC §1605, it is not necessary for there to coexist both a benefit to the promisor and a detriment to the promisee. It is sufficient if the promisee suffers prejudice or agrees to do so. Beatrice Co. v State Bd. of Equalization (1993) 6 C4th 767, 783, 25 CR2d 438. Finally, the existence of the bargain can be implied from the circumstances; no formal request for a return promise is necessary. See DiGiacinto v Ameriko-Omserv Corp. (1997) 59 CA4th 629, 635, 69 CR2d 300 (finding employee accepted new compensation arrangement by continuing to work for employer).

Under CC §1614, a written instrument is sufficient to create a rebuttable presumption that consideration has been given. See also Altschul v Sayble (1978) 83 CA3d 153, 164, 147 CR 716 (recital that consideration has been received is admission and prima facie evidence of consideration). Not all written documents qualify for this presumption, however. The presumption does not apply to letters, but only to more formal legal documents. Michaelian v State Compensation Ins. Fund (1996) 50 CA4th 1093, 1112, 58 CR2d 133. Further, there is no presumption of consideration for oral agreements. See Murphy v T. Rowe Price Prime Reserve Fund, Inc. (9th Cir 1993) 8 F3d 1420. The burden of proof that consideration is insufficient or absent is on the person seeking to avoid the contract. CC §1615; Saks v Charity Mission Baptist Church (2001) 90 CA4th 1116, 1133, 110 CR2d 45.

The absence or failure of consideration is grounds for avoiding or rescinding a contract; it is a defense to an action for breach of a bilateral contract. Until the contract is rescinded or terminated, however, the contract remains in effect. Taliaferro v Davis (1963) 216 CA2d 398, 31 CR 164; Hofland v Gustafson (1955) 132 CA2d Supp 907, 282 P2d 1039. "Failure of consideration" generally means that the performance for which one party bargained has not been rendered, and it results from a fact or contingency that occurs after the contract is made. Taliaferro v Davis, supra; Boswell v Reid (1962) 199 CA2d 705, 19 CR 29. A delay in performance is not regarded as a failure of consideration unless the contract specifies that "time is of the essence." City of Larkspur v Marin County Flood Control & Water Conserv. Dist.

(1985) 168 CA3d 947, 214 CR 689.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.43 B. Adequacy, Sufficiency*

§3.43 B. Adequacy, Sufficiency

As a general rule, California courts do not concern themselves with the adequacy of consideration. Asmus v Pacific Bell (2000) 23 C4th 1, 15, 96 CR2d 179; Schumm v Berg (1951) 37 C2d 174, 231 P2d 39. Consideration does not necessarily need to be adequate for a contract to be enforceable. Altschul v Sayble (1978) 83 CA3d 153, 164, 147 CR 716; Bank of Cal. v Connolly (1973) 36 CA3d 350, 370 n7, 111 CR 468. "[U]nless the consideration given was so one-sided as to create an issue of unconscionability, the courts are not in a position to decide whether legal consideration agreed to by the parties is or is not fair." Third Story Music, Inc. v Waits (1995) 41 CA4th 798, 808, 48 CR2d 747.

As used in CC §1605, the term "good consideration" is equivalent to "valuable consideration" and does not refer to adequate consideration in the sense of monetary value. Bank of Cal., 36 CA3d at 370. See also Horton v Kyburz (1959) 53 C2d 59, 65, 346 P2d 399. Once it has been established that there is good consideration, the courts will normally not consider its sufficiency. Altschul, 83 CA3d at 164; Walters v Calderon (1972) 25 CA3d 863, 876, 102 CR 89. Good consideration must have some, at least de minimis, value, however. A. J. Indus., Inc. v Ver Halen (1977) 75 CA3d 751, 761, 142 CR 383; Walters, 25 CA3d at 876. But "some value means any value whatsoever, even that of a peppercorn, a tomtit, or one dollar in hand." 25 CA3d at 876 (emphasis in original). See also Estate of Freeman (1965) 238 CA2d 486, 488, 48 CR 1. This de minimis value is tested as of the time the contract is made, and not in light of subsequent events. A. J. Indus., Inc., 75 CA3d at 761; Crail v Blakely (1973) 8 C3d 744, 753, 106 CR 187. In bilateral contracts, one party's promise may serve as consideration for a promise by the other party, and any valid promise is sufficient consideration for the other party's promise. Mercer v Lemmens (1964) 230 CA2d 167, 40 CR 803. See Bleecher v Conte (1981) 29 C3d 345, 213 CR 852.

NOTE: *The concept of adequate consideration remains important in some circumstances. Under CC §3391(1), the remedy of specific performance is not available unless the party against whom enforcement is sought has received "adequate consideration." See §11.31 for discussion of adequacy of consideration in the context of specific performance. Further, courts are required to consider the relative value of consideration in a transaction alleged to be voidable under the fraudulent transfer laws. See CC §3439.04.*

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.44 C. Forbearance (CC §1606)*

§3.44 C. Forbearance (CC §1606)

Forbearance from suit on a claim, or any other relinquishment or surrender of a legal right, may be sufficient consideration to support a promise. "Forbearance—the decision not to exercise a right or power—is sufficient consideration to support a contract." Small v Fritz Cos. (2003) 30 C4th 167, 174, 132 CR2d 490. See also Michaelian v State Compensation Ins. Fund (1996) 50 CA4th 1093, 1112, 58 CR2d 133. The concept of forbearance as good consideration is reflected in CC §1606 as follows: "[P]rejudice suffered by the promisee, is also a good consideration for a promise, to an extent corresponding with the extent of the obligation, but no further or otherwise." Forbearance may not be sufficient consideration, however, if the claim is wholly invalid or worthless. Michaelian v State Compensation Ins. Fund, supra; Doria v International Union, Allied Indus. Workers of Am., AFL-CIO (1961) 196 CA2d 22, 38, 16 CR 429. But see Walters v Calderon (1972) 25 CA3d 863, 873, 102 CR 89 (forbearance of claimed right is good consideration, regardless of whether claimed right was actually effective); Healy v Brewster (1967) 251 CA2d 541, 59 CR 752 (forbearance may be sufficient consideration even if claim is wholly unfounded).

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§3.45 D. Preexisting Duty Rule (CC §1606)

As a general rule, a promise to perform a preexisting legal duty is not good consideration to support a binding contract. O'Byrne v Santa Monica-UCLA Med. Ctr. (2001) 94 CA4th 797, 808, 114 CR2d 575; US Ecology, Inc. v State (2001) 92 CA4th 113, 129, 111 CR2d 689 (memorandum of understanding lacked consideration; it added nothing to plaintiff's statutory duties as prospective licensee of State of California, and was not contract); Mission Oaks Ranch, Ltd. v County of Santa Barbara (1998) 65 CA4th 713, 77 CR2d 1, disapproved on other grounds in Briggs v Eden Council for Hope & Opportunity (1999) 19 C4th 1106, 1123 n10, 81 CR2d 471 (statutory obligation of county to prepare environmental impact report could not constitute consideration for contract). As the court in Auerbach v Great W. Bank (1999) 74 CA4th 1172, 1185, 88 CR2d 718, explained:

> *Generally speaking, a commitment to perform a preexisting contractual obligation has no value. In contractual parlance,… doing or promising to do something one is already legally bound to do cannot constitute the consideration needed to support a binding contract.*

The preexisting duty rule is codified in CC §1606 as follows: "An existing legal obligation resting upon the promisor… is also a good consideration for a promise, to an extent corresponding with the extent of the obligation, but no further or otherwise." The last clause of CC §1606, "to an extent corresponding with the extent of the obligation, but no further or otherwise," reflects that the preexisting duty rule is often at issue in cases involving modifications to existing contracts. In such cases, the courts do not require that each and every part of the bargained-for consideration for the modification be of a kind that would constitute consideration for a return promise. It is sufficient if some part of what is bargained for and given is not a preexisting legal obligation. As the court in House v Lala (1963) 214 CA2d 238, 243, 29 CR 450, stated:

> *It makes no difference that the agreed consideration consists almost wholly of a performance that is already required and that this performance is the main object of the promisor's desire. It is enough that some small additional performance is bargained for and given.*

See also Raedeke v Gibraltar Sav. & Loan Ass'n (1974) 10 C3d 665, 674 n3, 111 CR 693.

The Uniform Commercial Code has abolished the preexisting duty rule for modifications to contracts for the sale of goods, whether or not between merchants (see Com C §2209(1)), and for modifications to personal property equipment leases (see Com C §10208(a)). Any such modifications, however, are subject to the overriding requirement of good faith. A party is not free to extort additional consideration by refusing to perform its original obligation. See Com C §1304 (former Com C §1203); Official Comment 2 to UCC §2-209; Cal Comment 3 to Com C §2209.

The preexisting duty rule is implicated in debt restructuring or loan modification agreements under which a creditor agrees to accept less than 100 percent of what it is owed in full satisfaction of the original debt. A debtor would have little incentive to enter into such an agreement unless the discount is enforceable. Civil Code §§1521-1526 validate the practice of accord and satisfaction, even if the accord merely decreases the duty of only one party to the original agreement. For further discussion of the doctrine of accord and satisfaction, see §§8.42-8.45.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.46 E. Moral Obligations, Love and Affection (CC §1606)*

§3.46 E. Moral Obligations, Love and Affection (CC §1606)

Civil Code §1606 provides in part that "a moral obligation originating in some benefit conferred upon the promisor, or prejudice suffered by the promisee, is also a good consideration for a promise, to an extent corresponding with the extent of the obligation, but no further or otherwise." Therefore, to a limited extent, moral obligations may serve as consideration to support a valid contract. In general, a moral obligation constitutes sufficient consideration only when it is derived from a prior valid and enforceable legal obligation. Wilson v Wilson (1960) 54 C2d 264, 272, 5 CR 317; General Credit Corp. v Pichel (1975) 44 CA3d 844, 118 CR 913; Leonard v Gallagher (1965) 235 CA2d 362, 45 CR 211. Examples of contracts supported by moral consideration include a new promise to pay a debt that has been discharged in bankruptcy (Forman v Scott (1964) 231 CA2d 340, 41 CR 805) or a new note given to evidence a debt that is otherwise unenforceable under the statute of frauds (Fellom v Adams (1969) 274 CA2d 855, 79 CR 633) or the statute of limitations.

NOTE: *An agreement to repay a debt discharged in bankruptcy proceedings (known as a reaffirmation agreement) is also subject to Bankruptcy Code §524(c) (11 USC §524(c)), which outlines specific requirements that reaffirmation agreements must meet in order to be enforceable against the debtor.*

As a general rule, love and affection, without more, do not constitute valuable consideration necessary to support an enforceable contract. Walters v Calderon (1972) 25 CA3d 863, 873, 102 CR 89. Courts have noted love and affection, however, as an element in weighing the enforceability of contracts, particularly in intra-family settings. For example, in De Mille v Ramsey (1989) 207 CA3d 116, 120, 254 CR 573, the court upheld an agreement between two sisters to divide their mother's estate equally irrespective of the terms of their mother's will, which was made in consideration of "our mutual love and affection and desire to avoid litigation over the estate." In Henderson v Fisher (1965) 236 CA2d 468, 474, 46 CR 173, the court held that, in determining the adequacy of consideration for purposes of specific performance of a contract to transfer property under CC §3391(1), a court may consider factors such as the relationship of the parties, their friendship, love, affection, and regard for each other, in addition to the value of the property to be conveyed. In Ayoob v Ayoob (1946) 74 CA2d 236, 247, 168 P2d 462, the court ruled that a promise to marry was an adequate and valuable consideration for a subsequent transfer of property by the promisee.

Love and affection, as a potential element of consideration, should be distinguished from sexual services. Contracts in consideration of sexual services are unlawful as contracts for prostitution. Love and affection should also be distinguished from the performance, or promise to perform, services such as housekeeping or care giving, which are good consideration. See generally Whorton v Dillingham (1988) 202 CA3d 447, 248 CR 405; §3.41.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.47 F. Past Consideration*

§3.47 F. Past Consideration

In general, past consideration is not sufficient consideration to support a contract. Past consideration will not support a promise to the extent it exceeds an existing duty of the promisor. Passante v McWillliams (1997) 53 CA4th 1240, 1247, 62 CR2d 298; Leonard v Gallagher (1965) 235 CA2d 362, 373, 45 CR 211. The key factor is that consideration must be given in exchange for the promise. It must be bargained for at the time. See §3.42. Thus, if services have been rendered with an expectation of future payment, there is sufficient consideration for a contract. Passante, 53 CA4th at 1247.

In Passante, a company's corporate attorney arranged financing for the company. Later, the directors agreed to give him 3 percent of the company's stock, but then reneged on their promise. The attorney sued the company and two directors for breach of contract. The court found that the promise was merely a promise to make a gift and was not enforceable. The stock was not bargained for in exchange for arranging the loan. The attorney had already arranged the loan before the idea of giving him stock ever came up. Because there was no expectation of payment by either party when the loan was arranged, the promise to give the attorney stock was not bargained for and was therefore not enforceable.

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§3.48 G. Mutuality of Obligation, Illusory Promises

In bilateral contracts as distinct from unilateral contracts (see §§3.49-3.51), one or more promises may be given by one party in consideration of the promise or promises given by the other. Bleecher v Conte (1981) 29 C3d 345, 350, 213 CR 852. "A bilateral contract consists of mutual promises, made in exchange for each other by each of the two contracting parties." Sully-Miller Contracting Co. v Gledson/Cashman Constr., Inc. (2002) 103 CA4th 30, 36, 126 CR2d 400. For a promise to be deemed consideration, however, it must be legally binding. If a party making a promise does not assume a legal obligation, the agreement will not be valid and binding as a bilateral contract. "[W]here promises are exchanged as the consideration, the promises must be mutual in obligation. In other words, for the contract to bind either party, both must have assumed some legal obligations. Without this mutuality of obligation, the agreement lacks consideration and no enforceable contract has been created." Bleecher, 29 C3d at 350, citing Mattei v Hopper (1958) 51 C2d 119, 122, 330 P2d 625. See also Sully-Miller Contracting Co. v Gledson/Cashman Constr., supra; Money Store Inv. Corp. v Southern Cal. Bank (2002) 98 CA4th 722, 728, 120 CR2d 58.

If one party is under no real obligation to perform, that party's promise is considered illusory. The contract lacks mutuality of obligation and is not enforceable. Money Store Inv. Corp. v Southern Cal. Bank, supra; Scottsdale Ins. Co. v Essex Ins. Co. (2002) 98 CA4th 86, 94, 119 CR2d 62. Examples of illusory promises include: a promise to render performance entirely at the option of the promisor, a promise conditional on an event that the parties know cannot occur, a promise conditional on an event wholly within the promisor's control, or a reservation of an unqualified right to modify or terminate a contractual obligation. See Asmus v Pacific Bell (2000) 23 C4th 1, 15, 96 CR2d 179; Money Store Inv. Corp. v Southern Cal. Bank, supra. If the promisor's discretion is not unfettered, however, e.g., if it is subject to limitations such as fairness or reasonable notice, then the promise is not illusory and the contract is enforceable. Asmus v Pacific Bell, supra. The fact that a contract allows one party to establish or change the price charged for goods or services does not render the contract illusory, provided that the contract includes reciprocal promises. The party with discretion must exercise it in accordance with the standard of good faith and fair dealing. Perdue v Crocker Nat'l Bank (1985) 38 C3d 913, 923, 216 CR 345; Storek & Storek, Inc. v Citicorp Real Estate, Inc. (2002) 100 CA4th 44, 122 CR2d 267. See also CC §§1610-1611. Courts will look to the substance and terms of the contract itself in determining whether there is mutuality. Roman v Superior Court (2009) 172 CA4th 1462, 92 CR3d 153 (arbitration clause beginning "I agree" did not render employment contract illusory because arbitration clause expressly covered all disputes, creating mutual agreement to arbitrate). Moreover, a contract that is otherwise illusory may be enforceable if the promisor renders at least part performance. Money Store Inv. Corp. v Southern Cal. Bank, supra.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.49 H. Unlawful Consideration (CC §1607)*

§3.49 H. Unlawful Consideration (CC §1607)

Civil Code §1607 provides that the consideration for a contract must be lawful within the meaning of CC §1667. For discussion of CC §1667, see §3.36. Civil Code §1608 provides: "If any part of a single consideration for one or more objects, or of several considerations for a single object, is unlawful, the entire contract is void." See also Yoo v Jho (2007) 147 CA4th 1249, 55 CR3d 243; McIntosh v Mills (2004) 121 CA4th 333, 17 CR3d 66. Thus, not only must the object of a contract be lawful, but the consideration itself must be lawful also. An example of unlawful consideration is a promise to refrain from wrongful conduct directed at the promisee or a third party. See, e.g., Kallen v Delug (1984) 157 CA3d 940, 203 CR 879 (attorney's promise to refrain from continued violation of his ethical duty to execute substitution of attorney form and turn over client files did not constitute lawful consideration); Grasko v Los Angeles City Bd. of Educ. (1973) 31 CA3d 290, 107 CR 334 (teachers' agreement to end illegal strike was not lawful consideration for board's agreement concerning teachers' employment).

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I. Unilateral Contracts

§3.50 1. Generally

The concept of a "unilateral contract" was eliminated in the Restatement (Second) of Contracts (1981). The drafters believed that the distinction made historically between bilateral and unilateral contracts retained current value only in the context of option contracts (see §4.14), by emphasizing that a promise may be binding only on the promisor even though the promisee is not bound by any promise. Restatement (Second) of Contracts §1, Comment f (1981). Nevertheless, the distinction survives in California case law, and its use has been growing in recent years, particularly in employment cases. See, e.g., Asmus v Pacific Bell (2000) 23 C4th 1, 10 n4, 96 CR2d 179. See §3.50.

California courts define unilateral contracts as contracts in which performance is exchanged for a promise. Vu v California Commerce Club, Inc. (1997) 58 CA4th 229, 233, 68 CR2d 31. Only one party makes a promise, and the consideration for the promise is an act or forbearance by the other party, rather than another promise. "In a unilateral contract, there is only one promisor, who is under an enforceable legal duty.… The promise is given in consideration of the promisee's act or forbearance." Asmus, 23 C4th at 10. In unilateral contracts, there is no mutuality of obligation, because there is a promise on only one side of the contract. See Asmus, 23 C4th at 14. Moreover, except for situations involving illegality (see §§3.36-3.41) or a preexisting duty (see §3.45), almost any bargained-for act or forbearance by the promisee will constitute adequate consideration for a unilateral contract. Asmus, 23 C4th at 10; Harris v Time, Inc. (1987) 191 CA3d 449, 456, 237 CR 584. "Courts will not require equivalence in the values exchanged or otherwise question the adequacy of the consideration.… If a performance is bargained for, there is no further requirement of benefit to the promisor or detriment to the promisee." 191 CA3d at 456.

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§3.51 2. Employment Policies; Personnel Manuals

A number of California cases have held that, depending on the facts and circumstances, employment policies or personnel manuals may create unilateral contracts that are accepted when employees continue their employment. See, e.g., Asmus v Pacific Bell (2000) 23 C4th 1, 10 n4, 96 CR2d 179; Scott v PG&E (1995) 11 C4th 454, 46 CR2d 427; DiGiacinto v Ameriko-Omserv Corp. (1997) 59 CA4th 629, 69 CR2d 300. For example, in Scott v PG&E, the plaintiff-employees had been demoted from senior management positions, resulting in salary and benefit reductions and loss of supervisory authority. The plaintiffs alleged that the defendant-employer breached an implied-in-fact contract not to demote its employees without good cause. The California Supreme Court held that there was ample evidence of such an implied-in-fact contract, based on the employer's personnel policy manual as well as testimony of one of its human resources managers. 11 C4th at 465.

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.52 3. Options*

§3.52 3. Options

Options represent the other context in which unilateral contracts typically arise. An option is a unilateral contract in which the optionor or promisor gives the power and right to the optionee, during the term of the option, to create a purchase contract, in exchange for consideration given by the optionee. City of Turlock v Paul M. Zagaris, Inc. (1989) 209 CA3d 189, 194, 256 CR 902. "An option, as a matter of legal theory, is considered to have a dual nature: on the one hand it is an irrevocable offer, which upon acceptance ripens into a bilateral contract, and on the other hand, it is a unilateral contract which binds the optionor to perform an underlying agreement upon the optionee's performance of a condition precedent." Marriage of Joaquin (1987) 193 CA3d 1529, 1532, 239 CR 175. In a typical option contract, a property owner invests another party with an exclusive right to purchase the property at a specified price within a certain period of time. Having paid for the option, the party holding the option is under no obligation to exercise it and remains free to let it lapse at the end of the option term. If the property owner has received consideration for the option, the property owner cannot terminate or revoke it during the option term without the optionee's consent. See Allen v Smith (2002) 94 CA4th 1270, 1279, 114 CR2d 898. Real estate options are discussed at length in California Real Property Sales Transactions, chap 8 (4th ed Cal CEB 2007). See also §4.14.

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§3.53 J. Promissory Estoppel

Promissory estoppel is a doctrine under which one party's promise and the other party's detrimental reliance on that promise operate as a substitute for consideration. See Platt Pac., Inc. v Andelson (1993) 6 C4th 307, 320, 24 CR2d 597; US Ecology, Inc. v State (2005) 129 CA4th 887, 903, 28 CR3d 894; CalFarm Ins. Co. v Krusiewicz (2005) 131 CA4th 273, 286, 31 CR3d 619. The doctrine "employs equitable principles to satisfy the requirement that consideration must be given in exchange for the promise sought to be enforced." Kajima/Ray Wilson v Los Angeles County Metro. Transp. Auth. (2000) 23 C4th 305, 310, 96 CR2d 747. California courts have adopted the formulation of the doctrine in the Restatement (Second) of Contracts §90(1) (1981), as follows:

> *A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.*

See Kajima/Ray Wilson, 23 C4th at 310; C & K Eng'g Contractors v Amber Steel Co. (1978) 23 C3d 1, 6, 151 CR 323. Under the doctrine of promissory estoppel, a promisor will be bound if he or she should reasonably expect the promisee to change substantially his or her position (either by act or forbearance) in reliance on the promise and if injustice can be avoided only by enforcement of the promise. Raedeke v Gibraltar Sav. & Loan Ass'n (1974) 10 C3d 665, 672 n1, 111 CR 693. The courts have identified four elements of the doctrine, as follows (see Toscano v Greene Music (2004) 124 CA4th 685, 692, 21 CR3d 732; Laks v Coast Fed. Sav. & Loan Ass'n (1976) 60 CA3d 885, 890, 131 CR 836):

- *A clear and unambiguous promise;*
- *Reasonable reliance by the promisee;*
- *The promisee's reliance is foreseeable by the promisor; and*
- *Substantial detriment or injury suffered by the promisee from his or her reliance.*

It is well established that the promise must be clear and unambiguous in its terms. If no clear promise is made, the doctrine is not applicable. Lange v TIG Ins. Co. (1998) 68 CA4th 1179, 1185, 81 CR2d 39.

The doctrine of promissory estoppel has often been applied by California courts to enforce a subcontractor's bid on which a general contractor has reasonably relied. See, e.g., C & K Eng'g Contractors, 23 C3d at 6; Diede Constr., Inc. v Monterey Mechanical Co. (2004) 125 CA4th 380, 22 CR3d 763. It has been applied to enable a plaintiff who left his job in reliance on an unfulfilled job offer from a third party to recover lost wages from the third party defendant, measured by what the plaintiff would have earned at his former employer but for the defendant's promise. See Toscano, 124 CA4th at 692. The doctrine is also applicable to contract modifications. See Platt Pac., Inc. v Andelson (1993) 6 C4th 307, 320, 24 CR2d 597.

In California, the doctrine may apply to claims against governmental entities, particularly if application of the doctrine would further public policy and prevent injustice. It cannot be invoked against the government, however, if it would operate "to defeat the effective operation of a policy adopted to protect the public." US Ecology, Inc. v State (2001) 92 CA4th 113, 135, 111 CR2d 689 (plaintiff's promissory estoppel claim for development costs under contract with State of California to develop and operate radioactive waste storage site survived demurrer). See also Kajima/Ray Wilson v Los Angeles County Metro. Transp. Auth. (2000) 23 C4th 305, 310, 96 CR2d 747 (under promissory estoppel theory, plaintiff allowed to recover bid preparation costs, but denied lost profits).

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Source: *Business Law/California Law of Contracts/3 Contract Formation: Consent, Legality, Consideration/§3.54 K. Consideration in Commercial Code Contracts (Com C §1204)*

§3.54 K. Consideration in Commercial Code Contracts (Com C §1204)

Commercial Code §1204 (former Com C §1201(44)) defines "value" for purposes of application of other Commercial Code sections. It states as follows:

> *Except as otherwise provided in Divisions 3, 4, 5, and 6, a person gives value for rights if the person acquires them:*
>
> *(1) in return for a binding commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a chargeback is provided for in the event of difficulties in collection;*
>
> *(2) as security for, or in total or partial satisfaction of, a preexisting claim;*
>
> *(3) by accepting delivery under a preexisting contract for purchase; or*
>
> *(4) in return for any consideration sufficient to support a simple contract.*

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4

Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting

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I. OFFER

§4.1 A. Generally

The common law concept of an offer, as one of the legal prerequisites to the formation of a binding contract, is not addressed as such in the California Civil Code. In the Civil Code, the concepts of offer and acceptance are embodied in the requirement for mutual consent. See CC §§1550(2), 1565. (Consent as an element of a valid contract under California law is discussed in §§3.1-3.35.) "Mutual assent usually is manifested by an offer communicated to the offeree and an acceptance communicated to the offeror." *Donovan v RRL Corp.* (2001) 26 C4th 261, 270, 109 CR2d 807. See also *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1230, 13 CR3d 544; *Alexander v Codemasters Group Ltd.* (2002) 104 CA4th 129, 141, 127 CR2d 145; Restatement (Second) of Contracts §§17, 22 (1981). An offer is thus one aspect of mutual consent; it is the first step in the conduct of the parties that may lead to the formation of a contract.

If the parties have documented their agreement in writing, identification of the offer that started it all is usually of little practical importance. Identifying an offer may become important, however, in cases involving, *e.g.,* preliminary negotiations, advertisements, requests for proposals, letters of intent, term sheets, application forms, or auctions. These contexts are discussed in §§4.4-4.11 and 4.16-4.18

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§4.2 B. Definition of Offer

An offer is defined as "the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it." *Donovan v RRL Corp.* (2001) 26 C4th 261, 271, 109 CR2d 807; *City of Moorpark v Moorpark Unified Sch. Dist.* (1991) 54 C3d 921, 930, 1 CR2d 896; Restatement (Second) of Contracts §24 (1981). This definition, however, may be difficult to apply to a series of communications that begins with informal introductions and proceeds through general discussions to more specific negotiations. At some point, the law recognizes that an offer has been made, but this is a legal conclusion that may or may not be consistent with the intent of the party whose words or conduct have been identified as the offer. "The determination of whether a particular communication constitutes an operative offer, rather than an inoperative step in the preliminary negotiation of a contract, depends upon all the surrounding circumstances.... The objective manifestation of the party's assent ordinarily controls, and the pertinent inquiry is whether the individual to whom the communication was made had reason to believe that it was intended as an offer." *Donovan v RRL Corp.* (2001) 26 C4th 261, 271, 109 CR2d 807 (citations omitted). See also *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1230, 13 CR3d 544.

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§4.3 C. Requirement of Certainty

For acceptance of an offer to result in formation of a contract, the offer must be sufficiently definite, or else call for the acceptance to supply sufficiently definite terms, so that the promised performance is reasonably certain. See *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 209, 45 CR3d 692; *People ex rel Lockyer v Fremont Gen. Corp.* (2001) 89 CA4th 1260, 1268, 108 CR2d 127; *Weddington Prods., Inc. v Flick* (1998) 60 CA4th 793, 812, 71 CR2d 265. The requirement for certainty has been recognized as having two aspects: first, did the parties intend to contract, and second, is there a basis for an appropriate remedy for breach. *Alexander v Codemasters Group Ltd.* (2002) 104 CA4th 129, 141, 127 CR2d 145. Restatement (Second) of Contracts §33 (1981) provides, in part:

> (1) Even though a manifestation of intention is intended to be understood as an offer, it cannot be accepted so as to form a contract unless the terms of the contract are reasonably certain.
> (2) The terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy.

The basic principle is that a contractual promise must be definite enough to enable a court to determine the scope of the duty, and the limits of the duty must be definite enough to provide a rational basis for the court's assessment of damages. *Bustamante v Intuit, Inc., supra*; *Ladas v California State Auto. Ass'n* (1993) 19 CA4th 761, 770, 23 CR2d 810; *Robinson & Wilson, Inc. v Stone* (1973) 35 CA3d 396, 407, 110 CR 675. Use or nonuse of the word "offer" is not dispositive in the analysis. If an essential element is left for future agreement of both parties, the contract may be too indefinite for enforcement. *Weddington Prods., Inc. v Flick*, *supra*. The certainty requirement is discussed further in §5.17.

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D. Preliminary Negotiations Distinguished

§4.4 1. Generally

The Restatement (Second) of Contracts §26 (1981) distinguishes an offer from preliminary negotiations as follows:

> A manifestation of willingness to enter into a bargain is not an offer if the person to whom it is addressed knows or has reason to know that the person making it does not intend to conclude a bargain until he has made a further manifestation of assent.

See also *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 214, 45 CR3d 692; *Careau & Co. v Security Pac. Bus. Credit, Inc.* (1990) 222 CA3d 1371, 1389, 272 CR 387; *Beck v American Health Group Int'l, Inc.* (1989) 211 CA3d 1555, 1562, 260 CR 237. In general, contract negotiations are interactions where the parties intend to enter into a binding contract in the future, but only if there are further manifestations of assent. If one party has *reason to know* that the other party's proposal is not intended to be a formal offer, there is no offer even though the first party understood it to be an offer. "Reason to know" depends not only on the parties' words or other conduct during the negotiations, but also on the facts and circumstances generally, including the parties' prior communications, course of dealing, and usages of their line of business. Restatement (Second) of Contracts §26, Comment a (1981). See also *Donovan v RRL Corp.* (2001) 26 C4th 261, 271, 109 CR2d 807; Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations* (1987) 87 Colum L Rev 217 (Mar. 1987). For further discussion of preliminary negotiations, including agreements to agree and letters of intent, see §§4.16-4.17.

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§4.5 2. Advertisements

In many, perhaps most, cases, an advertisement or other public notice of goods or services for sale is not considered a formal offer to sell, but rather as an invitation to the reader (or listener) to make an offer or to negotiate with the advertiser. See *Donovan v RRL Corp.* (2001) 26 C4th 261, 271, 109 CR2d 807; Restatement (Second) of Contracts §26, Comment b (1981). An advertisement will be so interpreted even if it is quite detailed, with specific prices for specific quantities of goods or services and specific information concerning the place or method of delivery. See *Lonergan v Scolnick* (1954) 129 CA2d 179, 276 P2d 8 ("form letter" describing specific parcel of land at specified "rock bottom" price held not to be offer); Restatement (Second) of Contracts §26, Comment b (1981); Richard A. Lord, 1 Williston on Contracts §4:7 (4th ed 1990).

An advertisement may constitute an offer, however, depending on how it is phrased. *Lim v TV Corp. Int'l* (2002) 99 CA4th 684, 689, 121 CR2d 333. In particular, an advertisement may be found to be an offer if it leaves nothing for negotiation and invites performance of a specific act without further communication. *Donovan,* 26 C4th at 272; *Lefkowitz v Great Minneapolis Surplus Store, Inc.* (Minn 1957) 86 NW2d 689, 691; Restatement (Second) of Contracts §26, Comment b (1981). Advertisements for rewards present the clearest example, because all that is necessary to accept the offer of a reward and conclude a bargain with the advertiser is to perform the specified act, *e.g.,* return a lost article or pet or furnish specified information. *Donovan v RRL Corp.*, *supra*. Such advertisements are essentially offers to enter into a unilateral contract. *Harris v Time, Inc.* (1987) 191 CA3d 449, 455, 237 CR 584. See §§3.50-3.52 for further discussion of unilateral contracts. In *Harris,* the communication at issue was a bulk-mail envelope with text offering to give the recipient a free calculator watch if the recipient opened the envelope by a specified date. Once opened, however, the mailer stated another condition for receipt of the watch. The court found that the text of the defendant's mailer was technically an offer to enter into a unilateral contract, but that the trial court's judgment of dismissal of the plaintiff's claims was correct because the plaintiff's claims of damage were de minimis.

An advertisement may also be construed as an offer by operation of consumer protection statutes such as Veh C §11713.1(e), which generally makes it unlawful for automobile dealers to fail to sell a vehicle at (or below) its advertised price. In *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807, the defendant, an automobile dealer, advertised a 2-year-old Jaguar XJ6 for a price that was 32 percent less than its market value, as a result of typographical and proofreading errors by the newspaper that ran the ad. The plaintiff attempted to buy the car for cash at the advertised price, but the dealer refused to sell it, asserting that the advertised price was a mistake. The plaintiff then sued the dealer for breach of contract, negligence, and fraud. Vehicle Code §11713.1(e) provides that it is unlawful for an automobile dealer to "[f]ail to sell a vehicle to any person at the advertised total price… , while the vehicle remains unsold, unless the advertisement states the advertised total price is good only for a specified time and the time has elapsed." The California Supreme Court held that, in view of Veh C §11713.1(e), an advertisement by a licensed automobile dealer for the sale of vehicle at a specified price constitutes an offer that is accepted when a consumer tenders the advertised price. 26 C4th at 274. The court nonetheless allowed the dealer to rescind the contract on the grounds that the dealer had made a unilateral mistake of fact. See §3.33.

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§4.6 3. Application Forms

At issue in *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1230, 13 CR3d 544, was Schwab's application form for customers wishing to open brokerage accounts, titled "Open a Schwab Account Today." The form included on the reverse an account agreement with an arbitration clause and a request to transfer shares from another broker. The agreement stated that the account would be effective only after Schwab approved the application. The plaintiff completed the application and submitted it to Schwab. Schwab initially notified the plaintiff that it had opened an account for her, but the following day notified her that it was denying her request for an account because of her poor credit rating. Notwithstanding this, a Schwab broker proceeded to transfer shares owned by the plaintiff from Merrill Lynch into a new Schwab account. When the plaintiff learned of the share transfer, she demanded that the shares be returned to Merrill Lynch, but Schwab did not do so until a month later. On appeal, the court addressed the question of whether a contract between the plaintiff and Schwab had been formed, so that the arbitration clause on the reverse of the application form was enforceable. The signature page of the application began, "I hereby request that [Schwab] open a brokerage account as indicated above.… I agree to read and be bound by the terms of the applicable Account Agreement…." The court found that this language, particularly the words, "I hereby request," indicated that the plaintiff did not expect that completing the application form would conclude her bargain with Schwab. Instead, it reflected an expectation that the application form was a *request* for a contract. No contract was formed, and accordingly, the arbitration clause on the reverse side of the application form was unenforceable.

Interestingly, a different result might have occurred in the *Lopez* case had the application form been submitted to Schwab electronically. Civil Code §1633(a) validates brokerage contracts made through electronic transmission of an application form by a customer. It provides as follows:

> Notwithstanding any other provision of law, an application by a prospective customer to enter into a brokerage agreement with a broker-dealer, which application is transmitted electronically and is accompanied by the prospective customer's electronic signature or digital signature as described in subdivisions (d), (e), (f), and (g), shall be deemed, upon acceptance by the broker-dealer, to be a fully executed, valid, enforceable, and irrevocable written contract, unless grounds exist which would render any other contract invalid, unenforceable, or revocable.

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§4.7 4. Price Quotations

A price quotation is normally a statement of the price per unit of a certain amount of goods or services. The quote may omit other terms of sale such as quantity, time and place of delivery, or payment terms. Price quotations may appear on a price list or in a catalogue, but, like advertisements, price quotations are generally understood as invitations to make an offer rather than as formal offers, even if directed to a specific customer. The surrounding circumstances determine whether a price quotation is in fact an offer. Restatement (Second) of Contracts §26, Comment c (1981). If a price quotation is made in connection with a prospective sale of goods, the issue will be governed by Uniform Commercial Code rules. See Com C §§2204-2207, discussed in §§4.36-4.38. See also *Lockheed Elec. Co., Inc. v Keronix, Inc.* (1981) 114 CA3d 304, 170 CR 591.

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§4.8 5. Auctions

In the context of an auction sale, there may be an issue of whether the seller's action of placing goods or services for sale at auction to the highest bidder is an offer or merely an invitation to make an offer, like a general advertisement. See §4.5. In *Lim v TV Corp. Int'l* (2002) 99 CA4th 684, 121 CR2d 333, the court found that the plaintiff had sufficiently pleaded the existence of a contract by alleging that (1) the defendant made an offer by announcing the terms of an auction for registration rights to an Internet domain name on its website, and (2) the plaintiff accepted the offer by placing the highest bid in accordance with the auction terms. The court rejected the defendant's assertion that its website posting was only a solicitation for an offer. Similarly, in *Carver v Teitsworth* (1991) 1 CA4th 845, 2 CR2d 446, the court found that a real estate seller had manifested an intent to be bound by the highest bid submitted; therefore, his request for sealed bids constituted an offer.

The Restatement (Second) of Contracts §28(1) (1981) expresses the prevailing view, that unless a contrary intention appears (*e.g.,* in published auction rules), the act of placing goods for auction with a reserve is an invitation to receive offers from successive bidders, which the auctioneer is free to accept or reject. Moreover, the auctioneer is free to withdraw the goods until he or she announces that the sale is completed. If goods are to be auctioned without a reserve, however, the auctioneer makes an offer to sell to the highest bidder, which is accepted by the highest bidder, and the goods cannot be withdrawn unless there are no bids made within a reasonable time. This rule is consistent with Com C §2328(3) (regarding auction sales of personal property).

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6. Invitations to Bid; Requests for Proposals

§4.9 a. Generally

As a general rule, an invitation to bid or a request for proposals from one private party to another is merely a request for an offer and not an offer that creates a power of acceptance in the bidder, unless the terms of the invitation indicate an intent by the party making it to be bound by a qualifying bid. See *Carver v Teitsworth* (1991) 1 CA4th 845, 2 CR2d 446, 449; Restatement (Second) of Contracts §26, comment d (1981); California Construction Contracts, Defects, and Litigation §§2.8-2.10, 5.2, 5.18 (Cal CEB 2008).

Large construction and public works contracts are typically awarded on the basis of competitive bidding. Invitations to bid on construction projects normally include detailed instructions regarding procedures for bid submissions, bidder qualifications, project specifications, rejection of bids, bonding requirements, and other matters. The bidding process may give rise to disputes concerning offer and acceptance, and multilevel construction contracts involving a prime contractor and one or more subcontractors may raise questions concerning promissory estoppel and justifiable reliance on subcontractor bids. See, *e.g., Diede Constr., Inc. v Monterey Mechanical Co.* (2004) 125 CA4th 380, 22 CR3d 763. See §4.11. Moreover, there are significant differences between private contracts and government contracts. The bidding procedures for public works contracts are largely governed by statutes intended to assure fairness and integrity, enhance competition, and obtain an economical result for the public.

NOTE: Contracts let by state and local governmental units in California are subject to the Public Contract Code, state regulations (*e.g.,* 21 Cal Code Regs §§1520-1521.9), and, as applicable, county or municipal ordinances. Contracts let by the federal government are governed by Title 41 of the United States Code and the Federal Acquisition Regulations (FAR) in Title 48 of the Code of Federal Regulations.

Public contracts generally must be awarded to the lowest responsible bidder (see, *e.g.,* Pub Cont C §§10180, 20672), while private owners usually reserve the right to reject any and all bids and to waive irregularities in the bidding process. For extensive discussion of both private and public construction contracts (including forms) and construction contract litigation in California, see California Construction Contracts, Defects, and Litigation (Cal CEB 2008).

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§4.10 b. Acceptance of Bids

Even in the context of public works contracts, the competitive bidding process is subject to the general rules of contract law. Once made, a bid becomes an irrevocable offer or option given to the public agency involved. The contract is formed and becomes binding and enforceable on acceptance of a valid bid. *Transdyn/Cresci, JV v City & County of San Francisco* (1999) 72 CA4th 746, 754, 85 CR2d 512; *Menefee v County of Fresno* (1985) 163 CA3d 1175, 1178, 210 CR 99. See *City of Susanville v Lee C. Hess Co.* (1955) 45 C2d 684, 694, 290 P2d 520. "A basic rule of competitive bidding is that bids must conform to specifications, and that if a bid does not so conform, it may not be accepted." *Ghilotti Constr. Co. v City of Richmond* (1996) 45 CA4th 897, 904, 53 CR2d 389. In accepting a bid, however, a public contracting entity may waive "inconsequential deviations" from contract specifications in the bid, provided that the deviation does not give the bidder an unfair competitive advantage. 45 CA4th at 900.

Before awarding a public works contract to a party who is not the lowest bidder, the public agency must (1) notify the lowest bidder of any evidence received from third parties or based on an independent investigation that reflects adversely on the bidder's qualifications, (2) afford the bidder an opportunity to rebut the adverse evidence, and (3) allow the bidder to present evidence that it is qualified to perform the contract. The public agency need not, however, conduct a quasi-judicial proceeding before rejecting the lowest bidder as not sufficiently responsible. *City of Inglewood-Los Angeles County Civic Ctr. Auth. v Superior Court* (1972) 7 C3d 861, 871, 103 CR 689.

For further discussion of the competitive bidding process for both public and private construction projects, see California Construction Contracts, Defects, and Litigation (Cal CEB 2008).

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§4.11 c. Subcontractor Bids

When a general contractor submits a bid based on the bid of a subcontractor, but the subcontractor attempts to withdraw its bid before the general contractor's bid is accepted by the project owner, the question arises of whether the subcontractor is nonetheless bound by its bid as submitted. Typically, the subcontractor argues that there was no formal acceptance of its bid by the general contractor before the subcontractor withdrew its bid. The general contractor typically counters that, by using the subcontractor's bid as the basis for its own bid, the subcontractor's bid had been accepted, although on condition that the project owner award the prime contract to the general contractor. Alternatively, the general contractor argues that by using the subcontractor's bid as a basis for its own bid, it detrimentally relied on the subcontractor's bid and that this detrimental reliance is sufficient to support formation of a contract between the general and the subcontractor, again on condition that the general contractor is awarded the prime contract.

In California, the subcontractor will be bound by its bid under the doctrine of promissory estoppel, if it was reasonable for the subcontractor to expect that the general contractor would rely on its bid. See *Kajima/Ray Wilson v Los Angeles County Metro. Transp. Auth.* (2000) 23 C4th 305, 310, 96 CR2d 747; *Drennan v Star Paving Co.* (1958) 51 C2d 409, 415, 333 P2d 757; *Diede Constr., Inc. v Monterey Mechanical Co.* (2004) 125 CA4th 380, 22 CR3d 763. The subcontractor's bid is deemed to carry with it an implied subsidiary promise that the bid will be kept open for a reasonable period of time to enable the general contractor to proceed in bidding on the prime contract. *Southern Cal. Acoustics Co. v C.V. Holder, Inc.* (1969) 71 C2d 719, 723, 79 CR 319; *Diede Constr., Inc*., 125 CA4th at 385. The doctrine of promissory estoppel as expressed in the Restatement (Second) of Contracts §90(1) (1981) has been judicially adopted in California, as follows:

> A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.

See *Kajima/Ray Wilson v Los Angeles County Metro. Transp. Auth., supra*; *C & K Eng'g Contractors v Amber Steel Co.* (1978) 23 C3d 1, 6, 151 CR 323. It is an equitable doctrine that operates as a substitute for consideration. See generally §3.53. In the seminal California case of *Drennan v Star Paving Co.*, *supra,* a subcontractor withdrew its bid before the bid was formally accepted by the general contractor, but after the general contractor had used it in the master bid for the construction project and had been awarded the contract. The California Supreme Court held the subcontractor's bid enforceable under the theory of promissory estoppel because the general contractor had reasonably and detrimentally relied on it. The subcontractor should have reasonably expected that its bid would be used by the general contractor in formulating the main bid. 51 C2d at 413. In effect, the subcontractor's bid becomes irrevocable for a limited period of time as a result of the general contractor's reliance on it in submitting the prime bid. The general contractor is required to act promptly, however, and is not free to delay accepting the subcontractor's bid once the prime contract has been awarded. *Southern Cal. Acoustics Co. v C.V. Holder, Inc.* (1969) 71 C2d 719, 723, 79 CR 319; *Saliba-Kringlen Corp. v Allen Eng'g Co.* (1971) 15 CA3d 95, 106, 92 CR 799. In light of the *Drennan* requirement that the subcontractor should reasonably know that the general contractor will use the subcontractor's bid to prepare the master bid, evidence of trade or industry practice may be critical. See, *e.g., Saliba-Kringlen Corp.*, 15 CA3d at 109.

For further discussion of subcontractor issues in public and private construction contracts, including the Subletting and Subcontracting Fair Practices Act (Pub Cont C §§4100-4114), see California Construction Contracts, Defects, and Litigation (Cal CEB 2008).

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§4.12 d. Offers by Merchants Under Com C §2205(b)

Commercial Code §2205(b) makes an offer by a "merchant" to a licensed contractor irrevocable for a limited period of time, despite the absence of consideration, if the merchant has actual or imputed knowledge that the contractor will rely on it in submitting its bid for a construction project to a third party. The offer is irrevocable for a period of 10 days after the contract is awarded, but in any case not longer than 90 days after the date of the merchant's offer. (The statute provides that the merchant remains free to specify that its offer will be held open for a shorter period of time.) If the offer is made orally and is for a price that is $2500 or more, the contractor must confirm it in writing within 48 hours. If the contractor fails to do so, the merchant is released from the offer. Com C §2205(b). The term "merchant" is defined in Com C §2104(1) as someone who "deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction…." Although Com C §2205(b) theoretically offers some clarity on the issue of subcontractor bidding, it is apparently not widely known or utilized in the construction industry. California Construction Contracts, Defects, and Litigation (Cal CEB 2008).

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§4.13 E. Revocable Offers (CC §§1586-1587)

As a general rule, contract offers are revocable. Unless an offer qualifies as an option (see §4.14), an offer may be revoked by the offeror at any time before its acceptance is communicated to the offeror, although not afterwards. CC §1586; *T.M. Cobb Co., Inc. v Superior Court* (1984) 36 C3d 273, 278, 204 CR 143; *City of Orange v San Diego County Employees Retirement Ass'n* (2002) 103 CA4th 45, 52, 126 CR2d 405.

Civil Code §1587 describes how an offer may be revoked, as follows:

> A proposal is revoked:
> 1. By the communication of notice of revocation by the proposer to the other party, in the manner prescribed by [CC §§1581 and 1583], before his acceptance has been communicated to the former;
> 2. By the lapse of the time prescribed in such proposal for its acceptance, or if no time is so prescribed, the lapse of a reasonable time without communication of the acceptance;
> 3. By the failure of the acceptor to fulfill a condition precedent to acceptance; or,
> 4. By the death or insanity of the proposer.

See also Restatement (Second) of Contracts §36 (1981). Revocation can be communicated by any usual and reasonable manner of communication, and notice of revocation is deemed given when placed in the course of transmission to the offeree. *Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 621, 2 CR2d 288 (citing CC §§1582-1583). Notice of revocation may be communicated indirectly, to an agent authorized on behalf of the offeree to accept such a notice. 1 CA4th at 622. See also Restatement (Second) of Contracts §§42-43 (1981).

An offer will be revoked not only by death of the offeror (CC §1587(4); *Newberger v Rifkind* (1972) 28 CA3d 1070, 1073, 104 CR 663), but also by death of the offeree (*Estate of Watts v Dickerson* (1984) 162 CA3d 1160, 208 CR 846). In *Watts,* noting the common law rule that offers are not assignable but rather are personal to the offeree, the court of appeal ruled that an offer could not be accepted by the executor of the offeree after the offeree's death. Only an irrevocable option can survive the death of the offeree and be accepted by the offeree's executor or administrator. 162 CA3d at 1164.

If the offeror states that the offer will remain open for a specific period of time, that statement is not binding on the offeror unless it is supported by valuable consideration given by the offeree. *Davies v Langin* (1962) 203 CA2d 579, 584, 21 CR 682. See also *Bellasi v Shackelford* (1962) 201 CA2d 265, 267, 19 CR 925. If supported by consideration, the offer left open constitutes an option contract. See *City of Orange v San Diego County Employees Retirement Ass'n* (2002) 103 CA4th 45, 51, 126 CR2d 405. Unless the offer does qualify as an option contract (see §4.14), however, the offeror can withdraw or revoke it at any time before it is accepted, despite the offeror's expressed intent to leave the offer open for a certain time.

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§4.14 F. Irrevocable Offers; Option Contracts

To become irrevocable, an offer normally must be supported by consideration, and, if it is supported by consideration, it constitutes an option contract. "[A]n irrevocable option is a contract made for consideration, to keep an offer open for a prescribed period." *City of Orange v San Diego County Employees Retirement Ass'n* (2002) 103 CA4th 45, 51, 126 CR2d 405 (citations omitted). See also *Arden Group, Inc. v Burk* (1996) 45 CA4th 1409, 53 CR2d 492. A common example is a real estate option, *e.g.,* under which A, in consideration for a sum paid by B, makes an offer to sell Blackacre to B for a specified amount at any time before a specified date. B holds an option to purchase Blackacre, which expires on the date specified. The Restatement (Second) of Contracts §25 (1981) defines an option contract as follows: "An option contract is a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer."

In theory, an offer may also be made irrevocable by operation of a statute. See Restatement (Second) of Contracts §25, Comment c (1981). In *T.M. Cobb Co., Inc. v Superior Court* (1984) 36 C3d 273, 204 CR 143, however, the California Supreme Court held that litigation settlement offers made under CCP §998 are not irrevocable, despite statutory language indicating that such an offer can be accepted within a 30-day period after it is made. For an offer to be irrevocable by statute, the statute must expressly notify the offeror that the offer will be irrevocable if made in accordance with the statute. 36 C3d at 283. For further discussion of offers under CCP §998, see §4.19.

In the context of an option, there are two distinct contracts: the option itself and the underlying contract to which the option relates. *T.M. Cobb Co. v Superior Court*, *supra*; *City of Orange v San Diego County Employees Retirement Ass'n, supra*. The option is a unilateral contract under which the offeree (optionee), for consideration, has the right and the power to create a contract during the term of the option. *City of Turlock v Paul M. Zagaris, Inc.* (1989) 209 CA3d 189, 194, 256 CR 902. In an option, only the offeror is bound, and the offeror's obligation is to keep the offer open for the stated period of time. The offeree has no obligation to exercise the option and accept the offer. *Chow v Levi Strauss & Co.* (1975) 49 CA3d 315, 122 CR 816. Once the option is exercised, however, the offeree has a right against the offeror for performance of the underlying contract to which the option relates, and this right cannot be defeated by the offeror through unilateral revocation or termination of the option. *City of Orange v San Diego County Employees Retirement Ass'n, supra,* citing *Warner Bros. Pictures, Inc. v Brodel* (1948) 31 C2d 766, 771, 192 P2d 949. See also *Allen v Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898.

To be enforceable, an option contract must be supported by consideration. *Allen,* 94 CA4th at 1280; *Torlai v Lee* (1969) 270 CA2d 854, 858, 76 CR 239. Civil Code §3391(1) provides that the remedy of specific performance is not available against a party who has not received adequate consideration for the contract. See chap 11 for further discussion of specific performance; see §3.43 for a discussion of the concept of adequate consideration. "Any consideration, however small, has been held sufficient for an option contract." *Kowal v Day* (1971) 20 CA3d 720, 727, 98 CR 118. The adequacy of consideration for an option is measured as of the date the option is given. *Polinsky v Vaughan* (1968) 268 CA2d 183, 194, 73 CR 764; *Glascock v Sukumlyn* (1955) 131 CA2d 587, 281 P2d 90. In the case of stock options granted to employees, consideration is inherent when employees continue their employment with knowledge of the options; no additional consideration in money or property is required. *Newberger v Rifkind* (1972) 28 CA3d 1070, 1073, 104 CR 663. Similarly, options to purchase real estate that are contained in a lease agreement are considered to be supported by sufficient consideration. The general consideration for the lease, including the covenant to pay rent, is deemed to support the purchase option as well as the right to occupy the premises. *Re v Wells Fargo Bank* (1969) 269 CA2d 783, 787, 75 CR 367.

Whether an option has been validly exercised is determined by reference to the general rules of offer and acceptance; ordinarily, the terms of the exercise must be identical to the terms of the offer. *Arden Group, Inc. v Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492. If an option contract specifies the particular manner in which the option is to be exercised, the provisions of the option contract must be strictly followed. If, however, the option contract merely suggests but does not affirmatively require a particular manner of exercise, another manner of exercise is not precluded. *Palo Alto Town & Country Village, Inc. v BBTC Co.* (1974) 11 C3d 494, 498, 113 CR 705.

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§4.15 G. Firm Offers by Merchants Under Com C §2205(a)

Under Com C §2205(a), applicable to offers made by merchants for the purchase or sale of goods, the common law rule that offers are revocable, even if the offeror states that the offer will be held open (see §4.13), is modified as follows:

> An offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months; but any such term of assurance on a form supplied by the offeree must be separately signed by the offeror.

In effect, Com C §2205(a) allows a merchant to create an option contract unilaterally in favor of an offeree without need for consideration or a consideration substitute, provided the offer is made in a signed writing and specifies that it will remain open for a period of time not exceeding 3 months. A "merchant" is defined in Com C §2104(1) as someone who deals in goods of the kind in the transaction or who by occupation holds himself or herself out as having knowledge or skill peculiar to the goods or practices involved (or to whom such knowledge or skill may be attributed by employment of a broker or other intermediary with such knowledge or skill). A corresponding statute applies to offers by merchants to lease (rather than to buy or sell) goods. See Com C §10205. For further discussion of merchants' firm offers under the Commercial Code, see California UCC Sales and Leases, chap 2 (Cal CEB 2002).

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H. Agreements to Agree, Contracts to Negotiate

§4.16 1. Generally

Intent of the parties controls. In general, whether a writing (or an oral agreement) constitutes a final agreement or merely an agreement to make a further agreement depends on the parties' intent. In the absence of ambiguity, the parties' intent is determined by construction of the writing (or the parties' words) as a whole, and the court's interpretation is governed by the parties' objective intent as evidenced by their words, and not their subjective intent. *Elyaoudayan v Hoffman* (2003) 104 CA4th 1421, 1430, 129 CR2d 41; *Beck v American Health Group Int'l, Inc.* (1989) 211 CA3d 1555, 1562, 260 CR 237. See also *Roth v Marquez* (9th Cir 1991) 942 F2d 617. Although courts are becoming increasingly liberal in supplying omitted terms to find an enforceable agreement, they will do so only if the parties' reasonable intentions can be ascertained. The general rule remains that if any essential elements of a promise are reserved for future agreement of both parties, no legal obligation arises until that future agreement is made. *Coleman Eng'g Co. v North Am. Aviation, Inc.* (1966) 65 C2d 396, 405, 55 CR 1; *Copeland v Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1255, 117 CR2d 875.

Agreements to agree. In particular, if the parties understand that the terms of their agreement are to be reduced to writing and signed by them, their assent must be evidenced in the manner they have agreed to or else there is no binding contract. *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 213, 45 CR3d 692. In *Bustamante*, the court found that the parties had at best an agreement to agree, which was not enforceable under California law. The parties had never agreed to create a new company without third party investor financing. They had only sketched out essential terms, leaving final points to be agreed on in the future, contingent on obtaining third party approvals. See also *Banner Entertainment, Inc. v Superior Court* (1998) 62 CA4th 348, 358, 72 CR2d 598 (under facts, no enforceable agreement to arbitrate disputes); *Beck v American Health Group Int'l, Inc.* (1989) 211 CA3d 1555, 1562, 260 CR 237 (letter at issue constituted agreement to agree, not binding contract, and was therefore not enforceable).

When oral agreement enforced. In contrast, in *Elyaoudayan v Hoffman, supra,* the parties orally agreed before the court on all material terms and conditions of a litigation settlement. Although the parties also contemplated a written settlement agreement, which was prepared but not signed, the court ruled that the oral agreement was enforceable under CCP §664.6. The court noted that if an oral agreement indicates it was not intended to be binding until a more formal written contract was signed, then there is no contract, but if, as in this case, the oral agreement shows nothing further than an intent to reduce the oral agreement to writing, the failure to reduce the oral agreement to writing does not negate the existence of the oral contract. 104 CA4th at 1430, citing *Harris v Rudin, Richman & Appel* (1999) 74 CA4th 299, 307, 87 CR2d 822. See also *DVD Copy Control Ass'n v Kaleidescape, Inc.* (2009) 176 CA4th 697, 97 CR3d 856 (specific performance was not precluded when licensing agreement required licensee to build its DVD system according to specifications that licensor would provide later); *Banner Entertainment, Inc. v Superior Court* (1998) 62 CA4th 348, 358, 72 CR2d 598.

NOTE: An oral agreement otherwise enforceable under general contract law principles may be unenforceable by operation of the statute of frauds. See CC §§1624, 1698, 2793-2794; CCP §§1971, 1974. The statute of frauds is discussed in §§4.43-4.49.

Contracts to negotiate distinguished. In *Copeland v Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 117 CR2d 875, the court of appeal made an important distinction between agreements to agree and contracts to negotiate the terms of an agreement. If the parties make good faith efforts but fail to reach a final agreement on the contract terms at issue, a contract to negotiate is deemed fully performed and the parties are discharged. The fact that the parties did not reach agreement does not constitute a breach of the contract to negotiate. A party would be liable for breach only if the failure to reach a final agreement was a result of a breach of that party's duty to negotiate or to negotiate in good faith. Contracts to negotiate are therefore not the same as agreements to agree. Courts that have found agreements to agree unenforceable have focused on the underlying contract, not on whether an agreement to negotiate the terms of that contract is enforceable in its own right. If the parties have a contractual obligation to negotiate, the covenant of

good faith and fair dealing attaches (as it does in every contract), and a cause of action for breach of that contract to negotiate will lie. *Copeland v Baskin Robbins U.S.A., supra*. See also *Racine & Laramie, Ltd., Inc. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 14 CR2d 335 (covenant of good faith and fair dealing does not apply to negotiation activities unless there is an underlying agreement to bargain in good faith, such as a letter of intent).

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§4.17 2. Letters of Intent

A letter of intent (sometimes called a memorandum of understanding or a term sheet) is a writing that documents the preliminary understandings of the parties to a proposed business transaction—who typically intend to enter into a formal contract soon afterwards. Its purpose is normally not to bind the parties immediately, but rather to provide a framework of key points that the parties intend to use as a basis for negotiating a final agreement. "[C]alling a document 'letter of intent' implies, unless circumstances suggest otherwise, that the parties intended it to be a nonbinding expression in contemplation of a future contract, as opposed to its being a binding contract." *Rennick v O.P.T.I.O.N. Care, Inc.* (9th Cir 1996) 77 F3d 309, 315, cert denied (1996) 519 US 865 (no contract between parties existed because letter of intent clearly said so). The title alone, however, does not render the document nonbinding. *Roth v Garcia Marquez* (9th Cir 1991) 942 F2d 617; *Republic of Nicaragua v Standard Fruit Co.* (9th Cir 1991) 937 F2d 469.

A letter of intent normally does not embody the parties' final agreement, and is usually superseded by the parties' definitive agreement through operation of a merger or integration clause. As stated by the Ninth Circuit in *Rennick,* 77 F3d at 315:

> Commonly a letter of intent is used so that people negotiating toward an agreement, who do not yet have one, can get their preliminary inclinations down on paper without committing themselves. This avoids a misunderstanding that a commitment has been made. It also has value in preserving a common understanding of what has been talked about in earlier negotiations, before spending the time and money on later negotiations, and justifies further expenditures on attorneys and others. It may be used to stimulate negotiations with third parties, as where a shopping center developer shows a prospective lender a letter of intent from a potential anchor tenant, to induce the prospective lender to commence negotiations.

Regardless of its title, however, a letter of intent may be enforced as a contract if its content shows that the parties intended to be bound and if all the other elements of an enforceable contract are present. *Rennick v O.P.T.I.O.N. Care, Inc., supra*; *California Food Serv. Corp. v Great Am. Ins. Corp.* (1982) 130 CA3d 892, 897, 182 CR 67. In *California Food Serv. Corp*., finding that the parties' letter of intent contained all of the necessary elements to create a binding contract, the court of appeal stated: "A letter of intent can constitute a binding contract, depending on the expectations of the parties.… These expectations may be inferred from the conduct of the parties and surrounding circumstances." 130 CA3d at 897.

Based on the express language of the documents at issue, most recent cases have found letters of intent not to be enforceable as binding contracts. In *J.B. Enters. Int'l, LLC v Sid & Marty Kroft Pictures Corp.* (CD Cal, Mar. 3, 2003, No. CV 02-7779 CBM (SHx)) 2003 US Dist Lexis 7668, the letter of intent contemplated a 30-day due diligence period, after which the parties would enter into a definitive stock purchase agreement. The letter stated that it did not create any binding obligation to consummate the stock purchase and that any obligation to purchase the stock "would arise only upon the signing of, and in accordance with, a definitive Purchase Agreement." Although the stock purchase agreement was drafted, it was never signed and the closing never occurred. The court held that the letter of intent did not create any contractual obligation on the part of defendants to purchase the plaintiffs' stock and refused to look to the parties' conduct to imply that the letter of intent created an obligation in contradiction to its express language. Similarly, in *VHB Assocs., Inc. v Orix Real Estate Equities* (CD Cal, Sept. 3, 2002, No. CV 02-4710 JFW (RNBx)) 2002 US Dist Lexis 17569, the court held that the letter of intent at issue was not binding because it merely outlined the terms under which one party would be interested in working with the other. It did not purport to bind either party to perform. See also *Beck v American Health Group Int'l, Inc.* (1989) 211 CA3d 1555, 1562, 260 CR 237.

At issue in *City of Vernon v Board of Harbor Commr's* (1998) 63 CA4th 677, 74 CR2d 497, was a document titled "Statement of Intent and Terms for Proposed Container & Intermodal Terminal" between the Port of Long Beach and the China Ocean Shipping Company (COSCO). The document stated in its first paragraph:

> The parties intend this statement to reflect the basic understanding between them, but agree that the transactions contemplated herein shall be subject to the execution of mutually acceptable definitive and final agreements to be negotiated [and] subject to the approval of the Board of Harbor Commissioners… and by [COSCO].… This statement does not constitute a legally binding commitment.

Given this language, the court of appeal held that COSCO could have no expectation of a binding contract. The statement of intent was only that and nothing more. 63 CA4th at 690.

If the parties to a proposed business transaction wish to enter into a letter of intent, they should decide at the outset whether and to what extent the letter is intended to be binding, and clearly express their intent in the letter. If they intend all or part of the letter to be enforceable, the letter of intent should describe remedies for breach, to assist a court in concluding that the letter of intent was intended to be binding and in determining the appropriate remedy. If a nonbinding letter of intent is intended, the letter should include language such as the following:

> **The Parties acknowledge that this letter does not set forth all matters on which the Parties must reach agreement in order for the _ _[*name of subject transaction*]_ _ to be consummated. In addition to the other conditions specified herein, the obligation of the Parties to consummate the _ _[*name of subject transaction*]_ _ is subject to the negotiation and execution of the _ _[*name(s) of definitive documents*]_ _. This letter is intended solely as a basis for further discussion; it is not intended to be and does not constitute a legally binding agreement.**

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§4.18 3. Loan Commitment Letters

A loan commitment letter is a type of letter of intent, which may or may not be binding on the lender depending on its terms. Loan commitment letters often contemplate that the parties will enter into a definitive loan agreement and related documents before the loan is funded. In general, a loan commitment is not binding unless it sets forth all material terms of the proposed loan and either the obligation of the lender to make the loan is unconditional or all conditions have been satisfied. The material elements of a loan commitment include (1) the identity of the lender, (2) the identity of the borrower, (3) the amount of the loan, and (4) the terms of repayment. If a loan commitment letter does not contain all essential terms of the loan, the prospective borrower cannot reasonably rely on it and the lender will not be liable for failure to make the loan. *Peterson Dev. Co. v Torrey Pines Bank* (1991) 233 CA3d 103, 115, 284 CR 367. See also *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1448, 1 CR3d 162. In *Peterson Dev. Co.,* the court held that no enforceable contract was created by the commitment letter because it did not adequately define the material terms of the loan. In *Careau & Co. v Security Pac. Bus. Credit, Inc.* (1990) 222 CA3d 1371, 1389, 272 CR 387, the court held that the plaintiffs had failed to state a cause of action for breach of contract because they had not specifically alleged performance of the conditions precedent stated in the loan commitment letter.

If a borrower pays a fee to the lender for a loan commitment, the loan commitment constitutes an option on the part of the borrower to obtain the loan on the terms specified in the letter. *Peterson Dev. Co. v Torrey Pines Bank, supra.*

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§4.19 I. Statutory Offers to Compromise (CCP §998)

Code of Civil Procedure §998 sets forth procedures for making an offer of compromise in connection with pending state court litigation or an arbitration proceeding. General contract principles govern the offer and acceptance process under the statute, unless application of those principles would conflict with or defeat the purpose of the statute. *T.M. Cobb Co., Inc. v Superior Court* (1984) 36 C3d 273, 280, 204 CR 143; *Elite Show Servs., Inc. v Staffpro, Inc.* (2004) 119 CA4th 263, 268, 14 CR3d 184. Offers to compromise under CCP §998 are discussed further in §5.96. For an extensive discussion of the specific procedures and requirements for offers under CCP §998 as well as leading case decisions, see California Civil Procedure Before Trial, chap 47 (4th ed Cal CEB 2004).

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§4.20 J. Lapse or Expiration of an Offer (CC §1587(2))

An offer may lapse or expire, and therefore become incapable of acceptance, by the passage of the time stated in the offer for its acceptance, or if no time is stated, the passage of a reasonable time without communication of acceptance. CC §1587(2). As stated by the court in *Davies v Langin* (1962) 203 CA2d 579, 584, 21 CR 682:

> In accordance with the general rules governing contracts, an offer which contains no specified time limit is revoked by operation of law by the lapse of an unreasonable period of time.... Where the offer does contain such a time limitation, revocation occurs upon the expiration of the period specified.

The end result is that the offeror has a right to refuse to recognize a late acceptance, but this right may be waived by the offeror, as did the offeror in the *Davies* case. See 203 CA2d at 585.

In *Sabo v Fasano* (1984) 154 CA3d 502, 201 CR 270, a real estate purchase contract provided that the buyer's offer would be void if not accepted within 5 days. The sellers accepted the offer on the 6th day, but later argued that because their acceptance occurred after the offer had expired, the sellers were not obligated to perform under the contract. The court of appeal ruled that the acceptance deadline in the contract was for the benefit of, and could be waived by, the buyer. Therefore, the buyer's action in proceeding with an escrow after the seller had accepted the buyer's offer constituted a waiver of the sellers' late acceptance. Further, the sellers knew that the buyer treated their acceptance as such and were therefore estopped from denying their contractual obligations.

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II. ACCEPTANCE

§4.21 A. Generally

As noted in §4.1, the Civil Code requirement of mutual consent encompasses both offer and acceptance. See CC §§1550(2), 1565. Acceptance is the other aspect of mutual consent. It is the second step in the parties' conduct that, if effective, will satisfy the Civil Code requirement for mutuality of consent (see CC §1580) and result in the formation of a contract. See generally *Donovan v RRL Corp.* (2001) 26 C4th 261, 270, 109 CR2d 807; *ASP Props. Group, L.P. v Fard, Inc.* (2005) 133 CA4th 1257, 1269, 35 CR3d 343; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 1230, 13 CR3d 544. The Restatement (Second) of Contracts §50(1) (1981) defines acceptance of an offer as "a manifestation of assent to the terms thereof made by the offeree in a manner invited or required by the offer." See *Quackenbush v Omnicar (In re First Capital Life Ins. Co.)* (1995) 34 CA4th 1283, 1288, 40 CR2d 816.

Under the Civil Code, acceptance, as an aspect of consent, must be free, mutual, and communicated to the offeree. See CC §1565; *Estate of Klauenberg* (1973) 32 CA3d 1067, 1070, 108 CR 669. "Consent is not mutual, unless the parties all agree upon the same thing in the same sense." CC §1580. The law will not enforce the terms of a contract or provide a remedy for breach without evidence of such consent. "One cannot be made to stand on a contract to which he has never consented." *Khajavi v Feather River Anesthesia Med. Group* (2000) 84 CA4th 32, 100 CR2d 627 (citations omitted).

NOTE: Acceptance is particularly an issue in the context of electronic contracting. Electronic contracting is discussed in §§4.54-4.66.

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§4.22 B. Manifestation of Assent (CC §1581)

Consistent with the principle that contract law is a matter of the objective manifestation of the parties' intent (see *De Anza Enters. v Johnson* (2002) 104 CA4th 1307, 1315, 128 CR2d 749), an essential element of a valid acceptance is that it must be manifested. *Stewart v Preston Pipeline, Inc.* (2005) 134 CA4th 1565, 1587, 36 CR3d 901 (objective manifestation of assent; contract binding despite claim that party did not read agreement before signing it). The offeree's subjective intent is normally irrelevant. "[T]he test of the true meaning of an acceptance or rejection is not what the party making it thought it meant or intended it to mean. Rather, the test is what a reasonable person in the position of the parties would have thought it meant." *Guzman v Visalia Community Bank* (1999) 71 CA4th 1370, 1376, 84 CR2d 581. See also *Beard v Goodrich* (2003) 110 CA4th 1031, 1038, 2 CR3d 160; *Alexander v Codemasters Group Ltd.* (2002) 104 CA4th 129, 141, 127 CR2d 145. This rule is reflected in CC §1581 as follows:

> Consent can be communicated with effect, only by some act or omission of the party contracting, by which he intends to communicate it, or which necessarily tends to such communication.

In effect, contract law requires that an acceptance be communicated by the offeree in a clear and unequivocal manner. *Gray v Stewart* (2002) 97 CA4th 1394, 1397, 119 CR2d 217. The court of appeal in *Guzman v Visalia Community Bank* explained that "an acceptance is not invalidated by the fact that it is 'grumbling,' or that the offeree makes some simultaneous 'request'.... Nevertheless, it must appear that the 'grumble' does not go so far as to make it doubtful that the expression is really one of assent." 71 CA4th at 1376 (citations omitted). See also *Panagotacos v Bank of America* (1998) 60 CA4th 851, 856 n2, 70 CR2d 595 (although made with some protest, an unqualified "grumbling" acceptance is sufficient to show agreement). Moreover, the apparent acceptance cannot add different or additional terms from what was offered, or else the acceptance becomes a counteroffer. *Guzman,* 71 CA4th at 1376. See §4.23.

There are two exceptions to the general rule that a valid acceptance depends solely on the offeree's objective manifestation of assent. The first is the situation when the offeree does not know that an offer has been made. Regardless of an apparent manifestation of the offeror's assent, the offeror will not be not bound by inconspicuous contractual provisions of which he or she was not aware, in a document the contractual nature of which is not obvious. See *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645; *Windsor Mills, Inc. v Collins & Aikman Corp.* (1972) 25 CA3d 987, 993, 101 CR 347. In effect, consent must be given knowingly. (In *Windsor Mills,* the court of appeal noted that the principle of knowing consent applies with particular force to arbitration clauses.) The second exception is found in cases involving fraud in the execution, discussed in §3.6. If an offeree's apparent manifestation of assent is induced by a misrepresentation regarding the nature or essential terms of a proposed contract, and the offeree does not know (or have reasonable opportunity to know) of the nature or essential terms of the proposed contract, the offeree's conduct is not effective as a manifestation of assent. *Larian v Larian* (2004) 123 CA4th 751, 762, 19 CR3d 916, citing *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 58 CR2d 875, and Restatement (Second) of Contracts §163, Comment a (1981). See also *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 959, 85 CR3d 817.

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§4.23 C. Content of Acceptance: Mirror Image Rule; Counteroffers (CC §1585)

Under the Civil Code, an acceptance must be absolute and unqualified in order to be effective (CC §1585):

> An acceptance must be absolute and unqualified, or must include in itself an acceptance of that character which the proposer can separate from the rest, and which will conclude the person accepting. A qualified acceptance is a new proposal.

If the acceptance is qualified, it constitutes (1) a rejection of the original offer, thereby terminating the offer, and (2) a new proposal or counteroffer, which in turn must be accepted by the original offeror for a binding contract to be formed. *Landberg v Landberg* (1972) 24 CA3d 742, 750, 101 CR 335; *Apablasa v Merritt & Co.* (1959) 176 CA2d 719, 1 CR 500. The terms of an offer must be "met exactly, precisely and unequivocally for its acceptance to result in the formation of a binding contract…; and a qualified acceptance amounts to a new proposal or counteroffer putting an end to the original offer…." *Panagotacos v Bank of America* (1998) 60 CA4th 851, 855, 70 CR2d 595 (citations omitted) (finding no binding real estate contract formed when offeree's acceptance proposed extension of closing deadline and alternative place of payment). If, in turn, the counteroffer is not accepted by the original offeror, it amounts to nothing. *Apablasa v Merritt & Co., supra* (finding that no definite proposal or agreement resulted from any of the parties' discussions).

Civil Code §1585 embodies the common law "mirror image" rule that, for contract formation, an offer must be met with an absolute, unconditional acceptance evidencing a meeting of the minds on each point, leaving nothing to future negotiation. The mirror image rule is reflected in Restatement (Second) of Contracts §59 (1981) as follows:

> A reply to an offer which purports to accept it but is conditional on the offeror's assent to terms additional to or different from those offered is not an acceptance but is a counter-offer.

Although the mirror image rule is not applicable to contracts for the sale of goods (see §4.38), it remains the general rule in California for non-Commercial Code contracts. See, *e.g., Bias v Wright* (2002) 103 CA4th 811, 127 CR2d 137 (summary judgment improper because there was factual issue of whether offeree's acceptance, which added condition that parties bear their own costs, was absolute and unequivocal as required by CC §1585); *Marcus & Millichap Real Estate Inv. Brokerage Co. v Hock Inv. Co.* (1998) 68 CA4th 83, 89, 80 CR2d 147 (finding no binding arbitration clause because contract expressly required both parties to initial clause, but only one party did so). In *Converse v Fong* (1984) 159 CA3d 86, 205 CR 242, the defendant's acceptance of the plaintiffs' offer was not absolute, but instead was made expressly conditional on her obtaining approval of her son, her accountant, and her attorney—none of whom were parties to the contract. The court of appeal found that by making her acceptance subject to this condition, the defendant introduced a new term, and no contract was formed until she received the approval of the other persons.

Although acceptance must constitute an unequivocal assent to the offer, it is not necessary that the identical language of the offer be repeated in the acceptance. *Beatty v Oakland Sheet Metal Supply Co.* (1952) 111 CA2d 53, 61, 244 P2d 25. One early insurance case departed slightly from the mirror image rule in finding that the plaintiff's failure to answer one question on an insurance application was immaterial and therefore did not prevent formation of the insurance contract. "While ordinarily it is the law that to accept an offer and make a binding contract the offeree must comply with all the conditions of the offer, substantial compliance is all that is required." *Metts v Central Standard Life Ins. Co.* (1956) 142 CA2d 445, 451, 298 P2d 621. The *Metts* case has apparently not been followed outside of the insurance context.

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§4.24 D. Who May Accept

Offers are strictly personal to the offeree, and therefore are not assignable. Only the person or persons to whom an offer is directed can accept it. *Estate of Watts v Dickerson* (1984) 162 CA3d 1160, 1163, 208 CR 846. In *Watts,* the court of appeal held that the defendant's statutory offer of compromise under CCP §998 (see §§4.19, 5.96) was revocable and terminated with the offeree's death. The purported acceptance by the offeree's estate administrators therefore had no legal effect. *Estate of Watts* is consistent with Restatement (Second) of Contracts §52 (1981), which provides that "[a]n offer can be accepted only by a person whom it invites to furnish the consideration." As noted in Restatement (Second) of Contracts §52, Comment c (1981), however, this rule is supplemented by the law of agency. In the absence of anything to the contrary, an offer may be accepted by an authorized agent of the offeree. See *Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 622, 2 CR2d 288.

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E. Communication of Acceptance

§4.25 1. Generally (CC §1582)

Acceptance of an offer must be communicated in the manner required by CC §1582:

> If a proposal prescribes any conditions concerning the communication of its acceptance, the proposer is not bound unless they are conformed to; but in other cases any reasonable and usual mode may be adopted.

Under CC §1582, any "reasonable and usual" mode of communication may be used to accept an offer, unless the offer requires a specific mode of acceptance. *Gray v Stewart* (2002) 97 CA4th 1394, 1397, 119 CR2d 217; *Estate of Klauenberg* (1973) 32 CA3d 1067, 1070, 108 CR 669. See *Palo Alto Town & Country Village, Inc. v BBTC Co.* (1974) 11 C3d 494, 113 CR 705 (holding CC §1582 applicable to options as well as revocable offers). The same rule is set forth in the Restatement (Second) of Contracts §60 (1981) as follows:

> If an offer prescribes the place, time or manner of acceptance its terms in this respect must be complied with in order to create a contract. If an offer merely suggests a permitted place, time or manner of acceptance, another method of acceptance is not precluded.

In *Gray v Stewart,* the court of appeal held that because the offer did not prescribe any specific mode of communication for the acceptance, the only requirement was that acceptance be communicated in a clear and unequivocal fashion. The offeree's unequivocal oral acceptance of the settlement offer while it remained open was a reasonable mode of communicating acceptance. The offer was therefore accepted as a matter of law. 97 CA4th at 1397.

In *Palo Alto Town & Country Village, Inc. v BBTC Co.* (1974) 11 C3d 494, 113 CR 705, the issue was whether the tenant's renewal option had been validly exercised. The lease stated that "[a]ll notices to be given to Lessee may be given in writing personally or by depositing the same in the United States mail, postage prepaid, and addressed to Lessee at the said premises." The tenant had prepared and timely mailed a written renewal notice to the landlord, but the landlord claimed it never received the notice. Relying on CC §1582, the California Supreme Court held that the tenant's notice was effective on mailing, because the lease did not prescribe any absolute condition regarding the manner of communicating exercise of the renewal option to the landlord. Therefore, "any reasonable and usual mode may be adopted." 11 C3d at 499, citing CC §1582.

Applying California law, the federal district court in *Ellefson v Megadeth, Inc.* (SD NY Jan. 13, 2005, No. 04 Civ 5395 (NRB)) 2005 US Dist Lexis 545 found that defendants had validly accepted plaintiff's counteroffer by sending a fully executed hard copy of the agreement by regular mail, notwithstanding that the parties had used fax and email to negotiate the agreement. Neither the plaintiff's original offer nor the counteroffer contained any restrictions on the manner of acceptance.

The circumstances in which an offer may be accepted by conduct or performance are discussed in §4.31.

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§4.26 2. Timing of Acceptance; Mailbox Rules

If an offer specifies a deadline for acceptance, but the acceptance is not timely made, the acceptance is deemed to be a counteroffer, which the original offeror may then either accept or reject. See CC §1582; *Ellefson v Megadeth, Inc.* (SD NY Jan. 13, 2005, No. 04 Civ 5395 (NRB)) 2005 US Dist Lexis 545 (applying California law); *Sabo v Fasano* (1984) 154 CA3d 502, 506, 201 CR 270. Under CC §1587(1), an offer that specifies a deadline for acceptance lapses if the deadline is not met. Therefore, a late acceptance cannot result in formation of a contract because the offer is no longer outstanding. See §4.20. The original offeror must communicate acceptance of the counteroffer for a contract to be formed. *Landberg v Landberg* (1972) 24 CA3d 742, 750, 101 CR 335.

The so-called "mailbox" rules for determining the point in time when a communication is effective between contracting parties arose at common law as courts grappled with cases involving slow communications over long distances. The common law principles of offer and acceptance, suitable for face-to-face bargaining in the marketplace, proved unable to address situations when offers, acceptances, counteroffers, and withdrawals crossed in the mails. See generally Hunter, Modern Law of Contracts §4:15 (3d ed 2007). As technology shrinks the time for transmission of communications and payments, the need to apply the mailbox rules decreases. The Restatement (Second) of Contracts §64 (1981) provides that acceptances given by "telephone or other medium of substantially instantaneous two-way communication" are governed by the same rules applicable to acceptances made in face-to-face communications. Nevertheless, whenever there is a delay between an initial communication and a response, the potential for application of the mailbox rules remains.

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§4.27 a. Mailbox Rule: Acceptance (CC §1583)

Under the Civil Code, an acceptance is effective on its placement "in the course of transmission," *i.e*., deposit in the mail, regardless of how long it takes for the acceptance to complete its journey to the offeror. Civil Code §1583 provides:

> Consent is deemed to be fully communicated between the parties as soon as the party accepting a proposal has put his acceptance in the course of transmission to the proposer, in conformity to [CC §1582].

California courts have interpreted CC §1583 to require that an acceptance must be placed out of the offeree's control to be considered as being "in the course of transmission." Generally, an acceptance will be deemed to be out of the offeree's control on delivery to the post office. "California's 'effective upon posting' rule, as codified in section 1583, thus holds that an acceptance of an offer is effective and deemed communicated upon its deposit in the mail." *Gibbs v American Sav. & Loan Ass'n* (1990) 217 CA3d 1372, 1376, 266 CR 517. See also *Morello v Growers Grape Prods. Ass'n* (1947) 82 CA2d 365, 370, 186 P2d 463. In *Gibbs,* the plaintiff delivered an acceptance of the defendants' counteroffer to the mail clerk in the plaintiff's office with instructions to deliver it to the post office. Later that day, the defendants orally revoked their counteroffer. The plaintiff's acceptance was not actually deposited in the mail until the next day. The court of appeal affirmed the trial court's judgment that the plaintiff's acceptance was not placed in the course of transmission beyond her control until the mail clerk delivered it to the post office. By that time, the counteroffer had been revoked, so no contract was formed. 217 CA3d at 1376. The same rule is applicable to exercise of an option. *Palo Alto Town & Country Village, Inc. v BBTC Co.* (1974) 11 C3d 494, 501, 113 CR 705.

Professor Llewellyn summed up the policy behind the mailbox rule as a balancing of the hardships in the event a letter is lost in transit. The offeror is merely holding the offer open, while the offeree is already relying on the contract it believes it has accepted on deposit of the letter and its ordinary transmittal and receipt. Llewellyn, *Our Case-Law of Contract*: *Offer and Acceptance, II*, 48 Yale LJ 779, 795 (1939).

The mailbox rule corresponds to the federal and state evidentiary presumption that correspondence is deemed received by the addressee when it is placed in a properly addressed envelope with correct postage prepaid and is deposited in the United States mail. See Evid C §641; *Busquets-Ivars v Ashcroft* (9th Cir 2003) 333 F3d 1008, 1009. See also *Craig v Brown & Root, Inc.* (2000) 84 CA4th 416, 100 CR2d 818.

There are apparently no California cases addressing the potential application of the mailbox rule when correspondence is sent by fax or delivered to private courier services such as FedEx, DHL, or the United Parcel Service. Federal courts have held that delivery to a private carrier does not comply with the statutory mailbox rule in the Internal Revenue Code, 26 USC §7502. See *Petrulis v Commissioner* (7th Cir 1991) 938 F2d 78; *Pugsley v Commissioner* (11th Cir 1985) 749 F2d 691. In *Osprey L.L.C. v Kelly-Moore Paint Co.* (Okla 1999) 984 P2d 194, the court held that a fax transmission (which the landlord asserted it had not received, but which was confirmed by a FedEx transmittal) was effective to renew a commercial lease. Yet in *Trinity Homes, LLC v Fang* (Nov. 13, 2003, No. CH02-2297) 2003 Va Cir Lexis 349, the court held the mailbox rule did not apply to validate a faxed acceptance, because the offeree's fax machine could not provide verification that the fax had been sent or received. Older California cases have applied the mailbox rule to acceptances sent by telegram, holding that the acceptance takes effect on deposit of the telegram for transmission. See *Sam Finman, Inc. v Rukuz Holding Corp.* (1955) 130 CA2d 758, 279 P2d 982.

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§4.28 b. Mailbox Rule: Revocation of Offer

Under the Civil Code, the mailbox rule of CC §1583 applies equally to a revocation or withdrawal of an offer. Revocation is effective on communication of notice of revocation to the offeree, in the same manner as communication of an acceptance, before an acceptance is communicated to the offeror. CC §1587(1). A revocation can be communicated by any usual and reasonable manner of communication, and notice of revocation is deemed given when placed in the course of transmission to the offeree. *Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 621, 2 CR2d 288 (citing CC §§1582-1583). See §4.13. The Civil Code rule differs from the rule stated in the Restatement (Second) of Contracts §§42, 68 (1981), which provides essentially that revocations are effective only on receipt by the offeree.

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§4.29 c. Mailbox Rule: Later Rejection Overtaking Acceptance

What of the situation where an offeree accepts an offer by depositing the acceptance in the mail, but then has second thoughts, and by a speedier form of communication contacts the offeror to reject the offer (and repudiate the acceptance)? Strict application of the mailbox rule of CC §1583 would indicate that the contract was formed immediately on deposit of the acceptance in the mail and that the purported rejection is ineffective. This result, however, is arguably inconsistent with the line of California cases holding that an unequivocal rejection of an offer, openly communicated by the offeree to the offeror, terminates the offer. See, *e.g., Guzman v Visalia Community Bank* (1999) 71 CA4th 1370, 1376, 84 CR2d 581 ("If the offeree's words or acts either indicate that the offeree is declining the offer or justify the offeror in so inferring, the offeree will be considered to have rejected the offer"). The issue does not appear to have been squarely addressed by a California court in a reported opinion to date.

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§4.30 3. Ratification (CC §1588)

Civil Code §1588 provides for ratification of a contract that is otherwise void for the lack of consent: "A contract which is voidable solely for want of due consent, may be ratified by a subsequent consent." Ratification is sometimes alleged to have occurred by a party's subsequent conduct. See §4.31. For example, in *BGJ Assocs., LLC v Wilson* (2003) 113 CA4th 1217, 7 CR3d 140, the court affirmed the trial court's finding that an oral joint venture agreement was voidable by reason of undue influence of one of the parties and that the plaintiff's conduct in conditionally tendering an initial capital contribution did not constitute a ratification of the proposed agreement. See also *Saret-Cook v Gilbert, Kelly, Crowley & Jennett* (1999) 74 CA4th 1211, 88 CR2d 732 (ratification by acceptance of benefits of agreement).

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F. Acceptance by Conduct

§4.31 1. Generally

The Civil Code recognizes that the existence of a contract may be implied from the conduct of the parties. Civil Code §1621 states that "[a]n implied contract is one, the existence and terms of which are manifested by conduct." Civil Code §1581 provides that a party's consent may be communicated by an "act or omission," and CC §1582 allows "any reasonable and usual mode" of acceptance unless the offer prescribes a specific manner of acceptance. Civil Code §1584 provides for acceptance by performance of conditions: "Performance of the conditions of a proposal, or the acceptance of the consideration offered with a proposal, is an acceptance of the proposal." See *Estate of Klauenberg* (1973) 32 CA3d 1067, 1070, 108 CR 669 (either executor's oral acceptance or his deposit of buyer's check and filing of verified return of sale constituted sufficient acceptance of buyer's offer).

NOTE: The Restatement (Second) of Contracts rule concerning acceptance by performance differs from the rule in CC §1584. Under the Restatement, an offer can be accepted by performance only if the offer expressly invites acceptance by performance. Restatement (Second) of Contracts §53(1) (1981). An express invitation is not required under the Civil Code.

Further, CC §1589 provides that an acceptance of the benefits of a contract constitutes an assumption of the obligations associated with it: "A voluntary acceptance of the benefit of a transaction is equivalent to a consent to all the obligations arising from it, so far as the facts are known, or ought to be known, to the person accepting." See *Melchior v New Line Prods., Inc.* (2003) 106 CA4th 779, 131 CR2d 347; *Norcal Mut. Ins. Co. v Newton* (2000) 84 CA4th 64, 100 CR2d 683. It is thus clear under California law that an offer may be accepted by conduct on the part of an offeree as well as by the offeree's words, unless the terms of the offer provide otherwise. See *Windsor Mills, Inc. v Collins & Aikman Corp.* (1972) 25 CA3d 987, 992, 101 CR 347; *Russell v. Union Oil Co.* (1970) 7 CA3d 110, 114, 86 CR 424.

In *Windsor Mills,* the court discussed one limit on the potential scope of an acceptance by conduct, as follows (25 CA3d at 992, citations omitted):

> [A]n offeree, knowing that an offer has been made to him but not knowing all of its terms, may be held to have accepted, by his conduct, whatever terms the offer contains.... However, when the offeree does not know that a proposal has been made to him this objective standard does not apply.... Hence, an offeree, regardless of apparent manifestation of his consent, is not bound by inconspicuous contractual provisions of which he was unaware, contained in a document whose contractual nature is not obvious.

The court in *Windsor Mills* found that the plaintiff had not accepted by conduct an agreement to arbitrate disputes under a supply contract, in effect holding that for an acceptance by conduct to be valid, it must be made with the offeree's knowledge; an acceptance by conduct will not be imputed to an offeree who is unaware that an offer has been made.

The issue of whether an offeree has accepted an offer by conduct has been presented in several cases involving the entertainment industry. See, *e.g., Desny v Wilder* (1956) 46 C2d 715, 299 P2d 257; *Melchior v New Line Prods., Inc.* (2003) 106 CA4th 779, 131 CR2d 347; *Gunther-Wahl Prods., Inc. v Mattel, Inc.* (2002) 104 CA4th 27, 128 CR2d 50. The facts of these cases are similar: Typically, the plaintiff has disclosed an idea for a television or motion picture production to the defendant, who has then proceeded to take and use the idea without compensating the plaintiff. Although the outcome of each case depends on the particular facts, and the decisions often result in remand for additional fact-finding, the courts have applied CC §1584 or §1589 to find an implied agreement to compensate the plaintiff. See, *e.g., Melchior v New Line Prods., Inc.*, *supra*; *Mann v Columbia Pictures, Inc.* (1982) 128 CA3d 628, 180 CR 522; *Blaustein v Burton* (1970) 9 CA3d 161, 88 CR 319.

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§4.32 2. Silence

As a general rule, silence or inaction in the face of an offer will not constitute acceptance of the offer. *Southern Cal. Acoustics Co. v C.V. Holder, Inc.* (1969) 71 C2d 719, 722, 79 CR 319; *Golden Eagle Ins. Co. v Foremost Ins. Co.* (1993) 20 CA4th 1372, 1385, 25 CR2d 242. See also *Circuit City Stores, Inc. v Najd* (9th Cir 2002) 294 F3d 1104, 1109. Nonetheless, several exceptions to this rule have been acknowledged by California courts:

- An acceptance by silence may be inferred if the offeree is under a duty to act, as for example, under CC §1589 (discussed in §4.31), which provides that acceptance of the benefits of a contract constitutes an assumption of the associated obligations. See *Golden Eagle Ins. Co. v Foremost Ins. Co.*, *supra*. The court in *Golden Eagle* noted that an insurance company's silence coupled with its retention of a policy renewal may be sufficient evidence of acceptance to place the renewal policy in full force. See also *Durgin v Kaplan* (1968) 68 C2d 81, 90, 65 CR 158, where the court noted that "a party will not be permitted to receive and enjoy benefits that he knows are being offered to him at a price without paying for them, if he had an opportunity to reject them when they were offered without any expense or material inconvenience. Silence may here consummate his acceptance because the facts fairly call upon him to speak." 68 C2d at 91 (citations omitted).
- Silence may constitute an acceptance if there is a relationship between the parties or a previous course of dealing by which silence should be understood as acceptance. *Southern Cal. Acoustics Co. v C.V. Holder, Inc.* (1969) 71 C2d 719, 722, 79 CR 319. See also *Circuit City Stores, Inc. v Najd* (9th Cir 2002) 294 F3d 1104, 1109; *Beatty Safway Scaffold, Inc. v Skrable* (1960) 180 CA2d 650, 4 CR 543.
- Silence may operate as an acceptance under the rule stated in Restatement (Second) of Contracts §69(1)(b): "Where the offeror has stated or given the offeree reason to understand that assent may be manifested by silence or inaction, and the offeree in remaining silent and inactive intends to accept the offer." See *Golden Eagle Ins. Co. v Foremost Ins. Co.* (1993) 20 CA4th 1372, 1385, 25 CR2d 242. Conversely, if the offeror has given the offeree reason to believe that the offeree's inaction will constitute acceptance, the offeror cannot reverse its position later and argue the offeree's inaction did *not* constitute an acceptance. 20 CA4th at 1387.

In the absence of special circumstances, however, an offeror cannot unilaterally impose silence as acceptance, *e.g.,* by stating in the offer that failure to respond within 10 days shall constitute acceptance. "[A] party cannot bind another to a contract simply by so reciting in a piece of paper." *Mitsui O.S.K. Lines, Ltd. v Dynasea Corp.* (1999) 72 CA4th 208, 212, 85 CR2d 1. See also *Sorg v Fred Weisz & Assocs.* (1970) 14 CA3d 78, 81, 91 CR 918 ("The tactic of attempting to create a contract by a letter stating a price, on the theory that silence and inaction would constitute an acceptance, has been consistently rejected by the courts"). The offeror may be the master of his or her offer, but not the acceptance.

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§4.33 3. Unsolicited Sending of Merchandise (CC §§1584.5-1584.6)

The Civil Code includes two consumer protection statutes, CC §§1584.5-1584.6, clarifying that a person is not obligated to pay for merchandise that he or she receives, but has not actually ordered or requested—thus negating any implication that the recipient accepts the merchandise by silence or inaction. Civil Code §1584.5 prohibits any person or entity from offering to sell goods by sending them on a voluntary and unsolicited basis to individuals who have not ordered them. The statute deems the receipt of any such merchandise an unconditional gift to the recipient, who may dispose of it in any manner without obligation to the sender, and gives the recipient the right to get an injunction (and attorney fees and costs) if the sender persists in sending billing statements to the recipient for the unsolicited merchandise. The statute includes exceptions for certain qualifying contractual arrangements under which the seller gives the consumer a form that the consumer may use to instruct the seller not to ship the merchandise. Civil Code §1584.6 provides similar protections to consumers who have terminated their membership in an organization that makes retail sales of merchandise to its members.

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§4.34 G. Implied-in-Fact Contracts (CC §1621)

Conduct of the parties. As discussed in §4.31, a valid acceptance can be implied from the conduct of the offeree. Civil Code §1621, however, which defines an implied contract as one "the existence and terms of which are manifested by conduct," is not limited in application to acceptances by conduct. Under CC §1621, an implied contract may be formed not only based on the offeree's conduct, but also based on the conduct of the offeror. As the court of appeal in *Mitsui O.S.K. Lines, Ltd. v Dynasea Corp.* (1999) 72 CA4th 208, 212, 85 CR2d 1, stated, "[a]n implied contract is one evidenced *in part or whole* by the parties' conduct rather than by an express exchange of promises" (emphasis supplied). An implied contract is one that arises from the parties' mutual agreement and intent when the parties' mutual promises have not been expressed in words. *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 4 CR3d 583. In *Scott v PG&E* (1995) 11 C4th 454, 463, 46 CR2d 427, citing *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 679, 254 CR 211, the California Supreme Court stated: "The recognition of implied-in-fact contract provisions is part of the modern trend in contract law to reverse 'the common law presumption that the parties' writing and the official law of contract are the definitive elements of the agreement. Evidence derived from experience and practice can now trigger the incorporation of additional, implied terms.'" It is important to note, however, that such an implied contract will not supersede the terms of an express agreement between the parties. *Falkowski v Imation Corp.* (2005) 132 CA4th 499, 518, 33 CR3d 724.

NOTE: Implied contracts under CC §1621 are also referred to as implied-in-fact contracts. See, *e.g., Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 850, 89 CR2d 540. Implied-in-fact contracts, however, must be distinguished from contracts implied in law, also referred to as quasi-contracts, which arise under the law of restitution as a remedy against unjust enrichment. Implied-in-law contracts are created without regard to the parties' intentions, and are technically not contracts at all. *McBride v Boughton* (2004) 123 CA4th 379, 388, 20 CR3d 115. See also *Blue Ridge Ins. Co. v Jacobsen* (2001) 25 C4th 489, 501, 106 CR2d 535. Implied-at-law contracts are discussed in §§11.66-11.70.

Manner of proof. The distinction between express and implied-in-fact contracts does not refer to a difference in legal effect, but rather only to the manner in which the parties have manifested their assent. The parties' express or apparent assent may be shown by their words or other conduct, or by circumstances such course of dealing, usage of trade, or course of performance. *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 850, 89 CR2d 540, citing Restatement (Second) of Contracts §4, Comment a (1981). The basic difference between an implied contract and an express contract lies in the manner of proof of the contract's existence and terms. The terms of an express contract are manifested by the parties' words, while the terms of an implied contract are shown by their conduct. *Youngman v Nevada Irrig. Dist.* (1969) 70 C2d 240, 246, 74 CR 398; *Friedman v Friedman* (1993) 20 CA4th 876, 887, 24 CR2d 892. For example, an implied contract may be found based on a course of conduct such as distributing products for a producer for many years (see *Varni Bros. Corp. v Wine World, Inc.* (1995) 35 CA4th 880, 41 CR2d 740) or an announced practice of increasing wages (*Youngman v Nevada Irrigation Dist.*, *supra*). Courts normally attempt to enforce the parties' actual understandings, and may examine the conduct of the parties to determine whether some terms of the contract should be implied from the circumstances. "[It] must be determined, as a question of fact, whether the parties acted in such a manner as to provide the necessary foundation for [an implied contract], and evidence may be introduced to rebut the inferences and show that there is another explanation for the conduct.... Such implied-in-fact contract terms ordinarily stand on equal footing with express terms." *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 677, 254 CR 211 (citations omitted).

Employment termination cases. The question whether the conduct of the parties has created an implied-in-fact agreement arises often in employment termination cases. The factual issue is whether an employer's course of conduct has created an implied contract not to terminate the plaintiff-employee without good cause, thus overcoming the presumption in Lab C §2922 that employment for an indefinite period is terminable at will. See, *e.g., Scott v PG&E* (1995) 11 C4th 454, 46 CR2d 427; *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211; *Binder v Aetna Life*

Ins. Co. (1999) 75 CA4th 832, 89 CR2d 540. In these cases, the courts will not limit their inquiry to the express agreements between the employer and employee, but also will examine the employer's human resources policies, personnel manuals, practices, and communications over the course of the employment relationship. "Enforceable expectations of employment security may also be inferred from the 'actions or communications by the employer reflecting assurances of continued employment,' as well as from other relevant circumstances such as longevity of service and industry practice." *Scott,* 11 C4th at 463, citing *Foley,* 47 C3d 654 at 680.

Continued performance. Another example of an implied contract is when parties continue to perform as they did under an express contract after the contract expires. In such a case, the court may conclude that a valid contract exists, having the same terms as the expired contract. See *U. S. ex rel Oliver v Parsons Co.* (9th Cir 1999) 195 F3d 457.

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§4.35 H. Rejection of Offers

An offer terminates if the offeree unequivocally rejects the offer and communicates that rejection to the offeror. After having done so, the offeree cannot then purport to accept the offer and create a binding contract. *Guzman v Visalia Community Bank* (1999) 71 CA4th 1370, 1376, 84 CR2d 581; *Beverly Way Assocs. v Barham* (1990) 226 CA3d 49, 55, 276 CR 240. Even in the absence of an unequivocal rejection, however, an offeree's manifestation of intent not to accept an offer may operate to terminate it. See Restatement (Second) of Contracts §38 (1981). If the offeree's actions or words indicate that the offeree is declining the offer (or justify the offeror in so concluding), the offeree will be deemed to have rejected the offer. *Guzman v Visalia Community Bank*, *supra*. See also *Born v Koop* (1962) 19 CR 379, 200 CA2d 519 (counteroffer constitutes rejection of previous offer).

The interpretation of a purported rejection is a question of fact. Like an acceptance (see §4.22), the test for an effective rejection is objective. The question is not what the offeree thought his or her words or conduct meant or were intended to mean. Instead, the test is what a reasonable person in the parties' position would have thought it meant. *Guzman v Visalia Community Bank*, *supra*.

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III. FORMATION OF CONTRACTS FOR SALE OR LEASE OF GOODS

§4.36 A. Formation Generally (Com C §§2204, 10204)

The rules governing formation of contracts for the sale of goods under the Uniform Commercial Code are intended to facilitate the ability of the parties to consummate purchase and sale transactions efficiently without need to comply with many complex legal formalities. This goal is reflected in Com C §2204(1), which provides that "[a] contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." See also Com C §10204(a) (corresponding rule for leases of goods). Commercial Code §2204(1) is thus consistent with the objective theory of contract (see §3.4) and CC §1621, which validates contracts implied in fact (see §4.34). Further, Com C §2204(2) provides that "[a]n agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined."

Even if one or more contract terms are left open, a contract for the sale of goods will not fail for indefiniteness if the parties intended to make a contract and a court has a reasonably certain basis for fashioning an appropriate remedy. Com C §2204(3). A substantially identical rule applies to formation of personal property lease agreements. See Com C §10204. Note that, under Com C §2204(3), mutual assent or a meeting of the minds on all essential terms is not required to form a contract, but rather only the parties' intent to make a contract, as long as there is a reasonably certain basis for granting a remedy. Official Comment to UCC §2-204. See *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 141 CR 157. For example, in *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636, when a buyer received a seller's price list and product description and contacted the seller by telephone, placing a specific order at a specific price for delivery on a certain schedule, the contract was formed when the order was placed and accepted. The terms stated in the buyer's purchase order were not discussed during the telephone call, and therefore were not part of the contract.

As stated in the Official Comment to former UCC §2-204:

> The test is not certainty as to what the parties were to do nor as to the exact amount of damages due the plaintiff. Nor is the fact that one or more terms are left to be agreed upon enough of itself to defeat an otherwise adequate agreement. Rather, commercial standards on the point of "indefiniteness" are intended to be applied, [the UCC] making provision elsewhere for missing terms needed for performance, open price, remedies and the like.

(See also Official Comment 3 to UCC §2-204 (2003)). Thus, a court may enforce a contract for the sale of goods despite missing terms. *Steiner v Mobil Oil Corp.* (1977) 20 C3d 90, 141 CR 157. The court need only make two findings: (1) that there is "some basis for concluding that the parties engaged in a process of offer and acceptance, rather than inconclusive negotiations," and (2) that the court has "sufficient information about the parties' incomplete transaction to apply the provisions of the California Uniform Commercial Code which fill in the gaps in parties' contracts." 20 C3d at 104. The gap-filling rules in the Commercial Code are discussed in §§5.56-5.69.

For more extensive discussion of formation issues regarding contracts for the sale or lease of goods, see California UCC Sales and Leases, chaps 2, 19 (Cal CEB 2002).

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§4.37 B. Manner of Acceptance (Com C §§2206, 10206)

Acceptance of an offer to buy or sell goods is governed by Com C §2206:

> (1) Unless otherwise unambiguously indicated by the language or circumstances:
> (a) An offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances;
> (b) An order or other offer to buy goods for prompt or current shipment shall be construed as inviting acceptance either by a prompt promise to ship or by the prompt or current shipment of conforming or nonconforming goods, but such a shipment of nonconforming goods does not constitute an acceptance if the seller seasonably notifies the buyer that the shipment is offered only as an accommodation to the buyer.
> (2) Where the beginning of a requested performance is a reasonable mode of acceptance an offeror who is not notified of acceptance within a reasonable time may treat the offer as having lapsed before acceptance.

The parallel rule for acceptances of offers to lease goods is set forth in Com C §10206. Commercial Code §2206(1)(a) is consistent with CC §1582 (which permits any "reasonable and usual" manner of acceptance unless otherwise required by the offeror) and rejects any artificial notion that only one mode of acceptance is envisioned by an offer. See Official Comment 2 to UCC §2-206. Under Com C §2206(2), an offeree who wishes to accept by beginning performance must do so by unambiguous conduct and must notify the offeror in due course. Official Comment 3 to UCC §2-206.

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§4.38 C. Nonconforming Acceptance (Com C §2207)

Commercial Code §2207 is intended to resolve the conflict created by a written acceptance that includes additional or different contract terms than the offer—the infamous "battle of the forms." Under Com C §2207(1):

> A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.

This section permits a nonconforming acceptance to be effective as an acceptance of the original terms of the offer, without the nonconforming terms, unless the acceptance expressly states that it is conditional on the offeror's assent to the nonconforming terms. Thus, for purposes of formation of contracts for the sale of goods, Com C §2207(1) rejects the common law "mirror-image" rule, codified in CC §1585, which requires an acceptance to mirror exactly the terms of an offer. See §4.23.

NOTE: The mirror-image rule of CC §1585 still applies to contracts not subject to the Commercial Code. See §4.23.

Under the mirror-image rule, a purported acceptance that differs from the offer is treated as a new proposal or counteroffer, which terminates the original offer. In contrast, under Com C §2207(1)-(2), only the additional terms are treated as a counteroffer. If the contract is between merchants, the additional terms actually become part of the contract unless (Com C §2207(2)):

- The offer expressly limits acceptance to the terms of the offer;
- The additional terms materially alter the offer; or
- Notification of objection to the additional terms has already been given or is given within a reasonable time after notice of them is received.

See, *e.g.*, *Lockheed Elec. Co., Inc. v Keronix, Inc.* (1981) 114 CA3d 304, 313, 170 CR 591, a classic "battle of the forms" case, in which the court found that one party's repeated insistence that its deliveries were subject to the additional "boilerplate" terms of its form was no more an adoption of those terms by the parties' joint course of dealing than was the other party's repeated insistence that its own form's boilerplate applied.

By operation of Com C §2207(3), however, even if the offeree's acceptance is made conditional on the offeror's consent to additional terms proposed by the offeree and the offeror does not consent to those terms, the existence of a contract for the sale of goods may nonetheless be inferred from the parties' conduct. In this case, the terms of the contract consist of those terms on which the parties' writings agree, plus any additional or supplementary terms incorporated into the contract through other provisions of the Commercial Code. See Com C §2207(3). The additional or supplementary terms may be derived from the parties' course of dealing. See Com C §1303(b) (former Com C §1205(1)). As the court in *Transwestern Pipeline Co. v Monsanto Co.* (1996) 46 CA4th 502, 515, 53 CR2d 887, stated:

> The governing rule is that one party should not be able to impose its terms and conditions on the other simply because it fired the last shot in the battle of forms. "Instead, all of the terms on which the parties' forms do not agree drop out, and the [Uniform Commercial Code] supplies the missing terms."

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IV. FORMALITIES

§4.39 A. Generally

Every contract requires mutual assent or consent (see §§3.2-3.3), and consent must be communicated to be effective (see §3.5). Contractual formalities generally operate to signify and confirm the parties' mutual consent to their agreement and are important for evidentiary purposes, in proving the existence of the contract.

In California, the use of seals has been abolished by statute. CC §1629; CCP §1932. Further, unless a contract affects real property and is intended to be recorded (see CC §1170), contracts need not be notarized to be effective; the execution of a contract may be proved in other ways described in the Civil Code. See CC §§1195, 1198.

Ordinarily, the parties' signatures on a written document that on its face is a contract signify their assent to all its terms. *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645. Signatures are discussed generally in §4.40. Under recent federal and state legislation, the parties' signatures may be electronic. See §§4.53-4.65. An unsigned written agreement, however, may be enforceable if the parties orally agreed to the written terms with the intent that the oral agreement should become binding. *Magness Petroleum Co. v Warren Resources of Cal., Inc.* (2002) 103 CA4th 901, 910, 127 CR2d 159. See also CC §3388 (when unsigned contract entitled to specific performance) and the discussion of oral agreements in §4.41. In like manner, an agreement written on a scrap of paper may be enforceable if it contains the essential terms of the parties' agreement and they intend to be bound. *Levin v Knight* (9th Cir 1996) 780 F2d 786.

Handshakes are significant, but may or may not indicate the parties' agreement. A handshake following negotiations does not necessarily mean that the parties have entered into a binding contract. It may be simply a gesture of friendship, indicating the absence of ill-will after a hard day's bargaining session. *Rennick v O.P.T.I.O.N. Care, Inc.* (9th Cir 1996) 77 F3d 309, cert denied (1996) 519 US 865.

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§4.40 B. Signatures (CC §14; Com C §1201(b)(37))

What constitutes a signature? A party's signature may take many forms. Under CC §14, a signature may include a party's mark under the following conditions:

> when the person cannot write, his name being written near it, by a person who writes his own name as a witness; provided, that when a signature is by mark it must in order that the same may be acknowledged or may serve as the signature to any sworn statement be witnessed by two persons who must subscribe their own names as witnesses thereto.

Under the Commercial Code, the term "signed" is defined to include "any symbol executed or adopted with present intention to adopt or accept a writing." Com C §1201(b)(37) (former Com C §1201(38)). Division 9, governing secured transactions, defines "authenticate" broadly to include not only signing, but also "[t]o execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record." Com C §9102(a)(7). Moreover, recent federal and state legislation expressly validates electronic signatures. Electronic contracting is discussed in §§4.53-4.65.

In *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807, the California Supreme Court held that a printed name of a company in an advertisement served as a "signature" so that the ad operated as an "offer" to readers of the ad.

Effect of signature. If it is clear from a provision in a proposed written contract (as well as any other evidence presented) that both parties intended that acceptance of the contract's terms would be signified only by the parties' signatures, a failure to sign the agreement means that no binding contract was created. *Basura v U.S. Home Corp.* (2002) 98 CA4th 1205, 1215, 120 CR2d 328; *Banner Entertainment, Inc. v Superior Court* (1998) 62 CA4th 348, 358, 72 CR2d 598. This is the rule even if the party later sought to be bound indicated that he or she was willing to sign the agreement. In contrast, if the parties orally agree on all of the terms of a proposed written contract with the mutual intent that the oral agreement will be binding, the mere fact that the formal written contract has not yet been signed does not alter the validity of the oral agreement. *Basura,* 98 CA4th at 1215. For further discussion of oral agreements, see §4.41.

NOTE: Corporate officers and other agents should clearly indicate that they are signing in a representative capacity, to avoid possible personal liability. See Com C §3402; Prob C §18000; *Home Fed. Sav. & Loan Ass'n v Ramos* (1991) 229 CA3d 1609, 284 CR 1.

Signature pages. Signing a signature page of a contract and delivering it to the other party normally signifies agreement. In *Kyocera Corp. v Prudential-Bache Trade Servs.* (9th Cir 2002) 299 F3d 769, 781, vacated on other grounds (9th Cir 2003) 341 F3d 987, the plaintiff's execution of a signature page of a contract that included a clause the plaintiff had previously rejected, and delivery of the signature page to the defendant's counsel, resulted in formation of contract. The court found that the plaintiff had constructive knowledge of the clause at issue but failed to object before signing. In *Ellefson v Megadeth, Inc.* (SD NY Jan. 13, 2005, No. 04 Civ 5395 (NRB)) 2005 US Dist Lexis 545 (applying California law), the court held that by faxing a signed signature page to an undisputed execution version of the agreement, the plaintiff indicated his willingness to be bound by its terms, rather than (as he later claimed) a desire to continue negotiations.

Signature by one party only. Several California cases have held that the receipt and acceptance by one party of a writing signed only by the other party, and purporting to embody all terms of an agreement between the two, binds the party accepting the document as well as the signer to its terms. *E.O.C. Ord, Inc. v Kovakovich* (1988) 200 CA3d 1194, 1199, 246 CR 456; *Bank of America v Security Pac. Nat'l Bank* (1972), 23 CA3d 638, 100 CR 438; *Benard v Walkup* (1969), 272 CA2d 595 77 CR 544. In such cases, the nonsigning party's acceptance of the contract is established by facts and circumstances other than that party's signature. For example, in *VHB Assocs., Inc. v Orix Real Estate Equities* (CD Cal, Sept. 3, 2002, No. CV 02-4710 JFW (RNBx)) 2002 US Dist Lexis 17569, the court found that the defendant's consent to the agreement was evidenced by its preparation of the document, its delivery of the document to the plaintiffs, its statement to the defendants that it would sign the agreement, and its offer to perform. See also *James De*

Nicholas Assocs. v Heritage Constr. Corp. (1970) 5 CA3d 421, 425, 85 CR 233 (defendant's acceptance of contract terms shown by defendant's preparation of agreement); *Kaneko v Okuda* (1961) 195 CA2d 217, 225, 15 CR 792 (fact that contract for sale of stock owned by defendants was not signed by one defendant did not serve to release other defendants from their obligations when contract made defendants' obligations joint and several and each party would receive some benefit from consideration to be paid by buyer); CC §3388 (party who has signed written contract may be compelled to specifically perform it even if other party has not signed it).

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§4.41 C. Oral Contracts (CC §1622)

The Civil Code expressly authorizes oral contracts, except those specifically required by statute to be in writing. CC §1622. An oral contract is one in which the parties' undertakings are expressed in words, but the words have not been reduced to writing. As such, it is distinguishable from a contract implied in fact, which is not expressed in words but rather is implied from the conduct of the parties. *Firchau v Diamond Nat'l Corp.* (9th Cir 1965) 345 F2d 269. For further discussion of implied-in-fact contracts, see §4.34. In the absence of a statutory requirement, "an oral agreement reached by the parties is binding unless it is clear that the parties intend that the agreement is not to be effective until reduced to writing." *Empire Steel Bldgs. Co. v Harvey Mach. Co.* (1954) 122 CA2d 411, 415, 265 P2d 32. Thus, the issues raised in the context of an oral contract are (1) whether the contract is one required by the statute of frauds (see §§4.43-4.47) or another statute to be in writing and (2) whether the parties have actually manifested their assent orally to the contract terms or are still negotiating (see §4.4).

The second issue is strictly an evidentiary question, dependent on the facts and circumstances. See *Rennick v O.P.T.I.O.N. Care, Inc.* (9th Cir 1996) 77 F3d 309, cert denied (1996) 519 US 865. As stated by the court in *Elyaoudayan v Hoffman* (2003) 104 CA4th 1421, 1430, 129 CR2d 41 (citations omitted):

> Whether [an oral agreement] constitutes a final agreement or merely an agreement to make an agreement depends primarily upon the intention of the parties. In the absence of ambiguity this must be determined by a construction of the [oral agreement] as a whole.… [If] the [oral agreement] at issue shows "no more than an intent to further reduce the [oral agreement] to a more formal [written] one" the failure to follow it with a more formal writing does not negate the existence of the prior [oral] contract.… However, where the [oral agreement] shows it was not intended to be binding until a formal written contract is executed, there is no contract.

See also *Harris v Rudin, Richman & Appel* (1999) 74 CA4th 299, 87 CR2d 822. The parties' negotiations may result in an enforceable oral contract if all of the contract terms are understood, even though the parties intend to execute a more formal written contract later on. *Khajavi v Feather River Anesthesia Med. Group* (2000) 84 CA4th 32, 100 CR2d 627. In *Stephan v Maloof* (1969) 274 CA2d 843, 79 CR 461, the court enforced an oral agreement to construct a shopping center when all of the material terms and conditions had been agreed on, although they were never reduced to writing.

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§4.42 D. Approval by Third Parties

Contracts are sometimes executed with the understanding that they will not become effective until they receive the approval of a third party. Under CC §1585 (the mirror-image rule; see §4.23), such an acceptance—one conditional on third party approval—amounts to a counteroffer, and does not create a binding agreement until the condition is fulfilled. In *Converse v Fong* (1984) 159 CA3d 86, 91, 205 CR 242, the defendant's acceptance of the plaintiffs' offer was not absolute, but was made expressly contingent on approval of certain third persons. The court ruled that by making acceptance subject to the approval of others, the defendant introduced a new term into the agreement, and there was no binding contract until the defendant received the approvals from the other persons. See also *Santa Clara-San Benito Chapter of Nat'l Elec. Contractors' Ass'n v Local Union No. 332* (1974) 40 CA3d 431, 436, 114 CR 909 (contract made by local union ineffective until approved by international union).

The same principle applies to agreements that are made subject to the approval of a corporation's board of directors. In *Rennick v O.P.T.I.O.N. Care, Inc.* (9th Cir 1996) 77 F3d 309, 314, cert denied (1996) 519 US 865, a letter of intent conditioned formation of the contract on board approval. The court held that no contract was formed without that approval, even though there were other manifestations of a willingness to enter into a bargain. As illustrated by *Jacobs v Tenneco W., Inc.* (1986) 186 CA3d 1413, 231 CR 351, however, the party subject to the board approval requirement has a good faith obligation to seek approval from the board, and the condition of board approval may be excused and the contract enforced if that party fails to do so. See also *Jacobs v Freeman* (1980) 104 CA3d 177, 163 CR 680.

NOTE: Corporations Code §313 provides that contracts bearing the signatures of two corporate officers from specified categories cannot be invalidated by the corporation for lack of authority if the other party did not have actual knowledge that the officers had no authority to execute the agreement. For further discussion of Corp C §313, see §2.69.

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Source: Business Law/California Law of Contracts/4 Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting/§4.43 E. Consent of Spouse or Domestic Partner (Fam C §§297.5, 1100, 1102; Corp C §25246)

§4.43 E. Consent of Spouse or Domestic Partner (Fam C §§297.5, 1100, 1102; Corp C §25246)

If a contract concerning real or personal property is entered into by an individual who is married or who is a partner of a registered California domestic partnership (see Fam C §§297-299.6), the individual's spouse or domestic partner may or may not be required to join in or consent to the agreement, depending on the type of property involved. For spouses, the issue is controlled by Fam C §§1100 and 1102 (as well as Corp C §25246), and these provisions are equally applicable to registered domestic partners by operation of Fam C §297.5. Under Fam C §1100(e), each spouse has a fiduciary duty to the other spouse in the management and control of their community assets and liabilities.

- **Community personal property.** Family Code §1100(c) prohibits a spouse from selling, conveying, or encumbering community personal property "used as the family dwelling, or the furniture, furnishings, or fittings of the home, or the clothing or wearing apparel of the other spouse or minor children which is community personal property" without the other spouse's written consent.
- **Community business property.** A spouse who is operating or managing a business (or an interest in a business) that is all or substantially all community personal property may act alone in all transactions, but must give prior written notice to the other spouse of "any sale, lease, exchange, encumbrance, or other disposition of all or substantially all of the personal property used in the operation of the business"—regardless how the property is titled. Fam C §1100(d). Any disposition of less than "substantially all" of the personal property used in the business presumably does not require notice to the other spouse. If the required notice is not given, the other spouse has the remedies set forth in Fam C §1101 (including, *e.g.,* a right to an accounting), but the validity of the transaction or of any interest transferred is not affected. Fam C §1100(d).
- **Securities.** Corp C §25246 (a criminal statute) makes it unlawful for any broker-dealer or agent to require, as a condition to the purchase or sale of securities in the name of a married person, that the prior consent or authorization of the spouse of that person be obtained. The term "broker-dealer" is broadly defined in Corp C §25004(a) to draw in issuers of securities.
- **Community real property.** Both spouses (either personally or through an authorized agent) are required to join in execution of any instrument by which community real property is sold, conveyed, or encumbered, or is leased for longer than 1 year. Fam C §1102(a).

Notwithstanding this general rule, conveyances by one spouse alone of property titled in the name of that spouse to a lessee, purchaser, or encumbrancer acting in good faith without knowledge of the marriage relationship are presumed valid. Fam C §1102(c)(2). Any action to set aside a conveyance executed by one spouse alone must be commenced within one year after recordation of the conveyance. Fam C §1102(d). For sample forms of spousal consent, see Drafting Business Contracts: Principles, Techniques & Forms, chap 18 (Cal CEB 1994).

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F. Statute of Frauds

1. Civil Code Statutes of Fraud

§4.44 a. Civil Code §1624(a)

California's main statute of frauds is found in CC §1624(a), and renders invalid the following types of contracts unless they (or a note or memorandum thereof) are in writing and signed by the party to be charged (or that party's agent):

- A contract that by its terms is not to be performed within a year from its effective date (CC §1624(a)(1));
- A promise to answer for a debt of another (except in certain cases detailed in CC §2794) (CC §1624(a)(2));
- An agreement for the lease for more than one year or for the sale of real property or an interest therein (CC §1624(a)(3));
- If such an agreement is signed by an agent on behalf of the party to be charged, the agency agreement must also be in writing and signed by the party to be charged (CC §1624(a)(3));
- An agreement, involving compensation or a commission, to authorize or employ an agent, broker, or other person to purchase or sell real estate, or to lease real estate for longer than 1 year, or to find a purchaser or seller of real estate or a lessee or lessor of real estate if the lease is for longer than 1 year (CC §1624(a)(4));
- An agreement that by its terms is not to be performed within the lifetime of the promisor (CC §1624(a)(5));
- An agreement to pay a debt secured by a mortgage or deed of trust on real property (CC §1624(a)(6));
- A contract to loan money or extend credit in an amount over $100,000, not primarily for personal, family, or household purposes, made by a person in the business of lending or extending credit (CC §1624(a)(7)).
- For purposes of CC §1624(a)(7), a contract to loan money secured solely by residential real estate consisting of 1 to 4 units is deemed to be for personal, family, or household purposes.

Civil Code §1624(b) includes an express exception for "qualified financial contracts," covering sophisticated money market transactions, interest and currency swaps, index options, commodity futures, and the like, provided there is sufficient electronic or written evidence that a contract was made. Further, CC §1624(c) expressly excepts lease transactions subject to Division 10 of the Commercial Code.

The sole purpose of the statute of frauds is to prevent perjured testimony in proof of important types of contracts; hence, the statute applies only to the types of contracts enumerated. *Sterling v Taylor* (2007) 40 C4th 757, 766, 55 CR3d 116; *Casa Herrera, Inc. v Beydoun* (2004) 32 C4th 336, 9 CR3d 97.

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Source: Business Law/California Law of Contracts/4 Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting/§4.45 b. Certain Contracts for Sale of Personal Property (CC §1624.5)

§4.45 b. Certain Contracts for Sale of Personal Property (CC §1624.5)

Civil Code §1624.5, added to the Civil Code as of January 1, 2007, is another statute of frauds applicable to certain non-Commercial Code contracts for the sale of personal property having a value of over $5000. By reference to the Uniform Electronic Transactions Act (UETA) (CC §§1633.1-1633.17), it validates contracts that are formed electronically. Electronic contracting is discussed further in §§4.54-4.66. Civil Code §1624.5(a) provides that, with specified exceptions,

> a contract for the sale of personal property is not enforceable by way of action or defense beyond five thousand dollars ($5,000) in amount or value of remedy unless there is some record, as defined in subdivision (m) of Section 1633.2, but solely to the extent permitted by applicable law, that indicates that a contract for sale has been made between the parties at a defined or stated price, reasonably identifies the subject matter, and is signed, including by way of electronic signature, as defined in subdivision (h) of Section 1633.2, but solely to the extent permitted by applicable law, by the party against whom enforcement is sought or by his or her authorized agent.

The term "record" is defined in CC §1633.2(m) to mean "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." "Electronic signature" is defined in CC §1633.2(h) as "an electronic sound, symbol, or process attached to or logically associated with an electronic record and executed or adopted by a person with the intent to sign the electronic record." See CC §1633.2 for other pertinent definitions.

Civil Code §1624.5 does not apply to contracts governed by the Commercial Code, including contracts for the sale of goods or securities, and security agreements. The statute also does not apply to certain "qualified financial contracts" as defined in CC §1624(b)(2) if certain specified conditions are met. CC §1624.5(b).

NOTE: Civil Code §1624.5 replaced former Com C §1206, which was repealed effective January 1, 2007.

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§4.46 c. Other Types of Contracts

As a general rule, partnership or joint venture agreements are not subject to the statute of frauds and need not be in writing (see Corp C §16101(10)), but an agreement between partners that transfers title to real estate is, and must satisfy the statute of frauds. *Kaljian v Menezes* (1995) 36 CA4th 573, 584, 42 CR2d 510.

Oral employment agreements of indefinite duration, which may be terminated at will or for cause at any time by one or both parties, are not subject to the statute of frauds, because they can be performed within 1 year (even if they actually last longer). *Abeyta v Superior Court* (1993) 17 CA4th 1037, 21 CR2d 680; *Jenkins v Family Health Program* (1989) 214 CA3d 440, 262 CR 798. If, however, an alleged oral employment agreement is for a specified duration of longer than 1 year, it is subject to the statute of frauds and is not enforceable. *Oracle Corp. v Falotti* (ND Cal 2001) 187 F Supp 2d 1184, aff'd (9th Cir 2003) 319 F3d 1106 (employment for at least 16 months); *Pfeifer v U.S. Shoe Corp.* (CD Cal 1987) 676 F Supp 969 (employment until age 65).

Contracts to make a will are subject to a special statute of frauds found in the Probate Code. See Prob C §21700. Agreements between spouses are also subject to a special statute of frauds in Fam C §852, which requires any agreement that effects a transmutation of real or personal property between spouses to be expressly made in writing and to be joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected. Otherwise, the agreement is invalid.

NOTE: Any agreement to enter into a contract that is subject to the statute of frauds is also within the statute of frauds and must be committed to writing. *Byrne v Laura* (1997) 52 CA4th 1054, 60 CR2d 908. In effect, independent of the parol evidence rule (see §5.33-5.43), the statute of frauds requires that a contract subject to it not be a product of parol evidence. "[The] parol evidence [rule] is a principle of substantive law; the statute of frauds is designed to prevent perjury and fraud." *Marriage of Shaban* (2001) 88 CA4th 398, 404, 105 CR2d 863. Thus, although parol evidence may be admitted to interpret a term used in a contract or to prove additional terms, the essential terms of a contract subject to the statute of frauds cannot be *established* by parol evidence. Rather, they must be found in a written memorandum or contract signed by the party against whom enforcement is sought. *Sterling v Taylor* (2007) 40 C4th 757, 767, 55 CR3d 116.

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§4.47 2. Commercial Code Statutes of Frauds (Com C §2201)

The general statute of frauds for contracts for the sale of goods requires a writing, "sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his or her authorized agent or broker," if the contract price is $500 or more. If the writing incorrectly states an agreed term, the contract is still enforceable, but only to the extent of the quantity of goods set forth in the writing. Com C §2201(1). Oral contracts between merchants are enforceable if confirmed within a reasonable time by a writing sufficient against the sender unless the recipient gives written notice of objection to its contents within 10 days after it is received. Com C §2201(2). Commercial Code §2201(3) allows contracts that do not satisfy the requirements of Com C §2201(1) but that are valid in other respects to be enforced in the following general situations:

- If the goods are to be specially manufactured for the buyer and the seller has made either a substantial beginning of their manufacture or commitments for their procurement;
- If the party against whom enforcement is sought admits in court that a contract was made, but the contract is only enforceable to the extent of the quantity of goods admitted; or
- With respect to goods for which payment has been accepted or which have been received and accepted.

For further discussion of Com C §2201, see California UCC Sales and Leases, chap 7 (Cal CEB 2002).

Contracts for the purchase and sale of investment securities under Com C §8113, like qualified financial contracts under CC §1624(b), need not be in writing to be enforceable, even if the contract is incapable of being performed within 1 year.

Commercial Code §9203(b), which is equivalent to a statute of frauds for secured transactions, is discussed in Secured Transactions in California Commercial Law Practice, chap 2 (2d ed Cal CEB 2001). The statute of frauds for leases of goods is found in Com C §10201. In general, commercial leases providing for rental payments totaling more than $1000 must be in writing, signed by the lessor (or the lessor's agent), with a sufficient description of the leased goods and the lease term. Com C §10201(a).

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§4.48 3. Requirement of Written Contract

In general, the statute of frauds requires either a written contract or a note or memorandum signed by the party to be charged. Because the statute of frauds mainly serves to prove that a contract exists, it is only necessary that the writing mention the essential terms of the parties' agreement. Any ambiguities usually can be resolved by extrinsic evidence, which constitutes a reliable indicator of the parties' intent in commercial or other arm's length transactions. *Marriage of Benson* (2005) 36 C4th 1096, 1108, 32 CR3d 471. The writing must contain the essential elements of the agreement, and what is essential depends on the circumstances, including the agreement and its context, the subsequent conduct of the parties, and the remedy sought. *Sterling v Taylor* (2007) 40 C4th 757, 770, 55 CR3d 116. See also *House of Prayer: Renewal & Healing Ctr. v Evangelical Ass'n for India* (2003) 113 CA4th 48, 53, 7 CR3d 24.

Sterling and *House of Prayer* addressed contracts for the sale of real estate. In both, the courts confirmed that a formal contract is unnecessary—a memorandum of the agreement is sufficient provided the memorandum contains all the material terms the contract, *i.e.,* the identity of the seller and buyer, the amount of the purchase price, and a description enabling the land to be identified. In *House of Prayer*, the court of appeal ruled that the time for payment of the purchase price was not an essential term because it could be implied by reference to CC §1657, which states that if no time is specified for performance of a required action, a reasonable time is allowed. Thus, the court ruled that a land sale agreement that failed to specify a time for performance was nevertheless enforceable.

In *Sterling*, the California Supreme Court made it clear that as long as the essential terms of the contract are set out in the memorandum or written contract, the statute is satisfied—even if the memorandum does not contain sufficient information to show what those terms mean.

Land descriptions in agreements for the sale of real property must have sufficient detail so that the land can be identified with reasonable certainty. This means that the land description must furnish the key by which it can be related to and identified with the location of the land on the ground. *Alameda Belt Line v City of Alameda* (2003) 113 CA4th 15, 5 CR3d 879.

NOTE: Evidence Code §250 defines the term "writing" broadly, to include "handwriting, typewriting, printing, photostating, photographing, photocopying, transmitting by electronic mail or facsimile, and every other means of recording upon any tangible thing, any form of communication or representation, including letters, words, pictures, sounds, or symbols, or combinations thereof, and any record thereby created, regardless of the manner in which the record has been stored."

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§4.49 4. Divisibility of Agreement

Under California law, if some of the terms of an agreement are subject to the statute of frauds but others are not, the enforceability of the agreement depends on whether the noncomplying terms are severable. If the agreement is severable or divisible, the parts that are not covered by the statute of frauds are enforceable. *Texaco, Inc. v Ponsoldt* (9th Cir 1991) 939 F2d 794, 800. See also *White Lighting Co. v Wolfson* (1968) 68 C2d 336, 345, 66 CR 697. If the promise falling within the statute of frauds is "clearly ancillary" to the contract as a whole, it may be excised and the remaining portions of the contract enforced. *Texaco,* 939 F2d at 801. The general rules for determining whether contractual provisions are severable or divisible are discussed in §5.70.

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§4.50 5. Estoppel to Plead Statute of Frauds

Avoidance of unjust enrichment. The doctrine of estoppel to plead the statute of frauds is based on the general equitable principle of the avoidance of unjust enrichment. It holds that a party may be estopped to assert the statute of frauds if such an estoppel is necessary to prevent the fraud that would result in some circumstances from a refusal to enforce an oral contract. *Tenzer v Superscope, Inc.* (1985) 39 C3d 18, 29, 216 CR 130. The doctrine is related, although not identical, to the rule stated in CC §1623:

> Where a contract, which is required by law to be in writing, is prevented from being put into writing by the fraud of a party thereto, any other party who is by such fraud led to believe that it is in writing, and acts upon such belief to his prejudice, may enforce it against the fraudulent party.

In *Tenzer,* the California Supreme Court ruled that an oral agreement under which the defendant agreed to pay the plaintiff a finder's fee in a real estate transaction could be enforced. The court noted that agreements for a commission or finder's fee involving licensed real estate brokers must be in writing under CC §1624(a)(4) (see §4.44). The court explained that this requirement is related to the statutory licensing requirements. 39 C3d at 27. In *Tenzer,* however, the finder was not a licensed broker. The defendant received the benefit of the finder's performance but then attempted to assert the statute of frauds to avoid paying the finder's fee. The court held that the doctrine of estoppel to plead the statute of frauds could be applied to the agreement to avoid unjust enrichment of the defendant. 39 C3d at 27.

When agreement fully performed. A party may be estopped from pleading the statute of frauds when the agreement has been fully performed or even partially performed. As the California Supreme Court in *Dougherty v California Kettleman Oil Royalties, Inc.* (1937) 9 C2d 58, 81, 69 P2d 155 (a case involving full performance) explained:

> The fact that the agreement between Dougherty and Ochsner rested in parol is of no legal significance in this case. This agreement was fully executed by Dougherty. Assuming the contract could not be performed within a year and therefore fell within the statute of frauds, the circumstances of this case, showing as they do complete performance by Dougherty, clearly create an estoppel to plead the statute.

See also *Dutton v Interstate Inv. Corp*. (1941) 19 C2d 65, 70, 119 P2d 138; *Dean v Davis* (1946) 73 CA2d 166, 168, 166 P2d 15; *Marr v Postal Union Life Ins. Co.* (1940) 40 CA2d 673, 679, 105 P2d 649 ("Where … there has been full performance upon the part of the party seeking to enforce the contract, the doctrine of estoppel arises").

In *Secrest v Security Nat'l Mortgage Loan Trust 2002-2* (2008) 167 CA4th 544, 84 CR3d 275, however, the court stated that the full performance exception to the statute of frauds did not apply when performance was the payment of money. The plaintiff contended the defendant was estopped from asserting the statute of frauds based on the plaintiff's partial performance in making a down payment. The court rejected this contention, stating (167 CA4th at 556):

> The principle that full performance takes a contract out of the statute of frauds has been limited to the situation where performance consisted of conveying property, rendering personal services, or doing something other than payment of money.

As examples of performance taking a contract out of the statute of frauds, the court cited *Dutton, supra* (negotiating oil leases and seeking share of royalties promised by defendants); *Dougherty, supra* (finding oil-bearing land and obtaining prospecting permits); *Dean, supra* (securing employment for the defendant); and *Marr, supra* (conveying real property to the defendants). 167 CA4th at 556.

The *Secrest* court held that under CC §1698, a written forbearance agreement unsigned by the previous holders came within the statute of frauds because it modified the terms of a note and deed of trust. The court noted that the mortgagees' $13,422 down payment was arguably full performance of the agreement, but did not rule that the holders of the note and deed of trust were estopped from asserting that the forbearance agreement was invalid under the statute of frauds. The court therefore affirmed the judgment, declaring that the notice of default and election to sell under the deed of trust was valid.

When agreement partly performed. A party may be estopped to assert the statute of frauds due to the other party's part performance, but "it must appear that a sufficient change of position has occurred so that the application of the

statutory bar would result in an unjust and unconscionable loss, amounting in effect to a fraud." *Anderson v Stansbury* (1952) 38 C2d 707, 715, 242 P2d 305. Moreover, "payment of money is not 'sufficient part performance to take an oral agreement out of the statute of frauds' … for the party paying money 'under an invalid contract … has an adequate remedy at law.'" 38 C2d at 716. See also *Sutton v Warner* (1993) 12 CA4th 415, 422, 15 CR2d 632. Part performance by the buyer may constitute an exception to the statute of frauds for real estate sales or lease contracts in situations when the buyer has taken possession and either makes a full or partial payment of the purchase price or makes valuable and substantial improvements on the property, in reliance on the oral agreement. *Sutton v Warner, supra*. See also *Alfaro v Community Hous. Improvement Sys. & Planning Ass'n* (2009) 171 CA4th 1356, 1396, 89 CR3d 659.

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§4.51 G. Delivery (CC §§1626-1627)

Civil Code §1626 provides that a written contract takes effect on its *delivery* to the party in whose favor it is made, or to his or her agent. Civil Code §1627 further provides that the provisions of the Civil Code "chapter on transfers in general" (CC §§1039-1090) concerning delivery of both absolute and conditional grants also apply to all written contracts. Civil Code §1054 states that a grant takes effect only on delivery by the grantor, but, under CC §1055, a duly executed grant is presumed to have been delivered at its date. Thus, for most written contracts, delivery will be presumed to have occurred on signing of the document. See *20th Century Plumbing Co. v Sfregola* (1981) 126 CA3d 851, 179 CR 144 (delivery of deed of trust presumed).

Civil Code §1056 clarifies that delivery cannot occur conditionally, and that delivery is necessarily absolute. Civil Code §1057, however, makes provision for deposit of a grant with a third person in escrow, to be delivered on performance of a condition. For further discussion of real estate escrows, see California Real Property Sales Transactions (4th ed Cal CEB 2007).

In *Kaneko v Okuda* (1961) 195 CA2d 217, 15 CR 792, the court affirmed the validity of an agreement by several individuals to sell stock of a closely held corporation under the circumstances, even though the agreement had not been signed by, or delivered to, all of the sellers. The court held that delivery of the agreement was not indispensable to its validity, and that retention of the agreement by one of the parties was not conclusive evidence of its nondelivery. See also *VHB Assocs., Inc. v Orix Real Estate Equities* (CD Cal, Sept. 3, 2002, No. CV 02-4710 JFW (RNBx)) 2002 US Dist Lexis 17569 (contract signed by both parties was binding, although fully signed copy was never delivered to plaintiff).

In contrast, in *LaMar v LaMar* (1947) 30 C2d 898, 186 P2d 678, a husband and wife entered into a property settlement agreement prepared by the husband's attorney. The husband signed two copies of the agreement and delivered it to his attorney, who delivered the signed copies to the wife's attorney. She signed both copies, kept one, and gave the other to her attorney, but her attorney never delivered that copy to her husband or his counsel. The husband later sent a letter to his wife revoking the agreement. The court held that because the fully signed agreement was never delivered to the husband, it never took effect. It was merely an offer to enter into a settlement agreement, and was revoked by the husband's later action.

For insurance policies, the significance of physical delivery of the policy depends on the intent of the parties. "Whether an insurance policy has or has not been delivered after its issuance so as to complete the contract and give it binding effect does not depend on its manual delivery to, or possession by, insured, but rather on the intention of the parties as manifested by their acts or words." *Ahern v Dillenback* (1991) 1 CA4th 36, 46, 1 CR2d 339 (citations omitted). Effectiveness of the policy, *i.e.,* when risk attaches, is often measured by its date of *issuance,* and issuance often involves constructive delivery, *e.g.,* to a broker. See generally 1 CA4th at 45.

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H. Contract Modification

§4.52 1. CC §§1697-1698

Under CC §1697, oral contracts may be modified "in any respect by consent of the parties, in writing, without a new consideration," and are extinguished to the extent of the modification. In *Healy v Brewster* (1967) 251 CA2d 541, 59 CR 752, the court held that if there is adequate consideration for an oral modification of a contract, and the party relying on the contract has fully performed, the contract may be enforced as modified even if the other party has not performed. 251 CA2d at 551 (citations omitted). Further, CC §1697 constitutes "a clear, direct, and unequivocal statutory mandate that no new additional consideration is required for the alteration of an oral contract by written modification." *Roehm Distrib. Co. v Burgermeister Brewing Corp.* (1961) 196 CA2d 678, 681, 16 CR 881.

Modifications of written contracts are governed by CC §1698, which provides that written contracts may be modified by:

- A contract in writing. CC §1698(a).
- An oral agreement to the extent that the oral agreement is executed (*i.e.,* performed) by the parties. CC §1698(b).
- An oral agreement supported by new consideration, unless the contract expressly provides otherwise. The statute of frauds (CC §1624) must be satisfied if the contract as modified is within its provisions. CC §1698(b).
- In appropriate cases, application of the law of "estoppel, oral novation and substitution of a new agreement, rescission of a written contract by an oral agreement, waiver of a provision of a written contract, or oral independent collateral contracts." CC §1698(d).

Oral modifications of written contracts are precluded only if the written contract provides solely for written modification. Thus, the parties to a written agreement may modify it by an oral agreement that has been fully executed (*i.e.,* performed); the written agreement remains in effect to the extent it has not been modified by the oral agreement. *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518. See also *Marani v Jackson* (1986) 183 CA3d 695, 228 CR 518. Moreover, a court may find that a written contract has been modified based on the subsequent conduct of the parties, if their conduct is inconsistent with and plainly contrary to the terms of the written agreement. *Diamond Woodworks, Inc. v Argonaut Ins. Co.* (2003) 109 CA4th 1020, 135 CR2d 736. See also *Biren v Equality Emergency Med. Group, Inc.* (2002) 102 CA4th 125, 125 CR2d 325. In *Secrest v Security Nat'l Mortgage Loan Trust 2002-2* (2008) 167 CA4th 544, 84 CR3d 275, the court held a written forbearance agreement unsigned by the previous holders came within the statute of frauds, because under CC §1698, it modified the terms of a note and deed of trust. See §4.50.

NOTE: Collective bargaining agreements are subject to special rules. Courts will allow oral modifications of collective bargaining agreements, even if the agreement specifies that it may be modified only in writing, because this practice is permissible under federal law. *Mechanical Contractors Ass'n v Greater Bay Area Ass'n* (1998) 66 CA4th 672, 78 CR2d 225.

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§4.53 2. Commercial Code §2209

Modifications of contracts for the purchase and sale of goods are governed by Com C §2209, which provides generally that an agreement modifying such a contract needs no consideration to be binding. Com C §2209(1). If the parties' signed agreement excludes modification or rescission except by a signed writing, it cannot be modified or rescinded in other ways. If the contract is between merchants, and the restriction on modification is on a form supplied by the merchant, the form must be separately signed by the other party. Com C §2209(2). If the contract is within the statute of frauds (Com C §2201; see §4.47), the requirements of the statute must be satisfied. Com C §2209(3). A modification or rescission that does not comply with the requirements of Com C §2209(2) or (3) may nonetheless operate as a waiver. Com C §2209(4). A party making a waiver regarding an unperformed part of a contract may retract the waiver by reasonable notice to the other party, unless the other party has materially changed position in reliance on the waiver. Com C §2209(5).

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V. ELECTRONIC CONTRACTING

A. E-Sign (15 USC §§7001-7031)

§4.54 1. Introduction

The Electronic Signatures in Global and National Commerce Act (E-Sign) (15 USC §§7001-7031) confirms the ability of parties to contract electronically, defining an "electronic signature" broadly as "an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record." 15 USC §7006(5). See §4.55. This definition encompasses so-called "click-wrap" agreements executed over the Internet (see §4.65), thus assuring their enforceability. E-Sign provides that any signature, contract, or other record cannot be denied legal effect, validity, or enforceability solely because it is in electronic form (15 USC §7001(a)(1)), and any contract cannot be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation (15 USC §7001(a)(2)). E-Sign, however, does not require any person to agree to use or accept electronic records or electronic signatures. 15 USC §7001(b)(2).

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Source: Business Law/California Law of Contracts/4 Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting/§4.55 2. Electronic Signatures

§4.55 2. Electronic Signatures

At common law, any symbol made with the intent to sign a document could qualify as a legally valid signature. The definition of "signed" in the Uniform Commercial Code includes "any symbol," as long as it is "executed or adopted with present intention to adopt or accept a writing." Com C §1201(b)(37). See also Cal Comment 39 to Com C §1201 (Aug. 15, 1988). E-Sign extends this approach to electronic signatures by requiring that an electronic signature possess three elements (15 USC §7006(5)):

- A sound, symbol, or process;
- Attached to or logically associated with an electronic record; and
- Made with the intent to sign the electronic record.

An electronic signature can take many forms, and can be created by many different technologies. Examples of electronic signatures that should qualify under E-Sign include:

- Typing the sender's name at the end of an e-mail message sent by him or her;
- Including a digitized image of a handwritten signature attached to an electronic document;
- A mouse click (*e.g.,* on an "I accept" or "I agree" button); and
- A "digital signature" (*e.g.,* a signature created through public key cryptography).

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Source: Business Law/California Law of Contracts/4 Contract Formation: Offer and Acceptance, Formalities, Electronic Contracting/§4.56 3. Exceptions to Applicability of E-Sign

§4.56 3. Exceptions to Applicability of E-Sign

E-Sign contains a number of exceptions to its application. It does not apply to a contract or other record to the extent that it is governed by (15 USC §7003(a)):

- A law governing the creation and execution of wills, codicils, or testamentary trusts;
- State laws governing adoption, divorce, or other family law matters;
- The Uniform Commercial Code (other than the articles governing sales and leases of goods), waivers under Com C §1306 (former Com C §1107), and the personal property statute of frauds under CC §1624.5 (former Com C §1206). E-Sign therefore does not apply to negotiable instruments, bank deposits and collections, letters of credit, bulk sales, documents of title, investment securities, secured transactions, or funds transfers.

Further, E-Sign does not apply to (15 USC §7003(b)-(c)):

- Court orders or notices, or official court documents, such as briefs and pleadings, required to be executed in connection with court proceedings;
- Notices of cancellation or termination of utility services;
- Notices of default, acceleration, repossession, foreclosure, or eviction, or the right to cure, under a credit agreement secured by, or a rental agreement for, an individual's primary residence;
- Notices canceling or terminating health insurance or benefits or life insurance benefits (except annuities);
- Product recalls; or
- Any document required to accompany the transportation or handling of hazardous materials, pesticides, or other toxic or dangerous materials.

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§4.57 4. Consumer Protection Features

In addition to granting legal effect to electronic documents generally, E-Sign includes several provisions intended to protect the rights of consumers in electronic transactions. E-Sign's consumer protection provisions are triggered only when a statute, regulation, or other rule of law requires that information relating to a transaction be provided or made available to a consumer in writing. 15 USC §7001(c). Providing information electronically in these circumstances is acceptable only if the consumer affirmatively consents to receive the information in electronic form, gives his or her consent electronically, and does so in a manner that reasonably demonstrates that he or she can access the information in the electronic format that will be used to provide it. 15 USC §7001(c)(1)(A), (c)(1)(C)(ii). "Consumer" is defined as "an individual who obtains, through a transaction, products or services which are used primarily for personal, family, or household purposes." 15 USC §7006(1).

Before giving consent, the consumer must receive a clear and conspicuous statement of his or her rights, the scope of the consent given, and how to withdraw the consent. 15 USC §7001(c). In particular, businesses are required to take the following actions:

- Inform the consumer of (1) any right to have an electronic record made available in nonelectronic (paper) form, (2) the right of a consumer to withdraw his or her consent to have the record provided in an electronic form, and (3) any conditions, consequences (such as termination of the parties' relationship), or fees if the consumer's consent is withdrawn (15 USC §7001(c)(1)(B)(i));
- Inform the consumer whether his or her consent applies (1) only to the specific transaction that gave rise to the obligation to provide the record, or (2) to identified categories of records that may be provided over the course of the parties' relationship (15 USC §7001(c)(1)(B)(ii));
- Describe the procedures the consumer is required to use to withdraw consent and to update information needed to contact the consumer electronically (15 USC §7001(c)(1)(B)(iii));
- Inform the consumer of (1) how, after consenting to the electronic record, the consumer may obtain a paper copy of the electronic record on request, and (2) the fee, if any, to be charged for such copy (15 USC §7001(c)(1)(B)(iv));
- Provide the consumer (before consent) with a description of the hardware and software requirements for access to and retention of the electronic records (15 USC §7001(c)(1)(C)(i)); and
- If the software or hardware requirements necessary to access the electronic record change, advise the consumer of (1) the new hardware and software requirements, and (2) the consumer's right to withdraw consent without the imposition of any fees or any condition or consequence not previously disclosed (15 USC §7001(c)(1)(D)(i)).

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§4.58 5. Electronic Record Retention

Under E-Sign, if the law requires that a record of a contract be retained, an electronic record is adequate for the purpose, provided that it "accurately reflects the information" in the contract and the record remains accessible for later reference in a form that can be accurately reproduced. 15 USC §7001(d)(1). E-Sign provides that the legal effect, validity, or enforceability of an electronic record "may be denied if such electronic record is not in a form that is capable of being retained and accurately reproduced for later reference by all parties or persons who are entitled to retain the contract or other record." 15 USC §7001(e). Even if a contract is not required by law to be retained, it is always advisable to keep a record of an electronic contract for evidentiary purposes. Thus, contracting parties should develop procedures for printing and saving electronic agreements to better assure their enforceability.

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B. Uniform Electronic Transactions Act (CC §§1633.1-1633.17)

§4.59 1. Overview

Before E-Sign, California adopted a version of the Uniform Electronic Transactions Act (UETA) (see CC §§1633.1-1633.17), which applies to transactions between parties who have each agreed to conduct a transaction electronically. UETA provides for the enforceability of electronic contracts, as well as for records retention and the evidentiary use of electronic records. As of this writing, almost all states have adopted a version of UETA. See http://www.nccusl.org/. Although broader than E-Sign, UETA covers many of the same issues as E-Sign and is therefore subject to federal preemption. E-Sign, however, has an exemption from federal preemption applicable in states where UETA has been enacted in the form recommended by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The California version of UETA is nonconforming; it substantially altered many of UETA's provisions. Under E-Sign, however, only provisions that would create an exception to the scope of UETA (as recommended by NCCUSL) and are otherwise inconsistent with E-Sign are subject to federal preemption by E-Sign. See 15 USC §7002. Thus, the scope of E-Sign's potential preemption of California's version of UETA is unclear. It is therefore advisable to assume that E-Sign's restrictions and exclusions will apply in California (and in any other state that has not enacted UETA in the form recommended by NCCUSL).

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§4.60 2. Scope of UETA; Exceptions

UETA applies generally to "electronic records and electronic signatures relating to a transaction" (CC §1633.3(a)) that are "created, generated, sent, communicated, received, or stored on or after January 1, 2000" (CC §1633.4), with exceptions for transactions:

- Subject to laws governing the creation or execution of wills, codicils, or testamentary trusts (CC §1633.3(b)(1));
- Subject to Division 1 of the Commercial Code, except Com C §1306 (former Com C §1107) regarding written waivers and CC §1624.5 (former Com C §1206), the UCC personal property statute of frauds (CC §1633.3(b)(2));
- Subject to Divisions 3 (negotiable instruments), 4 (bank deposits and collections), 5 (letters of credit), 8 (investment securities), 9 (secured transactions), and 11 (funds transfers) (CC §1633.3(b)(3));
- Subject to a law requiring specifically identifiable text or disclosures in a record (or portion of a record) to be signed separately, including initialed, with exceptions for certain real estate-related liquidated damages and arbitration clauses (CC §1633.3(b)(4)); or
- Subject to any one of the litany of California statutes cited in CC §1633.3(c).

Despite these exclusions, transactions subject to UETA remain subject to other applicable law, and transactions may be conducted electronically if permitted under other applicable law. CC §1633.3(d)-(f).

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§4.61 3. Consent Under UETA

Both E-Sign and UETA authorize parties to enter into electronic transactions, but do not require parties to do so. See 15 USC §7001(b)(2); CC §1633.5(a). Unlike E-Sign, UETA is premised on consent by the parties; the statute does not apply unless the parties have "agreed to conduct the transaction by electronic means." CC §1633.5(b). The consent requirement applies to both business and consumer transactions. Whether the parties have consented to conduct a transaction by electronic means is determined from the context and circumstances surrounding the transaction, and consent may be either express or implied. CC §1633.5(b). Under the California version of UETA, consent must be given by electronic means. CC §1633.5(b). If a company's website is capable of receiving electronic communications from customers, and a customer enters into a transaction with the company using the company's website, it can be inferred that both parties have impliedly agreed to conduct their transaction electronically.

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§4.62 C. Uniform Computer Information Transactions Act (UCITA)

The Uniform Computer Information Transactions Act (UCITA) was an effort spearheaded by the software industry to develop uniform state legislation with default rules for the creation and enforcement of contracts (including shrink-wrap and click-wrap licenses, see §§4.63-4.66) relating to electronic information. For example, it would cover agreements for the development, distribution, licensing, and transfer of computer software, multimedia products, computer databases, and Internet websites. The full text of the model uniform law is posted at http://www.law.upenn.edu/bll/ulc/ucita/2002final.htm. To date, only two states, Virginia and Maryland, have adopted UCITA. See Va Code Ann §§59.1-501.1—59.1-509.2; Md Comm'l Law Code Ann §§22-101—22-816. However, UCITA provides that companies based in a state that has not adopted UCITA may elect to have their contracts governed by the laws of a state that has adopted it. For example, a consumer in Oregon could purchase software issued by a California company and discover that the shrink-wrap license inside the package purports to be governed by Virginia law—and therefore UCITA.

UCITA has proved to be extremely controversial and has been opposed by various interest groups because of its perceived unfairness to consumers, alleged conflicts with federal copyright law, and other reasons. See, *e.g.,* http://www.ucita.com. California has not yet adopted UCITA, and UCITA's future is presently uncertain. In the summer of 2003, citing widespread opposition from consumers, libraries, and other interest groups, the National Conference of Commissioners on Uniform State Laws pulled its support for the legislation, announcing that it would not seek its adoption in any other state. Because UCITA is the law in Maryland and Virginia, however, and because it has served as a resource for judges in cases relating to electronic information, the controversy will likely continue. California practitioners should be generally familiar with the scope of UCITA, even though it has not been adopted in this state. If the parties to a contract for software or other electronic information do not wish UCITA to apply in interpretation or enforcement of the agreement, the parties should affirmatively disclaim its applicability in the text of the agreement.

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§4.62A D. ALI Software Contract Principles

In May 2009, the American Law Institute (ALI) approved the proposed final draft, dated March 16, 2009, of the Principles of the Law of Software Contracts (Principles), copies of which are available for purchase at http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=121. According to the Introduction, the Principles "seek to clarify and unify the law of software transactions" (Principles at 2) in view of the failure of the Uniform Computer Information Transactions Act (UCITA) to win general acceptance and the general inapplicability of Article 2 of the Uniform Commercial Code to software transactions. The Principles were not intended to be a restatement of the law, but rather to "account[] for the case law and recommend[] best practices." (Principles at 2.) The Introduction clarifies that the Principles "are not the law unless and until a court adopts [them]. Courts can apply the Principles as definitive rules, as a 'gloss' on the common law, U.C.C. Article 2, or other statutes, or not at all as they see fit." Principles at 2.

The Principles consist of 31 separate sections with accompanying comments, divided into 4 chapters addressing many topics, as follows:

- Chapter 1: Definitions, scope, and general terms (including provisions on unconscionability; choice of law; and choice of forum).
- Chapter 2: Formation and enforcement (including provisions on standard-form transfers of generally available software; enforcement of the standard form; and contract modification).
- Chapter 3: Performance (including provisions concerning implied indemnification; express and implied warranties; the parol evidence rule and its interpretation; and breach).
- Chapter 4: Remedies (including provisions on agreements to modify or limit remedies; liquidated damages; use of automatic disablement to impair use; and remedies in the absence of agreement).

The Principles are intended to apply to agreements for transfer of software for consideration, including agreements to sell, lease, license, access, or otherwise transfer or share software. Principles §1.06(a). The Principles do not cover digital art, databases, or other media content; do not cover security interests (Comment a to Principles §1.06); and may or may not cover embedded software, depending on the circumstances (Principles §1.07). A detailed analysis of the Principles is beyond the scope of this title.

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E. Enforceability of Shrink-Wrap, Click-Wrap, and Browse-Wrap Agreements

§4.63 1. Introduction

Advances in technology, as well as the statutory developments discussed in §§4.54-4.61, have given rise to alternative forms of contracting based on the user's acts rather than the user's signature for rights to use software and Internet-based functions. For example:

- A "shrink-wrap" license agreement refers to a contract formed when a user opens software packaging (often plastic shrink-wrap) and begins using the software.
- A "click-wrap" agreement is a contract formed by a user's action of clicking on a button or icon on a web page, or a screen launched as part of the installation of a software program on the user's computer, to indicate acceptance of contract terms. Click-wrap agreements are more accurately referred to as "click-through" or "click-to-accept" agreements and are now ubiquitous in online retail sales transactions.
- A "browse-wrap" or "click-free" agreement is a contract formed by a user's action of simply visiting or viewing an Internet website.

Both shrink-wrap and click-wrap software license agreements are commonly (and more properly) referred to as end user license agreements, or EULAs. Sections 4.64-4.66 provide an overview of issues concerning the enforceability of agreements in these formats. See also the developments discussed in §§4.62-4.62A.

NOTE: For a detailed checklist of suggestions for maximizing the enforceability of online contracts, see Ballon, E-Commerce & Internet Law, Treatise with Forms (2d ed West 2009) §21.05.

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§4.64 2. Shrink-Wrap Software Licenses

Courts originally viewed the enforceability of so-called "shrink-wrap" mass market software license agreements with skepticism, holding that contract terms hidden "inside the box" would not be enforceable because any contract was formed at the time of purchase and delivery of the box, not later when the box was opened. See, *e.g., Step-Saver Data Sys. v Wyse Technol.* & *Software Link, Inc.* (3d Cir 1991) 939 F2d 91. The modern view is reflected in *ProCD, Inc. v Zeidenberg* (7th Cir 1996) 86 F3d 1447, which continues to be the leading case on enforceability of shrink-wrap licenses. In *ProCD,* the Seventh Circuit held that a shrink-wrap license will be enforceable if (1) customers have an opportunity to review the terms of the license before making a final decision regarding use of the software, and (2) the license contains no contract terms that are unconscionable. The court found that a customer may signal agreement to the terms of the license by installing and using the software, regardless of whether he or she actually took the time to read the license. Only an opportunity to review is needed. Importantly, the Seventh Circuit also held that the issue of enforceability of the license was a matter of state law, not preempted by the federal copyright act. See also *Hill v Gateway 2000, Inc.* (7th Cir 1997) 105 F3d 1147 (plaintiffs accepted terms of unread license agreement shipped with computer by using computer).

California state courts and the Ninth Circuit have not yet provided definitive guidance on this matter, but the trend appears to be to follow *ProCD*. The issue often arises in copyright infringement actions; thus, decisions on the question are typically issued by federal courts as a matter of federal common law. See *Arizona Cartridge Remanufacturer's Ass'n v Lexmark Int'l Inc.* (9th Cir 2005) 421 F3d 981 (consumers had notice of restrictions on use and chance to reject them before opening cartridge; restrictions enforceable); *Meridian Project Sys. v Hardin Constr. Co., L.L.C.* (ED Cal 2006) 426 F Supp 2d 1101, 1107 (following *ProCD*); *Adobe Sys. v Stargate Software, Inc.* (ND Cal 2002) 216 F Supp 2d 1051 (shrink-wrap license enforced because user could return software if it did not agree with license terms); *SoftMan Prods. Co. v Adobe Sys.* (CD Cal 2001) 171 F Supp 2d 1075, 1088 (finding no assent to terms of shrink-wrap license).

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§4.65 3. Click-Wrap Agreements

Specific terms of online click-wrap agreements between users and software or service providers have been upheld in many cases. *CompuServe, Inc. v Patterson* (6th Cir 1996) 89 F3d 1257 was one of the first cases holding that a contract could be formed when a user indicates acceptance by interacting with a website. In that case, the Sixth Circuit upheld a forum selection clause in an online click-wrap agreement, which required the user to type "AGREE" at several points in the online document to indicate consent to its terms. The forum selection clause at issue was in a separate agreement incorporated by reference into the main registration agreement. The court found that the user's online conduct manifested assent to the terms of the main agreement as well as to the agreement incorporated by reference. See also *MySpace, Inc. v The Globe.com, Inc.* (CD Cal, Feb. 27, 2007, Case No. CV 06-3391-RGK (JCx)), 2007 WL 1686966 (MySpace click-through terms of service agreement enforced); *Koresko v RealNetworks, Inc*. (ED Cal 2003) 291 F Supp 2d 1157 (plaintiff clicked box on web page marked "I agree"; agreement enforced); *Net2Phone, Inc. v Superior Court* (2003) 109 CA4th 583, 135 CR2d 149 (upholding forum selection clause in VoIP-provider's click-wrap license agreement and terms of use; users were required to accept both in order to access provider's website and use provider's software).

In *Forrest v Verizon Communications, Inc*. (DC App 2002) 805 A2d 1007, the court enforced an online agreement entered into by clicking an "Accept" button below the window containing the text of the agreement. The web page cautioned users to read the agreement carefully. "A contract is no less a contract simply because it is entered into via a computer." 805 A2d at 1011. The federal district court in *Hotmail Corp. v Van$ Money Pie, Inc.* (ND Cal 1998) 47 USPQ2d 1020 enforced a click-wrap agreement that prohibited users of Hotmail's e-mail service from distributing spam through their Hotmail accounts. The court found that the defendant had agreed to the restriction by clicking an acceptance button indicating consent to Hotmail's online click-wrap agreement.

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§4.66 4. Browse-Wrap Agreements

Browse-wrap (or click-free) agreements are documents—such as terms of use, privacy policy statements, or software license modifications—posted on a website that do not require users to affirmatively interact with the site to show their consent to the document terms. Unlike a click-wrap agreement, a browse-wrap agreement "does not require the user to manifest assent to the terms and conditions expressly … [a] party instead gives his assent simply by using the website." *Southwest Airlines Co. v Boardfirst, LLC* (ND Tex, Sept. 12, 2007, No. 3:06-CV-0891-B) 2007 US Dist Lexis 96230 at *14. Typically, the website or the document itself includes a statement that a user's continued use of the website or the software downloaded from the site evidences the user's agreement to all of the terms and conditions of the document.

In ruling on the validity of browse-wrap agreements, courts consider primarily "whether a website user has actual or constructive knowledge of a site's terms and conditions prior to using the site." *Hines v Overstock.com, Inc*. (ED NY, Sept. 8, 2009, No. 09 CV 991) 2009 US Dist Lexis 81204 at *6, quoting *Southwest Airlines Co. v Boardfirst, LLC,* 2007 US Dist Lexis 96230 at *15). See also *Specht v Netscape Communications Corp.* (2d Cir 2002) 306 F3d 17, 20. Several courts that have considered browse-wrap agreements have been reluctant to enforce them because of their noninteractive nature. See, *e.g., Ticketmaster Corp. v Tickets.com, Inc.* (CD Cal, Mar. 7, 2003, CV99-7654-HLH) 2003 US Dist Lexis 6483, and the earlier decision in the same case, *Ticketmaster Corp. v Tickets.com, Inc.* (CD Cal, Mar. 27, 2000, CV 99-7654 HLH) 2000 US Dist Lexis 4553. The reasoning in these cases indicates that courts will require both notice (*i.e.,* making online agreements conspicuous to site users) and proof that a user actually accessed the online agreement before enforcing the agreement. The more action required on the part of the website user, the more likely a court will hold that a contract has been formed. Compare the *Ticketmaster* decisions with *Pollstar v Gigmania, Ltd.* (ED Cal 2000) 170 F Supp 2d 974, in which the court refused to enforce the terms of an online license agreement because the link to it was not sufficiently obvious. The *Pollstar* court did not rule that the license agreement was per se unenforceable, only that the website did not give users adequate notice of it.

Lack of notice was also a key factor in leading the court in *Douglas v U.S. Dist. Court* (9th Cir 2007) 495 F3d 1062 to vacate a lower court order compelling arbitration. At issue in *Douglas* were modifications to an online long-distance telephone service contract, which added an arbitration clause and class action waiver. The plaintiff never received notice of the changes. The court noted that a contracting party has no obligation to check the contract terms periodically to learn whether the other side has changed them. Previously, in *Specht v Netscape Communications Corp.* (2d Cir 2002) 306 F3d 17, the Second Circuit refused to enforce an arbitration clause contained in a browse-wrap software license agreement because end users were able to download the free software without reviewing the license agreement. See also *Hines v Overstock.com, Inc.* (ED NY, Sept. 8, 2009, 09 CV 991) 2009 US Dist Lexis 81204 at *9 (customer "lacked notice of the Terms and Conditions because the website did not prompt her to review the Terms and Conditions and because the link to the Terms and Conditions was not prominently displayed so as to provide reasonable notice of the Terms and Conditions").

In a commercial context, courts may be more inclined to find terms of use to be binding on users of Internet websites, particularly if the user accessed the site by an automated "robot" or "web crawler." In *Register.com, Inc. v Verio, Inc.* (2d Cir 2004) 356 F3d 393, the court found Verio's repeated access to and use of information from Register.com's WHOIS database evidenced consent to Register.com's terms of use, notwithstanding that Verio did not see the terms of use until after it had completed using the database and never clicked on an "I agree" button. Similarly, the court in *Cairo, Inc. v CrossMedia Servs., Inc.* (ND Cal, Apr. 1, 2005, No. C04-04825 JW) 2005 US Dist Lexis 8450, held that the terms of use found on CrossMedia's Internet site were binding, given the defendant's actual knowledge of the terms of use and continued use of the site. The court also found that, even if Cairo had no actual knowledge of the terms of use, its repeated access to the site via a "robot" resulted in imputed knowledge even though the robot was not capable of, and did not, collect information on the contents of such terms.

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Contract Interpretation, Modification, Waiver

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I. GENERAL RULES OF INTERPRETATION

§5.1 A. Objective Manifestations of Intention

Contract language is important. "The fundamental goal of contractual interpretation is to give effect to the mutual intention of the parties." *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 390, 33 CR3d 562; *County of San Diego v Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 415, 33 CR3d 583. As a general rule, the parties' mutual intention to which the courts give effect is determined by objective manifestations of the parties' intent, including the words used in their agreement, as well as extrinsic evidence of objective matters such as the surrounding circumstances in which the parties negotiated the contract; the nature, purpose, and subject matter of the contract; and the parties' subsequent conduct. *People v Shelton* (2006) 37 C4th 759, 767, 37 CR3d 354; *Wolf v Superior Court* (2004) 114 CA4th 1343, 1356, 8 CR3d 649; *De Anza Enters. v Johnson* (2002) 104 CA4th 1307, 1315, 128 CR2d 749. "Evidence of the undisclosed subjective intent of the parties is irrelevant to determining the meaning of contractual language.… Rather, it is the outward manifestation or expression of assent that is controlling." *Berman v Bromberg* (1997) 56 CA4th 936, 948, 65 CR2d 777 (citations omitted). See also *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1339, 96 CR3d 813; *California Teachers' Ass'n v Governing Bd. of the Hilmar Unified Sch. Dist.* (2002) 95 CA4th 183, 189, 115 CR2d 323.

By focusing on the objective intent of the parties, evidenced mainly by the words of their agreement, as the controlling factor in interpretation of the contract, California courts recognize the so-called objective theory of contract. *Founding Members of Newport Beach Country Club v Newport Beach Country Club, Inc.* (2003) 109 CA4th 944, 956, 135 CR2d 505. Yet California courts do not always confine their inquiry to the four corners of the document. In *Scott v PG&E* (1995) 11 C4th 454, 463, 46 CR2d 427, the California Supreme Court advocated a "realistic approach" to contract interpretation, allowing evidence of an employer's personnel policy manual and testimony of one of the employer's human resources managers to establish an implied-in-fact contract not to demote an employee without good cause. Citing *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 677, 254 CR 211, the court stated:

> [C]ourts seek to enforce the actual understanding of the parties to a contract, and in so doing may inquire into the parties' conduct to determine if it demonstrates an implied contract.

The recognition of implied-in-fact contract provisions is part of the modern trend in contract law to reverse "the common law presumption that the parties' writing and the official law of contract are the definitive elements of the agreement. Evidence derived from experience and practice can now trigger the incorporation of additional, implied terms." 47 C3d at 679.

Moreover, California courts have construed the parol evidence rule narrowly and will admit extrinsic evidence to explain the meaning of a written contract as long as the offered evidence is "relevant to prove a meaning to which the language of the instrument is reasonably susceptible," even if no ambiguity is apparent on the face of the document. *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 37, 69 CR 561. As stated by the California Supreme Court in the PG&E case (69 C2d at 38):

> In this state,… the intention of the parties as expressed in the contract is the source of contractual rights and duties.… A court must ascertain and give effect to this intention by determining what the parties meant by the words they used. Accordingly, the exclusion of relevant, extrinsic, evidence to explain the meaning of a written instrument could be justified only if it were feasible to determine the meaning the parties gave to the words from the instrument alone.

The parol evidence rule is discussed more fully in §§5.33-5.43.

The statutory rules of contract interpretation discussed in this chapter are expressed in general terms and therefore may provide a basis for differing alternative interpretations of a contract. Like California's equitable maxims of jurisprudence (CC §§3509-3548), for each rule that points to a result favoring one interpretation, another rule often can be found to justify a different outcome. Some commentators have suggested that rules of decision, such as the rules of contract interpretation, are intentionally designed so that each rule has an exception that can swallow the rule and that

courts use these rules selectively to justify an outcome reached for some other reason. See LoPucki & Weyrauch, *A Theory of Legal Strategy*, 49 Duke L J 1405 (Apr. 2000); Prince, *Contract Interpretation in California*: *Plain Meaning, Parol Evidence and Use of the "Just Result" Principle*, 31 Loy LA L Rev 557 (Jan. 1998). Regardless of possible inconsistencies, the rules of contract interpretation are important because they are in fact applied by California courts regularly in adjudicating contract disputes.

NOTE: Interpretation of a written contract is a question of law, which an appellate court reviews de novo. If the facts are not in dispute, the issue is strictly a legal question and the appellate court is free to draw its own conclusions of law from the undisputed facts. *Quality Wash Group V, Ltd. v Hallak* (1996) 50 CA4th 1687, 1694, 58 CR2d 592.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.2 B. Titles and Headings in Contracts

§5.2 B. Titles and Headings in Contracts

In contract drafting, it is usually desirable for the sake of clarity to provide headings for the major paragraphs of a contract, but headings should not be used alone to interpret the contract. The contract must be considered as a whole. CC §1641. See §5.9. One drafting technique for dealing with headings is to disclaim their significance for anything other than convenience of reference of the parties. For example:

> ***Captions or Headings.*** **All captions or headings are for reference only and shall not be considered in construing this agreement.**

A better practice is to ensure that the headings used correspond to the intended meaning of the related paragraph and to mirror the exact terms used in those paragraphs in the heading. See generally Drafting Business Contracts: Principles, Techniques & Forms §§17.29-17.30 (Cal CEB 1994).

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§5.3 C. Civil and Civil Procedure Code Rules of Contract Interpretation

In California, the common law rules of contract interpretation have been codified, principally in the Civil Code at CC §§1635-1663. See §§5.4-5.31. Rules of contract interpretation are also found at CC §§1610-1613 (see §5.32) and in the Code of Civil Procedure at CCP §§1856-1866. (The rules of contract interpretation in the Code of Civil Procedure are the same or similar to certain Civil Code rules, and are discussed below in the context of the analogous Civil Code rules.) The rules of interpretation for contracts subject to the Uniform Commercial Code are discussed in §§5.56-5.69.

Although the rules of interpretation of contracts have been part of the Civil Code since 1872, they remain vital tools for judicial interpretation of contracts in California, and are cited regularly in decisions as authority for resolution of contract litigation. See, *e.g., Santisas v Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830; *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1264, 10 CR2d 538; *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 72, 96 CR3d 316.

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§5.4 1. Uniformity of Interpretation (CC §1635)

The first Civil Code rule of contract interpretation, CC §1635, provides that "[a]ll contracts, whether public or private, are to be interpreted by the same rules, except as otherwise provided by this code." In interpreting a contract, the court must consider all rules of interpretation and give each its proper weight, as necessary, in order to arrive at the true meaning of the instrument. *City of Manhattan Beach v Superior Court* (1996) 13 C4th 232, 238, 52 CR2d 82. In general, the rules of contract interpretation are for the purpose of determining the meaning of the words used by the parties. *People ex rel Lockyer v R.J. Reynolds Tobacco Co.* (2003) 107 CA4th 516, 525, 132 CR2d 151. And unless there is a factual dispute about the meaning of contract language or a conflict in extrinsic evidence, the interpretation of a contract is a matter of law, subject to de novo review by the appellate court. *Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 891, 38 CR3d 78; *Mirpad v California Ins. Guar. Ass'n* (2005) 132 CA4th 1058, 34 CR3d 136; *Lopez v Charles Schwab & Co.* (2004) 118 CA4th 1224, 13 CR3d 544.

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§5.5 2. Mutual Intention to Be Given Effect (CC §1636)

Civil Code §1636 expresses the paramount rule of contract interpretation—that "[a] contract must be so interpreted as to give effect to the mutual intention of the parties as it existed at the time of contracting, so far as the same is ascertainable and lawful." As often stated by the California courts, "[t]he fundamental goal of contractual interpretation is to give effect to the mutual intention of the parties." *People v Shelton* (2006) 37 C4th 759, 767, 37 CR3d 354; *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 390, 33 CR3d 562. See also *State v Allstate Ins. Co.* (2009) 45 C4th 1008, 1018, 90 CR3d 1. That intent must, in the first instance, be determined from the language of the contract itself. 45 C4th at 1018; *City of Chino v Jackson* (2002) 97 CA4th 377, 382, 118 CR2d 349. See §5.7.

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§5.6 3. Ascertaining Intention: Civil Code Rules (CC §1637)

Civil Code §1637 provides that "[f]or the purpose of ascertaining the intention of the parties to a contract, if otherwise doubtful, the rules given in this chapter are to be applied." The reference to "this chapter" is unclear, because Title 3 of the Civil Code is not currently subdivided into chapters. Title 3 (CC §§1635-1663) includes nearly all the Civil Code rules of contract interpretation, which are discussed in §§5.4-5.32.

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§5.7 4. Ascertaining Intention: Contract Language (CC §§1638-1639)

Civil Code §§1638-1639 are slightly different formulations of essentially the same concept, that the mutual intent of the contracting parties should be determined, if possible, from objective evidence—the words of the contract itself. Civil Code §1638 provides that "[t]he language of a contract is to govern its interpretation, if the language is clear and explicit, and does not involve an absurdity." This section is broad enough to encompass oral agreements. Civil Code §1639 is limited to written agreements. It provides that "[w]hen a contract is reduced to writing, the intention of the parties is to be ascertained from the writing alone, if possible; subject, however, to the other provisions of this title."

Whether the contract is oral or written, in each case the court looks first to the words used by the parties. As stated by the California Supreme Court in *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 396, 33 CR3d 562, "[t]he mutual intention of the parties is to be inferred, if possible, solely from the written provisions of the contract. Where contractual language is clear and explicit, it governs." See also *State v Allstate Ins. Co.* (2009) 45 C4th 1008, 1018, 90 CR3d 1; *County of San Diego v Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 33 CR3d 583; *DVD Copy Control Ass'n v Kaleidescape, Inc.* (2009) 176 CA4th 697, 97 CR3d 856; *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 72, 96 CR3d 316. Both CC §§1638 and 1639 reflect the objective theory of contract. Although the parties' intent determines the meaning of the contract, the relevant intent is objective, *i.e.,* the parties' objective intent as evidenced by the words of the contract, not the subjective intent of one of the parties. *Badie v Bank of America* (1998) 67 CA4th 779, 802, 79 CR2d 273. "[I]n the first instance, contractual interpretation turns on "what was intended by what was said—not what a party intended to say." *Falkowski v Imation Corp.* (2005) 132 CA4th 499, 506, 33 CR3d 724.

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§5.8 5. When Writing May Be Disregarded (CC §1640)

Civil Code §1640 provides that "[w]hen, through fraud, mistake, or accident, a written contract fails to express the real intention of the parties, such intention is to be regarded, and the erroneous parts of the writing disregarded." Section 1640 constitutes an exception to the general rule, expressed in CC §1639, that the parties' intent is to be determined from the writing alone. See *Palm Springs S. & S. Inc. v Bering* (1963) 213 CA2d 177, 28 CR 526. For example, if a word in a contractual provision has been used inadvertently and the word is clearly inconsistent with, and repugnant to, the meaning of the parties, it will be rejected by the court. Similarly, if words have been omitted from a contract through clear inadvertence of the parties, the words may be supplied by construction, provided that the context indicates what they are. *Heidlebaugh v Miller* (1954) 126 CA2d 35, 38, 271 P2d 557 (finding that word ending "-out" was clearly omitted from phrase "with or with notice"). The court must take care, however, not to rewrite the contract. See *Rosen v State Farm Gen. Ins. Co.* (2003) 30 C4th 1070, 1078, 135 CR2d 361. "The courts will not imply a better agreement for parties than they themselves have been satisfied to enter into, or rewrite contracts whenever they operate harshly." *Vikco Ins. Servs., Inc. v Ohio Indem. Co.* (1999) 70 CA4th 55, 70, 82 CR2d 442.

The rule expressed in CC §1640 is related to the Civil Code provisions governing the remedy of reformation (CC §§3399-3402), discussed in §§11.62-11.64.

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§5.9 6. Interpreting Whole Contract (CC §1641; CCP §1858)

Civil Code §1641 provides that "[t]he whole of a contract is to be taken together, so as to give effect to every part, if reasonably practicable, each clause helping to interpret the other." Thus, if a contract term could have multiple meanings, the one selected should be the one that makes the contract as a whole make sense in the context of the case. "[L]anguage in a contract must be construed in the context of that instrument as a whole, and in the circumstances of that case, and cannot be found to be ambiguous in the abstract." *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 391, 33 CR3d 562. See also *County of San Diego v Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 33 CR3d 583; *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 72, 96 CR3d 316; *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1245, 37 CR3d 918. Courts should interpret a contract in such a way as to give force and effect to every provision, with each clause helping to interpret the others, and should avoid interpretations that render part of a contract surplusage, inoperative, or meaningless. *Boghos v Certain Underwriters at Lloyd's of London* (2005) 36 C4th 495, 503, 30 CR3d 787; *Elysian Inv. Group, LLC v Steward Title Guar. Co.* (2002) 105 CA4th 315, 129 CR2d 372; *City of Atascadero v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1998) 68 CA4th 445, 80 CR2d 329.

Code of Civil Procedure §1858 contains an analogous rule, which provides:

> In the construction of a statute or instrument, the office of the judge is simply to ascertain and declare what is in terms or in substance contained therein, not to insert what has been omitted, or to omit what has been inserted; and where there are several provisions or particulars, such a construction is, if possible, to be adopted as will give effect to all.

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§5.10 7. Interpreting Multiple Contracts in Single Transaction Together (CC §1642)

If the same transaction involves multiple contracts, CC §1642 requires them to be interpreted together. "Several contracts relating to the same matters, between the same parties, and made as parts of substantially one transaction, are to be taken together." CC §1642. See *Dell Merk, Inc. v Franzia* (2005) 132 CA4th 443, 453, 33 CR3d 694. In *Versaci v Superior Court* (2005) 127 CA4th 805, 26 CR3d 92, the court of appeal noted that although CC §1642 is most often applied to contemporaneously executed writings, it is also applicable to agreements executed by the parties at different times if the document signed later is in fact part of the same transaction. It is not necessary for the contract to recite that it incorporates another document, but the parties' intent that the other document be incorporated must be clear and unequivocal. 127 CA4th at 814. In *Mayers v Loew's, Inc.* (1950) 35 C2d 822, 221 P2d 26, Justice Traynor invoked §1642 in reversing the trial court's determination that a letter and bulletin were not part of a collective bargaining agreement. His opinion states (35 C2d at 827):

> Where two or more written instruments are executed contemporaneously, with reference to the other, for the purpose of attaining a preconceived object, they must all be construed together, and effect given if possible to the purpose to be accomplished.

In *Brookwood v Bank of America* (1996) 45 CA4th 1667, 53 CR2d 515, the court found that an employment agreement, the arbitration clause in a stock exchange registration agreement, and a securities registration application were all part of substantially the same transaction and should be interpreted as one. See also *BMP Prop. Dev. v Melvin* (1988) 198 CA3d 526, 243 CR 715 (separate land contract and loan arrangement were intended to be part of substantially the same transaction).

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§5.11 8. Interpreting Contracts to Make Them Lawful and Effective (CC §1643; CCP §1866)

Courts are required to give contracts a practical construction so that they will operate to carry out the parties' intent. Civil Code §1643 provides that "[a] contract must receive such an interpretation as will make it lawful, operative, definite, reasonable, and capable of being carried into effect, if it can be done without violating the intention of the parties." As the California Supreme Court in *Safeco Ins. Co. v Robert S.* (2001) 26 C4th 758, 765, 110 CR2d 844, stated, "[w]hen reasonably practical, contracts are to be interpreted in a manner that makes them reasonable and capable of being carried into effect, and that is consistent with the parties' intent."

If two constructions are possible, the courts will adopt the one that renders the contract valid and effective. *Byrne v Laura* (1997) 52 CA4th 1054, 60 CR2d 908; *City of San Diego v Rider* (1996) 47 CA4th 1473, 55 CR2d 422. See, *e.g., People v Parmar* (2001) 86 CA4th 781, 800, 104 CR2d 31 (construing language of contract between redevelopment agency and district attorney's office so as to preserve prosecutorial discretion and allow the interagency funding transaction to work as intended).

The Code of Civil Procedure contains a similar interpretive rule: "When a statute or instrument is equally susceptible of two interpretations, one in favor of natural right, and the other against it, the former is to be adopted." CCP §1866.

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§5.12 9. Interpreting Words in Their Ordinary Sense (CC §1644; CCP §§1861, 1865)

Civil Code §1644 requires contract language to be given its ordinary common meaning, unless it is clear that the parties intended a special or technical meaning:

> The words of a contract are to be understood in their ordinary and popular sense, rather than according to their strict legal meaning; unless used by the parties in a technical sense, or unless a special meaning is given to them by usage, in which case the latter must be followed.

See also *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 72, 96 CR3d 316; *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1245, 37 CR3d 918; *Butler v City of Palos Verdes Estates* (2005) 135 CA4th 174, 181, 37 CR3d 199. To determine the ordinary and popular meaning of a word, the court will typically consult a dictionary. *People ex rel Lockyer v R.J. Reynolds Tobacco Co.* (2004) 116 CA4th 1253, 1263, 11 CR3d 317. "[I]f the meaning a layperson would ascribe to contract language is not ambiguous, we apply that meaning." *Santisas v Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830; *Thompson v Miller* (2003) 112 CA4th 327, 335, 4 CR3d 905.

In *Coast Plaza Doctors Hosp. v Blue Cross* (2000) 83 CA4th 677, 684, 99 CR2d 809, the court held that the parties' agreement to arbitrate "any problem or dispute" arising under the parties' service contract plainly covered the plaintiffs' tort claims; accordingly, the claims were subject to arbitration. Citing *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1264, 10 CR2d 538, the court of appeal in *Coast Plaza* stated: "In interpreting an unambiguous contractual provision we are bound to give effect to the plain and ordinary meaning of the language used by the parties." 83 CA4th at 684. See also *Santisas v Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830 (construing attorney fee clause); *People v R.J. Reynolds Tobacco Co.* (2003) 107 CA4th 516, 524, 132 CR2d 151 (master settlement agreement in tobacco litigation).

Although insurance policies have special features and are subject to state regulation, the ordinary rules of contract interpretation are applicable to them. *County of San Diego v Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 33 CR3d 583; *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 33 CR3d 562. As stated by the California Supreme Court in *Haynes v Farmers Ins. Exch.* (2004) 32 C4th 1198, 1204, 13 CR3d 68, "[w]hen interpreting a policy provision, we gives its words their ordinary and popular sense except where they are used by the parties in a technical or other special sense." In *Haynes*, the court held that the insurer could not rely on a permitted user limitation in the policy because it was not conspicuous, plain, and clear. See also *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 72, 96 CR3d 316; *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1245, 37 CR3d 918.

Civil Code §1644 has two analogues in the Code of Civil Procedure. Code of Civil Procedure §1861 provides that "[t]he terms of a writing are presumed to have been used in their primary and general acceptation, but evidence is nevertheless admissible that they have a local, technical, or otherwise peculiar signification, and were so used and understood in the particular instance, in which case the agreement must be construed accordingly," and CCP §1865 provides in part that "[a] written notice, as well as every other writing, is to be construed according to the ordinary acceptation of its terms."

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§5.13 10. Technical Words (CC §1645)

In contrast with CC §1644, which requires words to be interpreted in their usual sense, CC §1645 provides that: "Technical words are to be interpreted as usually understood by persons in the profession or business to which they relate, unless clearly used in a different sense." In *Denver D. Darling, Inc. v Controlled Env't's Constr., Inc.* (2001) 89 CA4th 1221, 1236, 108 CR2d 213, the court cited CC §1645 in allowing admission of parol evidence to explain when, in the context of a building contract, the concrete surfaces in a cold-storage facility would be required to meet a high degree of flatness. In *Rosen v State Farm Gen. Ins. Co.* (2003) 30 C4th 1070, 135 CR2d 361, however, the California Supreme Court held that a homeowner's insurance policy that defined the term "collapse" to mean "actually fallen down or fallen into pieces" did not provide coverage for the imminent collapse of two decks. The policy language was clear and explicit, and susceptible of only one interpretation.

Simply because words have a technical meaning does not mean that that meaning should be adopted or relied on in every case. Civil Code §1645's rule of interpretation should not be applied to subvert other rules of interpretation based on strong public policy considerations. As the court in *American Star Ins. Co. v Insurance Co. of the W.* (1991) 232 CA3d 1320, 1330, 284 CR 45, noted, if courts always allowed technical meaning to dominate, they would be throwing out the plain meaning rule. In *American Star Ins.*, the court rejected the use of what it termed an "industry interpretation," stating that (232 CA3d at 1330)

> to allow industry interpretations to be the last word on the extent of coverage would contravene the most established rules of insurance contract interpretation: plain, unambiguous language controls; ambiguities must be construed against the insurer; if semantically possible without a strained or forced construction, the policy will be interpreted to provide coverage.

See also *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 75, 96 CR3d 316 (policy language defining "occurrence" was clear and explicit; plaintiff's suggested industry definition was "antithetical to the contract language").

In *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 46 CR2d 33, the parties' contract specified that it would be governed by and construed in accordance with the laws of the State of Delaware. The court held that both the technical and the popular meaning of the term "laws" included statutes of limitations and that the plaintiffs' action was therefore time-barred under the Delaware statute.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.14 11. Law and Usage of Place (CC §§1646, 1646.5)

§5.14 11. Law and Usage of Place (CC §§1646, 1646.5)

Civil Code §1646 states the general choice of law rule applicable when the contract is silent on that issue:

> A contract is to be interpreted according to the law and usage of the place where it is to be performed; or, if it does not indicate a place of performance, according to the law and usage of the place where it is made.

Civil Code §1646.5 addresses the enforceability of choice-of-law clauses in certain agreements. Choice of law and conflict of laws analysis in California is discussed more fully in §§5.51-5.55.

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§5.15 12. Circumstances (CC §1647; CCP §1860)

Civil Code §1647 states that a "contract may be explained by reference to the circumstances under which it was made, and the matter to which it relates." "[I]n evaluating the contractual language [courts take] into account all the facts, circumstances and conditions surrounding the execution of the contract." *Falkowski v Imation Corp.* (2005) 132 CA4th 499, 506, 33 CR3d 724. See also *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 73, 96 CR3d 316; *City of Hope Nat'l Med. Ctr. v Genentech, Inc.* (2008) 43 C4th 375, 75 CR3d 333 (jury may interpret contract when extrinsic evidence admitted). For example, in *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 69 CR 561, the California Supreme Court reversed a trial court determination that extrinsic evidence could not be admitted to prove whether an indemnity clause covered damage to all property regardless of ownership or only property of third parties. Citing §1647, the court stated (69 C2d at 38):

> In this state… the intention of the parties as expressed in the contract is the source of contractual rights and duties.… A court must ascertain and give effect to this intention by determining what the parties meant by the words they used. Accordingly, the exclusion of relevant, extrinsic, evidence to explain the meaning of a written instrument could be justified only if it were feasible to determine the meaning the parties gave to the words from the instrument alone.

The court continued that, because the meaning of words varies with the verbal context and surrounding circumstances, the meaning of a writing can be found only by its interpretation in light of all the circumstances that disclose the sense in which the writer used the words. 69 C2d at 38.

Courts rely on CC §1647 when applying the parol evidence rule, discussed in §§5.33-5.43. See *Wolf v Superior Court* (2004) 114 CA4th 1343, 1356, 8 CR3d 649; *Denver D. Darling, Inc. v Controlled Env't's Constr., Inc.* (2001) 89 CA4th 1221, 108 CR2d 213. In *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 89 CR2d 540, citing §1647, the court looked to the surrounding circumstances and conduct of the parties to determine the meaning of "good cause" in connection with termination of employment.

Civil Code §1647 has an analogue in CCP §1860, which provides that for proper interpretation of a contact, the judge should be made aware of "the circumstances under which [the contract] was made, including the situation of the subject of the instrument, and of the parties to it." See also *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 69 CR 561 (ambiguity need not be evident on face of document in order to admit parol evidence to construe it); *Southern Pac. Transp. Co. v Santa Fe Pac. Pipelines, Inc.* (1999) 74 CA4th 1232, 1240, 88 CR2d 777.

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§5.16 13. Restricting Contract to Its Apparent Object (CC §1648)

Civil Code §1648 provides that "[h]owever broad may be the terms of a contract, it extends only to those things concerning which it appears that the parties intended to contract." In other words, a contract will not be interpreted to extend beyond its subject matter. In *Victoria v Superior Court* (1985) 40 C3d 734, 222 CR 1, the court relied on CC §1648 in interpreting an arbitration clause in the membership agreement between Kaiser Foundation Hospitals and an employer so as to exclude an employee's claims for negligent infliction of emotional distress and negligent supervision, employment, and retention of a hospital employee. The court concluded that the alleged conduct (sexual assault, rape, and sodomy by an orderly) was outside the scope of the services covered by the agreement and thus outside the scope of the arbitration clause. 40 C3d at 739.

The rule of CC §1648 also finds application in cases where the right of a third party to enforce a contract as a third party beneficiary is at issue. The question for the court is whether the contracting parties intended the third party to benefit from the contract's provisions. See, *e.g., Business to Bus. Mkts., Inc. v Zurich Specialties London Ltd.* (2005) 135 CA4th 165, 170, 37 CR3d 295; *City of Hope v Cave* (2002) 102 CA4th 1356, 126 CR2d 283. For a general discussion of third party beneficiaries, see §§7.63-7.70.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.17 14. Ambiguity or Uncertainty (CC §1649; CCP §1864)

§5.17 14. Ambiguity or Uncertainty (CC §1649; CCP §1864)

As a general rule, a contract will not be enforceable unless it is sufficiently definite for the court to ascertain the parties' respective obligations and to determine whether those obligations have been performed or breached. *Bustamante v Intuit, Inc.* (2006) 141 CA4th 199, 209, 45 CR3d 692; *Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 623, 2 CR2d 288. The contract must be definite enough to provide a rational basis for assessment of damages in the event of nonperformance. *Ladas v California State Auto. Ass'n* (1993) 19 CA4th 761, 770, 23 CR2d 810. "The terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy." *Weddington Prods., Inc. v Flick* (1998) 60 CA4th 793, 811, 71 CR2d 265, quoting Restatement (Second) of Contracts §33(2) (1981). If the contract is so indefinite and uncertain that the parties' intent cannot be ascertained, the contract is void and unenforceable. *California Lettuce Growers, Inc. v Union Sugar Co.* (1955) 45 C2d 474, 481, 289 P2d 785; *Bustamante v Intuit, Inc., supra*. See also CC §1598. Courts generally do not favor destruction of contracts on the grounds of uncertainty, however, and if feasible, will enforce a contract if the reasonable intentions of the parties can be ascertained. *Patel v Liebermensch* (2008) 45 C4th 344, 349, 86 CR3d 366. Civil Code §1649 provides that "[i]f the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it." In other words, if A knows that B interprets an ambiguous provision in a certain way but does not clarify matters, A will be bound to B's interpretation. See *Ticor Title Ins. Co. v Employers Ins. of Wausau* (1995) 40 CA4th 1699, 1708, 48 CR2d 368; *People v Shelton* (2006) 37 C4th 759, 767, 37 CR3d 354.

An ambiguity exists when a contractual provision is capable of two or more constructions, any of which are reasonable. *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 73, 96 CR3d 316; *Cohen v Five Brooks Stable* (2008) 159 CA4th 1476, 1485, 72 CR3d 471. The fact that a term is not defined in the contract does not render it ambiguous, nor does the fact that the parties disagree over the meaning of the term or that it is susceptible to more than one meaning if isolated from its context. *Lockheed Martin Corp. v Continental Ins. Co.* (2005) 134 CA4th 187, 197, 35 CR3d 799. "[L]anguage in a contract must be construed in the context of [the] instrument as a whole, and in the circumstances of that case, and cannot be found to be ambiguous in the abstract." *County of San Diego v Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 415, 33 CR3d 583 (citations omitted). See also *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 33 CR3d 562; *Falkowski v Imation Corp.* (2005) 132 CA4th 499, 505, 33 CR3d 724. To determine whether a contract provision is ambiguous, the court may consider any extrinsic evidence that supports a reasonable interpretation as well as the express language of the provision. *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1246, 37 CR3d 918.

This rule of interpretation is often used in insurance coverage disputes, usually to extend coverage to the insured in case of ambiguity. See, *e.g., Safeco Ins. Co. v Robert S.* (2001) 26 C4th 758, 766, 110 CR2d 844; *AIU Ins. Co. v Superior Court* (1990) 51 C3d 807, 274 CR 820. As applied to an insurance policy, CC §1649 protects the objectively reasonable expectations of the insured rather than the insurer's subjective beliefs. *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1264, 10 CR2d 538; *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1245, 37 CR3d 918. If application of the rule does not eliminate the ambiguity, the language in question will be construed against the insurer, as the drafter who created the uncertainty. *County of San Diego,* 37 C4th at 415. But see *Prudential Ins. Co. v Superior Court* (2002) 98 CA4th 585, 119 CR2d 823 (determining policy was not ambiguous and denying coverage).

Civil Code §1649 has also been invoked to construe narrowly otherwise sweeping release-of-claims language. See, *e.g., Neverkovec v Fredericks* (1999) 74 CA4th 337, 351, 87 CR2d 856. See also *Vine v Bear Valley Ski Co.* (2004) 118 CA4th 577, 590, 13 CR3d 370 (pertinent question was how reasonable person in plaintiff's position would have believed defendant understood scope of release—in this case whether term "skiing" in release included snowboarding).

The Code of Civil Procedure analogue of CC §1649 is CCP §1864, which provides:

> When the terms of an agreement have been intended in a different sense by the different parties to it, that sense is to prevail against either party in which he supposed the other understood it, and when different

constructions of a provision are otherwise equally proper, that is to be taken which is most favorable to the party in whose favor the provision was made.

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§5.18 15. Particular Clauses Subordinate to General Intent (CC §1650; CCP §1859)

Civil Code §1650 provides that "[p]articular clauses of a contract are subordinate to its general intent." As the California Supreme Court has stated: "The problem is not what the separate parts of the contract may mean, but rather what the contract means as a whole. The separate parts have little weight when compared with the contract in its entirety." *Hunt v United Bank & Trust Co.* (1930) 210 C 108, 115, 291 P 184. See also *Newby v Anderson* (1950) 36 C2d 463, 224 P2d 673; *11382 Beach Partnership v Libaw* (1999) 70 CA4th 212, 82 CR2d 533. Civil Code §1650 expresses a primary rule of contract construction, that contracts must be interpreted as a whole, from the four corners of the document, and the parties' intent must be ascertained from the entire instrument and not isolated parts of it. "Individual clauses and particular words must be considered in connection with the rest of the agreement, and all of the writing and every word of it will, if possible, be given effect." *Ajax Magnolia One Corp. v Southern Cal. Edison Co.* (1959) 167 CA2d 743, 748, 334 P2d 1053. See also CC §1641, discussed in §5.9, and *Behniwal v Mix* (2005) 133 CA4th 1027, 1037, 35 CR3d 320.

The Code of Civil Procedure analogue of CC §1650 is CCP §1859, which provides that "in the construction of the instrument … when a general and [a] particular provision are inconsistent, the latter is paramount to the former. So a particular intent will control a general one that is inconsistent with it." See *Starlight Ridge S. Homeowners Ass'n v Hunter-Bloor* (2009) 177 CA4th 440, 447, 99 CR3d 20 (applying CCP §1859 to interpretation of CC&Rs). Code of Civil Procedure §1859 only applies, however, when the contract clauses at issue are truly inconsistent. *Boghos v Certain Underwriters at Lloyd's of London* (2005) 36 C4th 495, 504, 30 CR3d 787.

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§5.19 16. Original Writing Controls Over Printed Form (CC §1651; CCP §1862)

When a contract consists of a printed form that has been modified by the parties (or by another at their direction) in writing, and there is a conflict between the written terms and the printed terms, the written terms control over the printed ones. Similarly, when the parties have copied their written contract from a form and added so-called "purely original" terms to the copied provisions, the purely original terms will control over those taken from the form in the event of conflict. CC §1651; *Fidelity & Deposit Co. v Charter Oak Fire Ins. Co.* (1998) 66 CA4th 1080, 78 CR2d 429.

The distinction between "printed" and "written" refers to the difference between language in preprinted forms and more customized language added by the parties (66 CA4th at 1087):

> Where a contract is partly written or printed under the special direction of the parties, and the remainder is copied from a form prepared without reference to the particular contract in question, the parts which are original control those which are not.

Thus, "written" includes "typewritten" (*Gutzi Assocs. v Switzer* (1989) 215 CA3d 1636, 1642, 264 CR 538 (typewritten provision of note which prohibited prepayment controlled over conflicting preprinted provision)) and, presumably, would also include the more modern counterpart, "word processed." See also *United States Elevator Corp. v Associated Int'l Ins. Co.* (1989) 215 CA3d 636, 263 CR 760 (typewritten portion of insurance policy did not conflict with preprinted portion and therefore was not controlling).

One court has questioned whether §1651 can be applied to determine if a contract exists in the first place (*i.e.,* whether there has been an offer and an acceptance) or whether §1651 is limited in application to interpretation of a contract that has already been found to exist. *Roth v Malson* (1998) 67 CA4th 552, 560, 79 CR2d 226 (handwritten modifications to preprinted form of realty purchase-and-sale agreement controlled). By implication, if it is correct to limit the use of §1651 to interpretation of existing contracts, the same limitation would also apply to all of the other Civil Code rules for contract interpretation. CC §§1641-1650, 1652-1656.

The Code of Civil Procedure analogue of CC §1651 is CCP §1862, which provides that "[w]hen an instrument consists partly of written words and partly of a printed form, and the two are inconsistent, the former controls the latter."

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§5.20 17. Reconciling Repugnancies (CC §1652)

Civil Code §1652 restates, in part, the rule of CC §1641 (effect to be given to the contract as a whole; see §5.9): "Repugnancy in a contract must be reconciled, if possible, by such an interpretation as will give some effect to the repugnant clauses, subordinate to the general intent and purpose of the whole contract." CC §1652. See *11382 Beach Partnership v Libaw* (1999) 70 CA4th 212, 82 CR2d 533; *Estate of Petersen* (1994) 28 CA4th 1742, 34 CR2d 449. See also *Mechanics Bank v Rosenberg* (1962) 201 CA2d 419, 425, 20 CR 202 (interpreting assignment for benefit of creditors, court rejected argument that general reservation of rights included reservation of right to execute on assigned assets because that would undermine purpose of assignment for benefit of creditors).

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§5.21 18. Inconsistent Words (CC §1653)

Civil Code §1653 provides that "[w]ords in a contract which are wholly inconsistent with its nature, or with the main intention of the parties, are to be rejected." See *Sy First Family Ltd. Partnership v Cheung* (1999) 70 CA4th 1334, 83 CR2d 340 (applying rule, court held that stipulation submitting dispute to American Arbitration Association was an arbitration and that defendants were bound by arbitrators' award). See also *Safeco Ins. Co. v Robert S.* (2001) 26 C4th 758, 766, 110 CR2d 844 (citing rule, court held that because illegal act exclusion in insurance policy could not reasonably be given meaning under established rules of contract construction, it must be rejected as invalid); *ML Direct, Inc. v TIG Specialty Ins. Co.* (2000) 79 CA4th 137, 93 CR2d 846 (prior litigation exclusion in D & O policy found not inconsistent with retroactivity provision). See also *Flintkote Co. v General Acc. Assur. Co.* (ND Cal 2006) 410 F Supp 2d 875 (if court has adopted only reasonable construction of contract, "fact that some redundancy results is not fatal").

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§5.22 19. Interpretation Against Persons Causing Uncertainty (CC §1654)

Civil Code §1654 provides that "[i]n cases of uncertainty not removed by [the rules of CC §§1635-1653], the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist." Section 1654 reflects the well-settled rule of contract interpretation that "ambiguities are generally construed against the party who caused the uncertainty to exist." *Powerine Oil Co., Inc. v Superior Court* (2005) 37 C4th 377, 33 CR3d 562. See *City of Hope Nat'l Med. Ctr. v Genentech, Inc.* (2008) 43 C4th 375, 75 CR3d 333; *Benedek v PLC Santa Monica, LLC* (2002) 104 CA4th 1351, 129 CR2d 197 (citing CC §1654, court found release of liability executed by health club patron was unambiguous and enforceable); *Solis v Kirkwood Resort Co.* (2001) 94 CA4th 354, 360, 114 CR2d 265 (applying CC §1654, among other authorities, to interpret narrowly skier's prior release of ski area's liability in season pass agreement); *Maggio v Windward Capital Mgmt. Co.* (2000) 80 CA4th 1210, 96 CR2d 168 (ambiguity in arbitration clause).

Civil Code §1654 embodies the common law doctrine of contra preferentem, which requires ambiguous agreements to be construed against the drafter. It applies with special force when the person who drafted the agreement is a lawyer. *Mayhew v Benninghoff* (1997) 53 CA4th 1365, 62 CR2d 27.

The introductory clause in CC §1654 is important. If other rules of interpretation can remove the uncertainty, §1654 should not be applied. As stated in *Gutzi Assocs. v Switzer* (1989) 215 CA3d 1636, 1641, 264 CR 538 (citations omitted; emphasis in original), "[t]he purpose of [§1654] is to authorize the court, *when other rules of construction are not determinative*, to indulge in that construction which would be most favorable to the party who did not prepare the contract." See also *AIU Ins. Co. v Superior Court* (1990) 51 C3d 807, 831, 274 CR 820 (noting that application of §1654 occurs *after* attempting to resolve ambiguity with other rules of construction).

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§5.23 20. Implied Stipulations (CC §1655; CCP §1856(c))

Civil Code §1655 provides that "[s]tipulations which are necessary to make a contract reasonable, or conformable to usage, are implied, in respect to matters concerning which the contract manifests no contrary intention." In *Scott v PG&E* (1995) 11 C4th 454, 46 CR2d 427, the California Supreme Court found an implied contract term that an employer would not demote its employees except for good cause, based on the employer's personnel policy manual and testimony of one of the employer's human resource managers, and ruled that the employer had breached this agreement. In *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 852, 89 CR2d 540, the court of appeal ruled that the trial court must consider the surrounding circumstances to determine what the parties had impliedly agreed would constitute "good cause" for termination of an employee. The employer had expressly agreed not to terminate the employee except for good cause, but there was no further agreement regarding what would or would not qualify as good cause. The court was therefore required to supply a meaning that was reasonable under the circumstances.

In *Hinckley v Bechtel Corp.* (1974) 41 CA3d 206, 116 CR 33, the court refused to imply an obligation on the part of the defendant employer to notify its employee of an option to convert a group life insurance policy to an individual policy on termination of employment. Relying on *Stockton Dry Goods Co. v Girsh* (1951) 36 C2d 677, 227 P2d 1, the court in *Hinckley* outlined five conditions that must exist before a court has authority to insert implied covenants in a contract:

- The implication must arise from the language used or it must be indispensable to effectuate the intention of the parties;
- It must appear from the language used that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it;
- Implied covenants can only be justified on grounds of legal necessity;
- A promise can be implied only where it may be rightfully assumed that it would have been made if attention had been called to it; and
- There can be no implied covenant where the subject is completely covered by the contract.

See also *Frankel v Board of Dental Exam'rs* (1996) 46 CA4th 534, 545, 54 CR2d 128; *Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 804, 48 CR2d 747.

Compare the result in *Hinckley* to *Walker v Occidental Life Ins. Co.* (1967) 67 C2d 518, 523, 63 CR 45, in which the California Supreme Court held, on similar facts, that defendant employer had an implied obligation to give notice of termination of a group life insurance to an employee suspended from employment. The employee had a right to convert the group life policy to an individual one, and the court noted that the conversion privilege would be of little value if the employee were not entitled to be notified of the group policy termination.

Code of Civil Procedure §1856(c), which provides that course of dealing, usage of trade, or course of performance may be used to explain or supplement the terms of a contract, is conceptually related to CC §1655. See §5.42; *Southern Pac. Transp. Co. v Santa Fe Pac. Pipelines, Inc.* (1999) 74 CA4th 1232, 1241, 88 CR2d 777 (parties are presumed to contract in accordance with any fixed and established usage and custom of trade). Civil Code §1656, discussed in §5.24, is also relevant in determining what matters may properly be implied in a contract.

Civil Code §1655 is sometimes mentioned in connection with an analysis of the implied covenant of good faith and fair dealing. See, *e.g., Lazar v Hertz Corp.* (1983) 143 CA3d 128, 191 CR 849. For further discussion of the implied covenant of good faith and fair dealing, see §§6.33-6.36.

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§5.24 21. Implied Incidentals (CC §1656)

Civil Code §1656 provides:

> All things that in law or usage are considered as incidental to a contract, or as necessary to carry it into effect, are implied therefrom, unless some of them are expressly mentioned therein, when all other things of the same class are deemed to be excluded.

If a contract states a term clearly and unambiguously, however, custom or usage that would vary or contradict that term is not admissible. *Varni Bros. Corp. v Wine World, Inc.* (1995) 35 CA4th 880, 889, 41 CR2d 740. As the court in *Aozora Bank, Ltd. v 1333 North Cal. Blvd.* (2004) 119 CA4th 1291, 1296, 15 CR3d 340 (citations omitted), held, "A contract term will be implied only when 'it is so obvious that the parties had no reason to state [it].'"

In *Frankel v Board of Dental Exam'rs* (1996) 46 CA4th 534, 545, 54 CR2d 128, a dentist entered into a stipulated settlement in a disciplinary matter with the executive director of the Board of Dental Examiners to resolve a complaint. The settlement was expressly subject to approval by the Board. The court held that the dentist could not withdraw his consent before allowing the Board to meet, confer, and determine whether to approve the settlement. Allowing the Board a reasonable time to act on the stipulation was an implied incident of that agreement. The stipulation was binding and effective on the dentist when signed, subject only to the condition subsequent of Board approval. In so holding, the court in *Frankel* recited the same five rules stated by the California Supreme Court in *Stockton Dry Goods Co. v Girsh* (1951) 36 C2d 677, 681, 227 P2d 1, for determining when covenants may be implied. The rules are outlined in §5.23.

See §5.42 for discussion of the role of course of dealing, usage of trade, and course of performance in interpretation of California contracts not subject to Division 2 of the Commercial Code.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.25 22. Presumptions Concerning Sales Tax, Schedules (CC §1656.1)

§5.25 22. Presumptions Concerning Sales Tax, Schedules (CC §1656.1)

In California, sales tax is imposed on retailers of tangible personal property. See Stats 1978, ch 1211, §§19, 22. Sales tax is not the responsibility of the purchaser. Civil Code §1656.1, however, provides that the retailer and the purchaser may agree that the purchaser shall reimburse the retailer for sales tax. CC §1656.1(a). See also Stats 1978, ch 1211, §22. The parties' agreement to add sales tax to the price of the property sold is governed exclusively by the terms of their sales agreement if it makes provision for sales tax. CC §1656.1(a). In the absence of an explicit provision, there is a rebuttable presumption that the parties have agreed to the addition of sales tax reimbursement to the sales price if (CC §1656.1(a)):

- The sales agreement expressly provides for the addition of sales tax reimbursement;
- The sales tax reimbursement is shown on the sales receipt or other proof of sale; or
- The retailer posts a notice that sales tax will be added to all or certain items sold (whichever is applicable) in a location visible to purchasers, or else includes the notice in price tags, advertisements, or other publications directed to purchasers.

Alternatively, if the retailer posts one of the following notices in its premises or on a price tag or advertisement, there is a rebuttable presumption that the price of the property sold includes the sales tax (CC §1656.1(b)):

- "All prices of taxable items include sales tax reimbursement computed to the nearest mill."
- "The price of this item includes sales tax reimbursement computed to the nearest mill."

Retailers who include sales tax reimbursements in the price of their merchandise must use a schedule provided or approved by the State Board of Equalization. CC §1656.1(c)(1). If the sale price exceeds the amount specified in the schedule, tax reimbursement "may be computed by applying the applicable tax rate to the sales price, rounded off to the nearest cent by eliminating any fraction less than one-half cent and increasing any fraction of one-half cent or over to the next higher cent." CC §1656.1(c)(2).

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§5.26 23. Time of Performance (CC §1657)

Civil Code §1657 provides:

> If no time is specified for the performance of an act required to be performed, a reasonable time is allowed. If the act is in its nature capable of being done instantly—as, for example, if it consists in the payment of money only—it must be performed immediately upon the thing to be done being exactly ascertained.

Whether a particular time for performance is reasonable or not is a question of fact and depends on the circumstances of a particular case. *Kotler v Pacificare of Cal.* (2005) 126 CA4th 950, 24 CR3d 447; *Consolidated World Invs., Inc. v Lido Preferred Ltd.* (1992) 9 CA4th 373, 11 CR2d 524. In *Kotler,* the court of appeal reversed a trial court's grant of summary judgment in favor of the defendant HMO. The plaintiff in *Kotler* was suffering from Lyme disease, and the HMO had delayed authorizing referral of the plaintiff to an infectious disease specialist for 6 weeks. The court held that a triable issue existed whether the HMO had fulfilled its implied obligation to provide the plaintiff timely treatment of his condition.

In contracts for the sale of real property, a reasonable time for payment may be implied. *Patel v Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366 (real estate option contract did not specify length of escrow period, but reasonable time was implied under §1657).

Time for performance is discussed further in §§8.8-8.11.

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§5.27 24. Joint and Several Liability Presumed if Joint Benefit Conferred (CC §1659)

Civil Code §1659 provides that "[w]here all the parties who unite in a promise receive some benefit from the consideration, whether past or present, their promise is presumed to be joint and several." Section 1659 does not require that the benefit be received equally, as long as each of the promisors received some benefit from the contract. *Olson v Foster* (1941) 42 CA2d 493, 109 P2d 388. See *Kaneko v Okuda* (1961) 195 CA2d 217, 15 CR 792 (noting that presumption of joint and several liability in §1659 is rebuttable); *Keppelman v Heikes* (1952) 111 CA2d 475, 245 P2d 54 (corporate and individual defendants were jointly and severally liable, regardless of whether they were partners or joint venturers). In *Davis v Morris* (1940) 37 CA2d 269, 99 P2d 345, the court held that members of a mining partnership named in a lawsuit as individuals were jointly and severally liable, notwithstanding that the members were not sued as a partnership. See also CC §1430-1432. Joint and several obligations are discussed more fully in §§7.69-7.80.

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§5.28 25. Joint and Several Liability Presumed in Joint Undertaking (CC §1660)

Civil Code §1660 provides that "[a] promise, made in the singular number, but executed by several persons, is presumed to be joint and several." See *William v Reed* (1952) 113 CA2d 195, 248 P2d 147, in which the court held that when a promissory note is drafted in the singular but is signed by several comakers, the presumption is that the promise and the obligations of the comakers are joint and several. See also CC §§1430-1432; *Dabney v Dabney* (1935) 9 CA2d 665, 51 P2d 108. Joint and several obligations are discussed more fully in §§7.71-7.82.

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§5.29 26. Executed and Executory Contracts Defined (CC §1661)

Civil Code §1661 provides that "[a]n executed contract is one, the object of which is fully performed. All others are executory." See *Fanucci & Limi Farms v United Agri Prods.* (9th Cir 2005) 414 F3d 1075 (the term "executed" means fully performed). Note that this definition is different from the one used by courts interpreting the Bankruptcy Code (Title 11 USC), which focuses on whether material unperformed duties exist on both sides of the contract such that the failure of one party to perform would excuse performance by the other party. See *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492.

The distinction between executory and executed contracts may have substantive effects. See, *e.g., Smith v Allen* (1968) 68 C2d 93, 65 CR 153 (contract of sale executed when vendor conveyed property and took back deed of trust; parties' rights thereafter determined by statutes governing foreclosure on default); *Lockheed Missiles & Space Co. v Gilmore Indus.* (1982) 135 CA3d 556, 185 CR 409 (if document was executed agreement, then Lab C §3864 governing liability to reimburse or hold harmless would apply). In *Branche v Hetzel* (1966) 241 CA2d 801, 51 CR 188, the court construed separate agreements as a single incomplete transaction, and thus an executory contract, and as a result, applied the rule allowing recovery by a defaulting vendee to prevent the vendor from being unjustly enriched as a result of the vendee's willful default—a rule that would be unavailable on a fully performed contract.

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§5.30 27. Uniform Vendor and Purchaser Risk Act (CC §1662)

California has enacted the Uniform Vendor and Purchaser Risk Act. See CC §1662. The Act applies to contracts for the purchase and sale of real property that do not allocate the risk of loss or destruction of that property before the transfer of both legal title and possession of the property from the seller to the purchaser. Loss or destruction includes a taking by the state under the power of eminent domain. Under the Act, if all or a material part of the real property is destroyed without fault of the purchaser before either legal title or possession of the real property has passed to the purchaser, the seller cannot enforce the contract and the purchaser is entitled to a refund of any payment of the purchase price or deposit already made. CC §1662(a). Conversely, if the destruction or taking occurs through no fault of the seller after either legal title or possession has been transferred to the purchaser, the purchaser is not relieved of its contractual obligations and the seller may enforce the contract against the purchaser. CC §1662(b). See *Long v Keller* (1980) 104 CA3d 312, 163 CR 532; *Palos Verdes Props. v County Sanitation Dist. Number 5* (1960) 177 CA2d 679, 2 CR 537. See generally California Real Property Sales Transactions (4th ed Cal CEB 2007).

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§5.31 28. Euro as Form of Payment (CC §1663)

In 1998, California enacted CC §1663, which recognized the introduction of the Euro as a form of currency. This statute specifies that the Euro is a commercially reasonable substitute for the currencies it replaces and incorporates by reference the conversion rates and regulations of the Council of the European Union. CC §1663. It was enacted to assure that international contracts specifying the national currencies being replaced by the Euro would remain enforceable. Stats 1998, ch 62, §2.

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§5.32 29. Ascertaining Consideration (CC §§1610-1613)

The Civil Code includes a series of statutes addressed to fixing the amount of consideration if the contract is silent or the method specified for determining it is or becomes impossible. Civil Code §1610 provides that a contract need not specify the amount of consideration or the means for ascertaining it—it may be left to the decision of a third person or regulated by any specified standard. If a contract does not specify the amount of consideration or the method for its determination, or if the contract leaves the amount to the discretion of a third party, the consideration must be "so much money as the object of the contract is reasonably worth." CC §1611. This rule is consistent with Com C §2305 (discussed in §5.62), which provides for a reasonable price in contracts for the sale of goods if the contract is silent.

Civil Code §1612 states that the entire contract is void if the contract provides an exclusive method by which the consideration is to be ascertained, but the method is on its face impossible to execute. In contrast, under CC §1613, if an exclusive method for determining consideration appears possible on its face, but is or becomes impossible to execute, then only that provision is void. Neither CC §1612 nor CC §1613 is consistent with Com C §2305, which operates to imply a reasonable price in contracts for the sale of goods in similar circumstances. See §5.62.

Consideration as one of the essential elements for formation of a contract is discussed in §§3.42-3.54.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/ II. PAROL EVIDENCE RULE/§5.33 A. Generally (CC §§1625, 1639; CCP §1856)

II. PAROL EVIDENCE RULE

§5.33 A. Generally (CC §§1625, 1639; CCP §1856)

California's parol evidence rule is set forth in both the Civil Code and the Code of Civil Procedure, with the most complete statement of the rule appearing in CCP §1856. Code of Civil Procedure §1856(a) provides:

> Terms set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement.

Although the terms set forth in a writing described in CCP §1856(a) may not be contradicted, CCP §1856(b) provides that they may be explained or supplemented by evidence of consistent additional terms, unless the writing is intended as a compete and exclusive statement of the terms of the parties' agreement. Further, the terms of a writing may be explained or supplemented by course of dealing or usage of trade or by course of performance. CCP §1856(c). See §5.42. The question of whether the writing is intended as a final, complete, or exhaustive expression of the parties' agreement is one for the court, not the jury. CCP §1856(d).

The parol evidence rule is also stated in the Civil Code, as follows (CC §1625):

> The execution of a contract in writing, whether the law requires it to be written or not, supersedes all the negotiations or stipulations concerning its matter which preceded or accompanied the execution of the instrument.

The rule is further reflected in CC §1639, which provides that "[w]hen a contract is reduced to writing, the intention of the parties is to be ascertained from the writing alone, if possible; subject, however, to the other provisions of this title."

In general, the rule prohibits the introduction of any extrinsic evidence, either oral or written, to vary or supplement the terms of an integrated written instrument. It does not, however, prohibit the introduction of extrinsic evidence to explain the meaning of a written instrument, provided that the meaning advanced is one to which the written instrument is reasonably susceptible. *Wagner v Columbia Pictures Indus., Inc.* (2007) 146 CA4th 586, 52 CR3d 898. See also *Casa Herrera, Inc. v Beydoun* (2004) 32 C4th 336, 343, 9 CR3d 97. Further, if a written contract is not integrated, *i.e.,* is not the final and complete agreement of the parties, then the rule does not prohibit the introduction of extrinsic evidence concerning any matter on which the agreement is silent and which is not inconsistent with its written terms. *Ri-Joyce, Inc. v New Motor Vehicle Bd.* (1992) 2 CA4th 445, 452, 3 CR2d 546.

The parol evidence rule is not merely an evidentiary rule, but a rule of substantive law that renders an integrated, written agreement the exclusive and binding contract of the parties, no matter how persuasive the evidence may be of additional oral understandings. See *Casa Herrera, Inc. v Beydoun, supra*; *Alling v Universal Mfg. Corp.* (1992) 5 CA4th 1412, 1433, 7 CR2d 718; *Banco do Brasil, S.A. v Latian, Inc.* (1991) 234 CA3d 973, 1000, 285 CR 870. If the writing is intended as a complete and exclusive statement of the parties' agreement, even evidence of consistent additional terms is not admissible. *Brinton v Bankers Pension Servs., Inc.* (1999) 76 CA4th 550, 90 CR2d 469; *Esbensen v Userware Int'l, Inc.* (1992) 11 CA4th 631, 14 CR2d 93. As the California Supreme Court in *Casa Herrera* stated (32 C4th at 344):

> The parol evidence rule… establishes that the terms contained in an integrated written agreement may not be contradicted by prior or contemporaneous agreements. In doing so, the rule necessarily bars consideration of extrinsic evidence of prior or contemporaneous negotiations or agreements at variance with the written agreement.… In other words, the evidentiary consequences of the rule follow from its substantive component—which establishes, as a matter of law, the enforceable and incontrovertible terms of an integrated written agreement.

"Integrated" means that the parties have embodied the complete terms of an agreement in a writing, so that, as a matter of law, the writing *is* the agreement. 32 C4th at 344. The writing constitutes a "jural act," *i.e.,* conduct that alters the parties' voluntary legal relationship. The critical issue in determining whether the writing is integrated is whether the parties intended the writing to serve as the complete and exclusive embodiment of their agreement. *FPI Dev., Inc. v Nakashima* (1991) 231 CA3d 367, 387, 282 CR 508. See also *Alling v Universal Mfg. Corp.* (1992) 5 CA4th 1412,

1436, 7 CR2d 718 (factors to be considered in determining whether agreement is integrated).

The parties' written agreement may be integrated in whole or in part, and if only in part, the parol evidence rule will apply only to that part. *Founding Members of Newport Beach Country Club v Newport Beach Country Club, Inc.* (2003) 109 CA4th 944, 953, 135 CR2d 505; *Haggard v Kimberly Quality Care, Inc.* (1995) 39 CA4th 508, 517, 46 CR2d 16. If an agreement is partly oral and partly written, parol evidence may be used to establish those parts of the agreement that are oral. In such a case, however, parol evidence is not admissible to "contradict the plain terms of that part of the contract that is set forth in writing." *Buffalo Arms, Inc. v Remler Co.* (1960) 179 CA2d 700, 709, 4 CR 103.

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§5.34 B. Parol Evidence Analysis

Parol evidence analysis is a two-step process. *ASP Props. Group, L.P. v Fard, Inc.* (2005) 133 CA4th 1257, 1267, 35 CR3d 343; *Pacific State Bank v Greene* (2003) 110 CA4th 375, 386, 1 CR3d 739. First, the court must determine whether the parties intended the writing in question to constitute a final, complete statement of their agreement, *i.e.,* to be integrated. *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 37, 69 CR 561; *Masterson v Sine* (1968) 68 C2d 222, 225, 65 CR 545. The court does so by provisionally receiving, without actually admitting, all credible evidence regarding the parties' intent, in order to determine whether the agreement is ambiguous, *i.e.,* whether it is reasonably susceptible to the interpretation advanced by one party. If it is, extrinsic evidence may be admitted to assist in the second step, which is to interpret the agreement, subject to other evidentiary rules. *Pacific State Bank*, 110 CA4th at 386. See also *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 73, 96 CR3d 316; *Wolf v Superior Court* (2004) 114 CA4th 1343, 8 CR3d 649. The test has been stated by the California Supreme Court as follows (*PG&E,* 69 C2d at 37):

> The test of admissibility of extrinsic evidence to explain the meaning of a written instrument is not whether it appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible.

See also *Wagner v Columbia Pictures Indus., Inc.* (2007) 146 CA4th 586, 52 CR3d 898; *Masterson v Sine, supra*; *Roden v Bergen Brunswig Corp.* (2003) 107 CA4th 620, 132 CR2d 549. If the agreement is not reasonably susceptible to the interpretation advanced by the party offering the parol evidence, then the evidence is not admissible. *Wagner v Columbia Pictures Indus., Inc., supra*. From a drafter's perspective, if a document is intended to be a full and complete statement of the parties' agreement, the document should say so.

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§5.35 1. Standard of Review

Different standards of appellate review may be applicable to the steps described in §5.34, depending on the context in which an issue arises. The threshold question of ambiguity—whether the offered parol evidence is relevant to prove a meaning to which the contract language is reasonably susceptible—is a question of law, and therefore subject to review de novo. *ASP Props. Group, L.P. v Fard, Inc.* (2005) 133 CA4th 1257, 1267, 35 CR3d 343. The second step—determining the meaning of the ambiguous language—may require a different standard of review, depending on the nature of the parol evidence. If the evidence is conflicting and involves credibility issues, any reasonable construction will be upheld as long as it is supported by substantial evidence. 133 CA4th at 1267. If no parol evidence is introduced, however, or if the parol evidence is not conflicting, interpretation of the contract is a question of law, and the appellate court will independently construe the writing. *City of Chino v Jackson* (2002) 97 CA4th 377, 383, 118 CR2d 349. See also §5.39.

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§5.36 2. Merger or Integration Clauses

"Merger" or "integration" clauses, such as the following, are often inserted in written contracts in an effort to prevent resort to prior or contemporaneous oral agreements:

> **This contract sets forth the entire agreement between the parties, and supersedes all other prior or contemporaneous oral or written agreements and understandings. This contract may be modified or amended only by a writing signed by the parties.**

A merger or integration clause is intended to confirm that no *previous* understandings or agreements exist between the parties other than those contained in the instant writing. The inclusion of an integration clause in a contract may be conclusive on the issue of integration. *Banco do Brasil, S.A. v Latian, Inc.* (1991) 234 CA3d 973, 285 CR 870. It will be given great weight, although it may not in itself be determinative. *Salyer Grain & Milling Co. v Henson* (1970) 13 CA3d 493, 91 CR 847.

A merger or integration clause will not bar admission of parol evidence of mutual mistake of fact, fraud, duress, undue influence, illegality, alteration, lack of consideration, or other cause for invalidity. *Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739. Further, a merger or integration clause does provide protection against subsequent oral modifications insofar as it specifically limits amendments to signed writings. To the extent that a subsequent oral agreement has been performed or partially performed by the parties, however, a merger or integration clause does not prevent enforcement of the oral modification. CC §1698(b). Nor does it preclude enforcement of an oral modification in an appropriate case by application of the law of estoppel, oral novation and substitution of a new agreement, rescission, waiver, or independent collateral contract. CC §1698(d). Civil Code §1698 is discussed further in §5.84.

Neither an integration clause nor the parol evidence rule will bar admission of evidence of *subsequent* agreements. *Beggerly v Gbur* (1980) 112 CA3d 180, 188, 169 CR 166. Any subsequent agreement, however, must conform to the express requirements of the integration clause. In *Tomlinson v Qualcomm, Inc.* (2002) 97 CA4th 934, 945, 118 CR2d 822, the court held that a change in a company's employment policy made after an at-will employment contract was entered into did not supersede the contract; the contract provided that it could be modified only by a writing signed by the chairman of the board.

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§5.37 3. Collateral Agreements; Incorporation of Extrinsic Documents by Reference

Historically, California courts held that whether an agreement was integrated was to be determined solely from the face of the document. But in 1968, in *Masterson v Sine* (1968) 68 C2d 222, 227, 65 CR 545, the California Supreme Court acknowledged that it was impossible to ascertain the parties' intent that a writing was to be the sole memorial of their agreement strictly from the writing itself, and reduced the scope of the parol evidence rule by holding that evidence of a collateral agreement should be excluded only if the finder of fact is likely to be misled. The collateral agreement itself must be examined to determine whether the parties intended it to be included in, excluded from, or otherwise affected by the original writing. 68 C2d at 226. See also *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 69 CR 561. As the court of appeal in *Software Design & Application, Ltd. v Price Waterhouse, LLP* (1996) 49 CA4th 464, 470, 57 CR2d 36, explained:

> Faced with deciding whether the parties intended a written instrument to be the exclusive repository of their agreement, courts may consider all the surrounding circumstances, including prior negotiations, and may examine the collateral agreement itself to ascertain if it was meant to be part of the bargain.... However, the collateral agreement will be looked to only insofar as it does not directly contradict the express terms of the writing. Further, it must be an agreement which, in the normal course of events, might be made as a separate contract.

See also *FPI Dev., Inc. v Nakashima* (1991) 231 CA3d 367, 282 CR 508.

In *DVD Copy Control Ass'n v Kaleidescape, Inc.* (2009) 176 CA4th 697, 97 CR3d 856, the court held that

> the terms of an extrinsic document may be incorporated by reference in a contract so long as (1) the reference is clear and unequivocal, (2) the reference is called to the attention of the other party and he consents thereto, and (3) the terms of the incorporated document are known or easily available to the contracting parties.

See also *Amtower v Photon Dynamics, Inc.* (2008) 158 CA4th 1582, 71 CR3d 361.

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§5.38 4. Contradictory Evidence

If the writing was intended to integrate all terms, *i.e.,* to be a final, complete statement of the parties' agreement, then the court must determine whether the proffered evidence varies or contradicts the written agreement at issue. *Banco do Brasil, S.A. v Latian, Inc.* (1991) 234 CA3d 973, 1001, 285 CR 870. If the proffered parol evidence directly contradicts the parties' written agreement, it must be excluded because it cannot reasonably be presumed that the parties intended to include directly contradictory provisions in the same agreement. *Haggard v Kimberly Quality Care, Inc.* (1995) 39 CA4th 508, 46 CR2d 16. See also *Software Design & Application, Ltd. v Price Waterhouse, LLP* (1996) 49 CA4th 464, 57 CR2d 36; *Consolidated World Invs., Inc. v Lido Preferred Ltd.* (1992) 9 CA4th 373, 11 CR2d 524. If the parol evidence does not contradict the written agreement, it may be admitted if it meets the general test for admissibility stated in §5.34. See *Esbensen v Userware Int'l, Inc.* (1992) 11 CA4th 631, 14 CR2d 93; *Bancod do Brasil, S.A. v Latian, Inc., supra*.

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§5.39 5. Latent Versus Patent Ambiguities

Parol evidence is properly admitted to construe a written instrument if its language is ambiguous. *Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739. The test of whether parol evidence is admissible to construe an ambiguity is not whether the contract language appears to the court to be plain and unambiguous on its face, but instead whether the evidence presented is relevant to prove a meaning to which the language is reasonably susceptible. *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 69 CR 561; *Lockheed Martin Corp. v Continental Ins. Co.* (2005) 134 CA4th 187, 197, 35 CR3d 799. "An ambiguity exists when a party can identify an alternative, semantically reasonable, candidate of meaning of a writing." *Solis v Kirkwood Resort Co.* (2001) 94 CA4th 354, 360, 114 CR2d 265.

An ambiguity can be "patent," *i.e.,* one arising from the face of the agreement, or "latent," *i.e.,* one revealed by extrinsic evidence. *Benedek v PLC Santa Monica, LLC* (2002) 104 CA4th 1351, 1357, 129 CR2d 197. This distinction, however, has little current significance in application of the parol evidence rule. In either case, parol evidence is admissible to explain the agreement if it meets the "reasonably susceptible" test discussed above and in §§5.33-5.34. See *Lockheed Martin Corp. v Continental Ins. Co.* (2005) 134 CA4th 187, 197, 35 CR3d 799; *Wolf v Superior Court* (2004) 114 CA4th 1343, 8 CR3d 649. If a case involves a latent ambiguity and the extrinsic evidence is uncontested, the meaning of the language at issue may be determined as a matter of law and may be reviewed by an appellate court de novo. If the extrinsic evidence does not eliminate the ambiguity, however, an issue of fact arises, and the appellate court must defer to the trial court's assessment of the extrinsic evidence. *Solis,* 94 CA4th at 360.

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§5.40 6. Evidence of the Circumstances (CCP §§1856(g), 1860)

The parol evidence rule expressly allows introduction of evidence of the circumstances under which an agreement has been made. See CCP §1856(g). Code of Civil Procedure §1860 provides:

> For the proper construction of an instrument, the circumstances under which it was made, including the situation of the subject of the instrument, and of the parties to it, may also be shown, so that the judge [will] be placed in the position of those whose language he is to interpret.

Evidence of the circumstances surrounding the making of the contract is admissible as a threshold matter to determine whether the contract is ambiguous or otherwise to interpret the agreement. *City of Hope Nat'l Med. Ctr. v Genentech, Inc.* (2008) 43 C4th 375, 75 CR3d 333. See, *e.g., People v Shelton* (2006) 37 C4th 759, 767, 37 CR3d 354 (plea agreement); *American Alternative Ins. Corp. v Superior Court* (2006) 135 CA4th 1239, 1245, 37 CR3d 918 (insurance policy); *Alling v Universal Mfg. Corp.* (1992) 5 CA4th 1412, 1436, 7 CR2d 718 (purchase agreement). See generally *PG&E v G.W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 C2d 33, 40, 69 CR 561; *Neverkovec v Fredericks* (1999) 74 CA4th 337, 350, 87 CR2d 856. Code of Civil Procedure §1860 is a companion to CC §1647, discussed in §5.15.

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§5.41 7. Exceptions for Mistake, Invalidity, Illegality, Fraud (CCP §1856(e)-(g))

The parol evidence rule has specific statutory exceptions for mistake, invalidity, illegality, and fraud. See CCP §1856(e)-(g). The California Supreme Court narrowed the scope of the fraud exception 70 years ago to exclude promissory fraud. See *Bank of America v Pendergrass* (1935) 4 C2d 258, 263, 48 P2d 659. "Promissory fraud" refers to a promise made without any intention to perform it. See CC §1572(4). The fraud exception to the parol evidence rule is not applicable to promissory fraud if the evidence at issue is being offered to show a promise that contradicts an integrated written agreement. "Unless the false promise is either independent of or consistent with the written instrument, evidence thereof is inadmissible." *Alling v Universal Mfg. Corp.* (1992) 5 CA4th 1412, 1436, 7 CR2d 718. The exclusion for promissory fraud is sometimes referred to as the "Pendergrass rule." See *Wang v Massey Chevrolet* (2002) 97 CA4th 856, 118 CR2d 770.

Promissory fraud must be distinguished from fraud in the inducement based on misrepresentations of fact. Parol evidence of misrepresentations of fact regarding the content of the agreement at the time of signing is admissible under CCP §1856(g). *Pacific State Bank v Greene* (2003) 110 CA4th 375, 379, 1 CR3d 739; *Wang,* 97 CA4th at 870. Such evidence is admissible because it does not serve to contradict the terms of the parties' integrated agreement, but rather to show that the writing has no legal effect. *Edwards v Centex Real Estate Corp.* (1997) 53 CA4th 15, 42, 61 CR2d 518. "A party may claim fraud in the inducement of a contract containing a provision disclaiming any fraudulent misrepresentations and introduce parol evidence to show such fraud." *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 37 CR3d 364. Fraud in the inducement is discussed in §3.11.

The same limitation on the scope of the parol evidence rule applies to mistake, illegality, invalidity, and other defenses to formation of a contract. See *Pacific State Bank v Greene* (2003) 110 CA4th 375, 384, 1 CR3d 739; *Mitchell v Leslie* (1995) 39 CA4th Supp 7, 46 CR2d 419. For example, parol evidence is admissible to prove the illegality of a contract or to show that a course of dealing between the parties is illegal or against public policy. See, *e.g., Mitchell v Leslie*, *supra*. It is admissible to show a mutual mistake of fact (*Hess v Ford Motor Co.* (2002) 27 C4th 516, 525, 117 CR2d 220) or a failure of consideration (*FPI Dev., Inc. v Nakashima* (1991) 231 CA3d 367, 282 CR 508). It is also admissible to prove a condition precedent to the effectiveness of a contract, because there is no contract if the condition has not been satisfied. *Haines v Bechdolt* (1965) 231 CA2d 659, 42 CR 53. Parol evidence of the parties' intent is admissible to assist the court in determining whether a binding agreement was ever reached. *Banner Entertainment, Inc. v Superior Court* (1998) 62 CA4th 348, 72 CR2d 598.

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§5.42 8. Course of Dealing, Usage of Trade, Course of Performance (CCP §1856(c))

The concepts of course of dealing, usage of trade, and course of performance are important for interpretation of contracts subject to the Uniform Commercial Code. These concepts are discussed more fully in §§5.56-5.59. The Code of Civil Procedure extends application of these concepts to interpretation of contracts not governed by the UCC. Under CCP §1856(c), course of dealing, usage of trade, or course of performance may be used to explain or supplement the terms of a contract—even if the parties fully intend the written contract to constitute a final expression of their agreement. In analyzing these concepts in the context of a contract not subject to the UCC, the court may draw on Commercial Code precedent. *Employers Reins. Co. v Superior Court* (2008) 161 CA4th 906, 74 CR3d 733 (course of performance evidence admissible in interpreting insurance policies); *Bert G. Gianelli Distrib. Co. v Beck & Co.* (1985) 172 CA3d 1020, 1040 n5, 219 CR 203. See also CC §§1655-1656 (discussed in §§5.23-5.24); *Binder v Aetna Life Ins. Co.* (1999) 75 CA4th 832, 853, 89 CR2d 540 ("General usages of trade and course of dealing may also supplement or explain an agreement"); *Southern Pac. Transp. Co. v Santa Fe Pac. Pipelines, Inc.* (1999) 74 CA4th 1232, 1241, 88 CR2d 777 (parties are presumed to contract in accordance with any fixed and established usage and custom of trade). In *Patel v Liebermensch* (2008) 45 C4th 344, 349, 86 CR3d 366, the court ruled that "usual and reasonable" customs in the real estate industry could determine incidental terms of a real estate option contract. In *Wolf v Superior Court* (2004) 114 CA4th 1343, 8 CR3d 649, the court held that evidence of entertainment industry custom and usage was admissible to explain the meaning of the term "gross receipts" in a royalty agreement.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.43 C. Commercial Code Parol Evidence Rule (Com C §2202)

§5.43 C. Commercial Code Parol Evidence Rule (Com C §2202)

The Commercial Code's parol evidence rule applicable to contracts for the sale of goods is slightly less restrictive than the rule stated in the California Code of Civil Procedure (CCP §1856; see §5.33). It provides as follows (Com C §2202):

> Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented.
>
> (a) By course of dealing, course of performance, or usage of trade (Section 1303); and
>
> (b) By evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement.

Instead of presuming that the parties intended their writing to constitute a final, fully integrated agreement, Com C §2202 assumes that the parties' writing does not express their full agreement unless the court so finds. California Comment 1 to Com C §2202; Official Comment 1(a) to former UCC §2-202. Although parol evidence is inadmissible to *contradict* the term of a writing, evidence of course of dealing, usage of trade, or course of performance may be admissible to *explain or supplement* (and thus, perhaps vary) the meaning of the writing. See Com C §2202; *Morey v Vannucci* (1998) 64 CA4th 904, 75 CR2d 573; *Balfour, Guthrie & Co. v Gourmet Farms* (1980) 108 CA3d 181, 187, 166 CR 422. This is consistent with the Restatement approach. See Restatement (Second) of Contracts §§220-223 (1981) (extrinsic evidence may be used to explain use of stated or unstated terms, usage of trade, or course of dealing in order to explain or supplement a writing).

Commercial Code §10202 (which is identical to Com C §2202) is the parol evidence rule applicable to leases of goods.

For further discussion of the parol evidence rule in contracts for the sale or lease of goods, see California UCC Sales and Leases, chap 7 (Cal CEB 2002).

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III. CHOICE OF FORUM, CHOICE OF LAW

A. Forum Selection Clauses, Consent to Personal Jurisdiction

§5.44 1. Generally

Requirements for validity. Contracting parties have a limited right to designate the forum in which to resolve disputes. Although the parties cannot confer subject matter jurisdiction on a court by contract, when two or more courts have subject matter jurisdiction, the general rule in California is that a forum selection clause limiting suits under the contract to one of them will be upheld if the contract was entered into freely and voluntarily by the parties after arm's-length negotiation and enforcement of the clause would not be unreasonable. *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 495, 131 CR 374. See also *Olinick v BMG Entertainment* (2006) 138 CA4th 1286, 1294, 42 CR3d 268; *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 127 CR2d 847. "[A] valid forum-selection clause designating a particular forum for dispute resolution regardless of residence" operates as an express consent to personal jurisdiction. *Nobel Farms, Inc. v Pasero* (2003) 106 CA4th 654, 658, 130 CR2d 881. See also *Berard Constr. Co. v Municipal Court* (1975) 49 CA3d 710, 721, 122 CR 825. Even if the forum selection clause is in an adhesion contract (see §§5.72-5.74), it will be enforced "as long as the clause provided adequate notice to the [party] that he was agreeing to the jurisdiction cited in the contract." 104 CA4th at 201 (citations omitted). See also *Carnival Cruise Lines, Inc. v Shute* (1991) 499 US 585, 113 L Ed 2d 622, 111 S Ct 1522 (forum selection clause in cruise ship ticket); *Schlessinger v Holland America, N.V.* (2004) 120 CA4th 552, 16 CR3d 5. The courts recognize that such clauses play an important role in interstate commerce, by providing a level of certainty for businesses and their customers that disputes will be resolved in a particular forum. *Net2Phone, Inc. v Superior Court* (2003) 109 CA4th 583, 587, 135 CR2d 149.

Consumer contracts. This general rule has been limited in the context of consumer contracts. In *Aral v Earthlink, Inc.* (2005) 134 CA4th 544, 561, 36 CR3d 229, the court held that a forum selection clause in a contract for high-speed Internet access, which would have required a California consumer to travel to the state of Georgia to recover a loss in the range of $40 to $50, was unreasonable as a matter of law. The court noted that although a party challenging a forum selection clause has a heavy burden, "the burden was not intended to be insurmountable." If it is clear that trial in the designated forum will be "so gravely difficult and inconvenient" that the plaintiff as a practical matter will be denied his or her day in court, the forum selection provision will not be enforced. In *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699, the court affirmed that a consumer class action against an Internet service provider could proceed in California, notwithstanding a forum selection clause in the service contract that designated Virginia as the forum for litigating disputes. The class action alleged violations of the California Unfair Competition Law (UCL) (Bus & P C §§17200-17210) and the California Consumers Legal Remedies Act (CLRA) (CC §§1750-1784). 90 CA4th at 5. The court found that transferring the action to Virginia would necessitate a waiver of the consumers' statutory remedies under the CLRA, in violation of the CLRA's antiwaiver provisions. The court held that California courts will not defer to a forum selected in the contract if to do so would substantially diminish the rights of California residents in violation California public policy. 90 CA4th at 12. See also *Doe 1 v AOL LLC* (9th Cir 2009) 552 F3d 1077. In addition, CCP §395(c) generally renders void and unenforceable any provision of a consumer contract that purports to waive the venue rules of CCP §395(b), and Com C §10106, which contains a similar rule for personal property leases when the lessee is a consumer.

Million-dollar contracts. Choice of forum clauses in contracts involving at least $1 million of consideration that designate a California court are validated by statute. Code of Civil Procedure §410.40 provides:

> Any person may maintain an action or proceeding in a court of this state against a foreign corporation or nonresident person where the action or proceeding arises out of or relates to any contract, agreement, or undertaking for which a choice of California law has been made in whole or in part by the parties thereto and which (a) is a contract, agreement, or undertaking, contingent or otherwise, relating to a transaction involving in the aggregate not less than one million dollars ($1,000,000), and (b) contains a provision or provisions

under which the foreign corporation or nonresident agrees to submit to the jurisdiction of the courts of this state.

Code of Civil Procedure §410.40 applies retroactively to all contracts entered into before, on, or after its effective date in 1992.

Service of process by mail, cognovit notes. A contract may also provide for service of process by mail, even though such a provision is not consistent with the California statutes regarding service of process. *National Equip. Rental, Ltd. v United Lumber Co.* (1972) 24 CA3d 1012, 101 CR 291. However, a cognovit clause in a promissory note authorizing the confession of a judgment against the payee by any attorney without prior notice is not enforceable in California. *General Motors Acceptance Corp. v Codiga* (1923) 62 CA 117, 216 P 383. See generally CCP §§1132-1134; *Isbell v Sonoma* (1978) 21 C3d 61, 145 CR 368 (predecessor cognovit note statutes unconstitutional).

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§5.45 2. Who May Enforce

In *Bancomer, S.A. v Superior Court* (1996) 44 CA4th 1450, 52 CR2d 435, the court held that a bank could not enforce a forum selection clause in a land purchase agreement between individual purchasers and a resort developer, because the bank was not a party to the agreement. The court found that the bank was not a third party beneficiary of the agreement, nor was the bank sufficiently related to the transaction to enable it to claim a benefit from the forum selection clause. Moreover, the claims against the bank for fraudulent inducement were beyond the scope of the forum selection clause. 44 CA4th at 1454. But see *Bugna v Fike* (2000) 80 CA4th 229, 95 CR2d 161 (contractual forum selection clause applied to nonsignatories who were key participants in transactions and so "closely related to the agreements" that they could enforce clause); *CQL Original Prods., Inc. v National Hockey League Players Ass'n* (1995) 39 CA4th 1347, 46 CR2d 412 (enforcing Ontario, Canada, forum selection clause in licensing agreement; plaintiff's officers were experienced business persons who had signed the contracts voluntarily and clause had rational relationship to licensing agreement); *Cal-State Bus. Prods. & Servs., Inc. v Ricoh* (1993) 12 CA4th 1666, 16 CR2d 417 (enforcing forum selection clauses against commercial litigants who had signed contracts with forum selection clauses voluntarily; nexus existed between transactions in question and selected forum state).

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§5.46 3. Mandatory Versus Permissive Forum Selection Clauses

There is a distinction between choice of forum clauses that are mandatory—*i.e.,* those that require suit to be brought in a particular jurisdiction—and those that are permissive—*i.e.,* those that allow suit to be brought in a particular jurisdiction at the option of a party. Mandatory choice of forum clauses, if enforceable, are normally enforceable without reference to the doctrine of forum non conveniens, and challenges based on that doctrine will not stand. *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 131 CR 374; *Olinick v BMG Entertainment* (2006) 138 CA4th 1286, 1294, 42 CR3d 268; *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 127 CR2d 847. The test for enforceability of a mandatory choice of forum clause is simply whether the clause is unfair or unreasonable. *Olinick v BMG Entertainment, supra.* In contrast, if the forum selection clause is permissive, a defendant can invoke the doctrine of forum non conveniens successfully. *Intershop Communications, AG v Superior Court, supra.* See also *Appalachian Ins. Co. v Superior Court* (1984) 162 CA3d 427, 208 CR 627 (forum non conveniens applied despite contract clause submitting parties to jurisdiction of any court chosen by plaintiff); *Great N. Ry. Co. v Superior Court* (1970) 12 CA3d 105, 90 CR 461 (listing 25 factors that court should consider when determining convenience of forum).

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§5.47 4. Venue Selection Clauses Distinguished

Forum selection clauses are to be distinguished from *venue* selection clauses. "Forum" refers to a jurisdictional place—such as the courts of California—while "venue" refers to the geographical place where the case will be heard and from where a jury will be selected. *Arntz Builders v Superior Court* (2004) 122 CA4th 1195, 19 CR3d 346; California Civil Procedure Before Trial, chap 8 (4th ed Cal CEB 2004). As discussed in §5.44, forum selection clauses are enforced unless unreasonable. Venue selection clauses, however, have long been held void as against the public policy expressed in the venue provisions of the Code of Civil Procedure, which determine the proper court to hear an action. 122 CA4th at 1202; *Alexander v Superior Court* (2003) 114 CA4th 723, 8 CR3d 111. See CCP §§395-395.5. The rule is the same for clauses that purport to waive a party's right to seek a change of venue as a clause that purports to affirmatively specify venue—both are unenforceable. *Arntz Builders,* 122 CA4th at 1201. See also *CQL Original Prods., Inc. v National Hockey League Players Ass'n* (1995) 39 CA4th 1347, 46 CR2d 412; CCP §395(c) (provisions of consumer contracts purporting to waive venue rules of CCP §395(b) void and unenforceable).

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.48 5. Construction Contracts (CCP §410.42)

§5.48 5. Construction Contracts (CCP §410.42)

Construction contracts for projects within California are subject to a special rule in CCP §410.42 concerning forum selection, which provides:

> The following provisions of a contract between the contractor and a subcontractor with principal offices in this state, for the construction of a public or private work of improvement in this state, shall be void and unenforceable:
>
> (a) A provision which purports to require any dispute between the parties to be litigated, arbitrated, or otherwise determined outside this state.
>
> (b) A provision which purports to preclude a party from commencing such a proceeding or obtaining a judgment or other resolution in this state or the courts of this state.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.49 6. Letters of Credit (Com C §5116(e))

§5.49 6. Letters of Credit (Com C §5116(e))

Commercial Code §5116(e) allows the parties to a letter of credit to designate a forum for settling disputes in accordance with other provisions of Division 5 of the Commercial Code.

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§5.50 7. Consumer Lease Contracts (Com C §10106(b))

Division 10 of the Commercial Code limits the parties' ability to choose a judicial forum in consumer leases. Com C §10106(b). The judicial forum chosen by the parties to a consumer lease will not be enforceable if it specifies a forum in a county other than the county in which the lessee signed the lease, the county in which the lessee resides at the commencement of the action, the county in which the lessee resided at the time the lease contract became enforceable, or the county in which the goods are permanently stored. Com C §10106(a). Choice of forum clauses in nonconsumer leases are prima facie valid. Official Comment to UCC §2A-106.

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B. Conflicts of Law; Choice of Law

§5.51 1. In Absence of Choice-of-Law Clause

Civil Code §1646 contains the vintage 1872 rule for what law governs interpretation of the provisions of a contract when the contract itself is silent on that issue: "A contract is to be interpreted according to the law and usage of the place where it is to be performed; or, if it does not indicate a place of performance, according to the law and usage of the place where it is made." A slightly different formulation appears in the Code of Civil Procedure, as follows: "The language of a writing is to be interpreted according to the meaning it bears in the place of its execution, unless the parties have reference to a different place." CCP §1857.

California courts apply a three-step "governmental interest" analysis to determine what law applies to resolution of a dispute in the absence of an effective choice-of-law clause. In *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 919, 103 CR2d 320, the California Supreme Court described this analysis as follows:

- In general, the forum will apply its own law unless one of the litigants timely invokes the law of another state. In that event, the litigant must demonstrate that the other state's law will further the interest of that state and that it is appropriate for the forum to apply that law to the instant case. The proponent of the foreign law must identify the applicable rule of law and show that it differs materially from the law of California. Even if two or more states are involved, there may not be a conflict of laws problem if the relevant laws of each state are the same. In that situation, the trial court may apply California law.
- If the court finds that the laws of the two states are materially different, it then must determine what interest (if any) each state has in having its own law applied to the case. Even if the laws are materially different, there will not be a conflict if only one of the states has an interest in having its law applied. The court will apply that state's law.
- Only if the court determines that the laws are materially different and that each state has an interest in having its own law applied will there be an actual conflict of laws. The court must then perform a "comparative impairment" analysis and select the law of the state whose interests would be more impaired if its law were not applied. In doing so, the court must consider the history, status, function, and purpose of the laws in question, and the relative commitment of each state to the laws involved.

The California Supreme Court noted that these rules apply whether the dispute involves tort or contract and that a separate conflict of laws analysis must be made for each issue in the case. 24 C4th at 920. See also *ABF Capital Corp. v Grove Props. Co.* (2005) 126 CA4th 204, 215, 23 CR3d 803; *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73.

According to the court of appeal in *Frontier Oil Corp. v RLI Ins. Co.* (2007) 153 CA4th 1436, 63 CR3d 816, adoption of the governmental interest analysis does not mean that the judiciary has abrogated the legislative mandate of §1646 (153 CA4th at 1459):

> [T]he choice-of-law rule in §1646 determines the law governing the interpretation of a contract, notwithstanding the application of the governmental interest analysis to other choice-of-law issues. … Broad statements declaring the governmental interest analysis under California's choice-of-law rule and rejecting traditional choice-of-law rules should be viewed in light of the particular choice-of-law issues that were before the court in these cases.

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2. Enforceability of Choice-of-Law Clauses

a. Choice of California Law

§5.52 (1) Generally

In *Cronus Invs., Inc. v Concierge Servs.* (2005) 35 C4th 376, 25 CR3d 540, the California Supreme Court found that a contract choice-of-law clause reading "[t]his agreement shall be construed and enforced in accordance with and governed by the laws of the State of California, without giving effect to the conflict of laws provisions thereof" generally incorporated California law, including certain provisions of the California Arbitration Act (CCP §§1280-1294.2).

NOTE: A choice-of-law clause binds only the parties to the contract. Third party claims will not be subject to the choice of law or choice of forum in the contract. See *Paracor Fin., Inc. v General Elec. Capital Corp*. (9th Cir 1996) 96 F3d 1151, 1165. Further, non-contract claims, such as fraud, tort, or statutory claims such as claims under unfair competition laws, may also fall outside a choice-of-law clause, depending on how the provision is drafted.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.53 (2) Transactions of $250,000 or More (CC §1646.5)

§5.53 (2) Transactions of $250,000 or More (CC §1646.5)

If the contract includes a choice-of-law clause specifying that California law shall govern the rights and duties of the parties, CC §1646.5 may apply to validate the clause if the contract relates to a transaction involving at least $250,000 in consideration. Civil Code §1646.5 (as amended effective January 1, 2007) provides, in part:

> Notwithstanding Section 1646, the parties to any contract, agreement, or undertaking, contingent or otherwise, relating to a transaction involving in the aggregate not less than two hundred fifty thousand dollars ($250,000), including a transaction otherwise covered by subdivision (a) of Section 1301 of the Commercial Code, may agree that the law of this state shall govern their rights and duties in whole or in part, whether or not the contract, agreement, or undertaking or transaction bears a reasonable relation to this state.

Civil Code §1646.5 also states that it is retroactive in effect; thus, it applies to contracts entered into both before and after its effective date in 1992. In providing that qualifying choice of law clauses are valid even if the transaction does not bear a reasonable relation to California, §1646.5 is broader than the general rule of the Commercial Code, Com C §1301(a) (former Com C §1105(1)) (see §5.55), which requires that there be a reasonable relationship between the transaction and the state law selected. Moreover, §1646.5—by its phrase "including a transaction otherwise covered by subdivision (a) of Section 1301 of the Commercial Code"—apparently supersedes Com C §1301(a) for contracts otherwise subject to the Commercial Code that specify California law as the governing law.

Civil Code §1646.5 does not apply to contracts for labor or personal services or to transactions of a primarily personal, family, or household purposes. Further, it does not apply to matters governed by the Commercial Code provisions listed in Com C §1301(c) (former Com C §1105(2))—namely, the rights of creditors against sold goods under Com C §2402; personal property leases under Com C §§10105-10106; bank deposits and collections under Com C §4102; letters of credit under Com C §5116; bulk sales under Com C §6103; investment securities under Com C §8110; perfection, the effect of perfection, and priority of security interests and agricultural liens under Com C §§9301-9307; and funds transfers under Com C §11507. This is consistent with Com C §1301 itself, which, with the exception of the areas specified in Com C §1301(c), broadly validates choice of law clauses as long as the transaction at issue bears a "reasonable relation" to the selected jurisdiction. See §5.55.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.54 b. Choice of Non-California Law: Nedlloyd Lines B.V. v Superior Court

§5.54 b. Choice of Non-California Law: *Nedlloyd Lines B.V. v Superior Court*

The leading California case on the enforceability of contractual choice of law clauses is *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330. The contract at issue in *Nedlloyd* specified that the contract would be governed by Hong Kong law, and it was clear that Hong Kong had a substantial connection with the contracting parties. In *Nedlloyd*, the California Supreme Court expressly adopted the approach of Restatement (Second) of Conflict of Laws §187 (1988) and outlined the steps to be followed by courts in analyzing whether a choice of law clause should be enforced as follows (3 C4th at 465):

- First, the court must determine either (1) that the jurisdiction selected by the parties has a "substantial relationship" to the parties or their transaction, or (2) that the parties' choice of law has another reasonable basis. If neither of these two tests is met, the choice of law clause is not enforceable.
- If either test is met, the court must then determine whether the state law chosen is contrary to a fundamental policy of California.
- If there is no such conflict, the choice of law clause is enforceable.
- If, however, the law chosen does involve a fundamental conflict with California law, the court must determine whether California's interest in the matter at issue in the suit is "materially greater" than the interest of the other jurisdiction. If it is, the choice of law clause will not be enforced. If it is not, the choice of law clause is enforceable.

Under the facts presented in *Nedlloyd,* the court ruled that the parties' choice of Hong Kong law would be upheld. 3 C4th at 471.

If one of the parties to the contract is incorporated in the chosen state, a "substantial relationship" is deemed to exist and the parties are also deemed to have a reasonable basis for their choice of law. *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 1546, 46 CR2d 33. See also *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 899, 72 CR2d 73. For an analysis of what may or may not be considered a "fundamental policy" of the state of California for purposes of applying *Nedlloyd,* see State Bar of California, Business Law Section, Report on Third-Party Remedies Opinions, App 10, B-3-B-13 (2007).

The *Nedlloyd* approach was confirmed in *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76, and *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 103 CR2d 320. See also *Klussman v Cross Country Bank* (2005) 134 CA4th 1283, 36 CR3d 728; *Aral v Earthlink, Inc.* (2005) 134 CA4th 544, 563, 36 CR3d 229.

NOTE: *Nedlloyd* did not mention CC §1646.5 (see §5.53), no doubt because *Nedlloyd* was decided just prior to the enactment of CC §1646.5. But it is important to note that CC §1646.5 by its terms applies only to contracts that specify the law of "this state," *i.e.,* California, as the governing law. Therefore, CC §1646.5 would not have been relevant under the *Nedlloyd* facts. The *Nedlloyd* analysis is pertinent only to contracts not subject to the Commercial Code (see §5.55) that designate the law of a jurisdiction other than California.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.55 3. Commercial Code Transactions (Com C §1301)

§5.55 3. Commercial Code Transactions (Com C §1301)

Choice of law in transactions subject to the Uniform Commercial Code is governed in the first instance by Com C §1301(a)-(b) (former Com C §1105(1)), which provides that:

> (a) Except as otherwise provided in this section, when a transaction bears a reasonable relation to this state and also to another state or nation, the parties may agree that the law either of this state or of the other state or nation shall govern their rights and duties.
> (b) In the absence of an agreement effective under subdivision (a), and except as provided in subdivision (c), this code applies to transactions bearing an appropriate relation to this state.

Under Com C §1301(a), parties are generally free to choose the law that will apply to their transaction, subject to the requirement that the transaction bears a reasonable relationship to the jurisdiction chosen. Official Comment 1 to former UCC §1-105 stated that the "reasonable relation" test is similar to that articulated by the U.S. Supreme Court in *Seeman v Philadelphia Warehouse Co.* (1927) 274 US 403, 71 L Ed 1123, 47 S Ct 626. Normally, the law selected must be that of a jurisdiction "where a significant enough portion of the making or performance of the contract is to occur or occurs." Official Comment 1 to former UCC §1-105. As discussed in §5.53, however, if the contract designates California law as the governing law and the consideration is at least $250,000, CC §1646.5 would override Com C §1301(a) with the result that California law will apply, even if California law does not bear a reasonable relation to the transaction.

If the parties to a contract subject to the Commercial Code do not make an express choice of law in accordance with Com C §1301(a), California law will apply to the contract if the transaction bears an "appropriate relation" to California. Com C §1301(b). Official Comment 2 to former UCC §1-105 stated:

> [T]he mere fact that suit is brought in a state does not make it appropriate to apply the substantive law of that state. Cases where a relation to the enacting state is not "appropriate" include, for example, those where the parties have clearly contracted on the basis of some other law, as where the law of the place of contracting and the law of the place of contemplated performance are the same and are contrary to the law under the Code.

See *Barclays Discount Bank Ltd. v Levy* (9th Cir 1984) 743 F2d 722 (affirming application of California law in dispute under promissory notes between California and Israeli merchants, made in Israel but payable in California, that did not contain choice of law provisions).

Commercial Code §1301(c) (former Com C §1105(b)) outlines eight exceptions to the general rule of Com C §1301(a), which effectively limit the parties' ability to choose applicable law. If one of the exceptions applies, the parties' choice of law is enforceable only if and to the extent permitted by the section referenced:

- The first exception, in Com C §2402, regarding the reclamation rights of creditors against goods sold, requires application of the fraudulent transfer laws of the state in which the goods are situated.
- The second exception, in Com C §4102, concerning bank deposits and collections, requires application of the law of the place where the bank or branch is located.
- The third exception, in Com C §5116, sets forth detailed choice of law and conflicts of law rules for letters of credit.
- The fourth exception, in Com C §6103, applicable to bulk transfers, requires application of California law to bulk sales by a seller whose place of business or major executive office is in California.
- The fifth exception, in Com C §8110, sets forth detailed choice of law and conflicts of law rules for investment securities.
- The sixth exception, in Com C §§9301-9307, specifies the law applicable to perfection, the effect of perfection and nonperfection, and priority of security interests and agricultural liens.
- The seventh exception, in Com C §§10105-10106, addresses certain leased goods. For leased goods covered by a certificate of title, the law of the state that issued the certificate of title generally applies to the lease. Com C §10105. For consumer leases, choice of law provisions will be enforceable only if the chosen law is that of a

jurisdiction where the lessee resides when the lease goes into effect (or within 30 days after that date), where the lease was executed, or where the leased goods will be used. Com C §10106. Commercial leases of goods not covered by a certificate of title are subject to the general Commercial Code choice of law rule in Com C §1301(a).

- The last exception, in Com C §11507, sets forth detailed choice of law and conflicts of law rules for funds transfers.

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IV. COMMERCIAL CODE RULES OF CONTRACT INTERPRETATION

§5.56 A. Course of Dealing and Usage of Trade (Com C §1303)

For contracts governed by the Commercial Code, the parties' course of dealing, if any, and any usage of trade can be important interpretive tools. See Com C §1303 (former Com C §1205). These concepts allow courts to take into account prior acts and understandings of the parties in interpreting their contracts, recognizing that people do not necessarily write down completely or accurately all aspects of their agreements.

Commercial Code §1303(d) (former Com C §1205(3)) provides:

> A course of performance or course of dealing between the parties or usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware is relevant in ascertaining the meaning of the parties' agreement, may give particular meaning to specific terms of the agreement, and may supplement or qualify the terms of the agreement. A usage of trade applicable in the place in which part of the performance under the agreement is to occur may be so utilized as to that part of the performance.

See *Everex Sys., Inc. v Official Creditors' Comm. of CFLC, Inc. (In re CFLC, Inc.)* (BAP 9th Cir 1997) 209 BR 508, aff'd (9th Cir 1999) 166 F3d 1012; *New W. Fruit Corp. v Coastal Berry Corp.* (1991) 1 CA4th 92, 1 CR2d 664. The course of dealing or usage of trade need not be universal—it is sufficient if it is widely enough known or adopted in the sphere in which the parties operate. See *Bullis v Security Pac. Nat'l Bank* (1978) 21 C3d 801, 808 n9, 148 CR 22. Underlying the application of Com C §1303(d) (former Com C §1205(3)) is the notion that prior conduct between the parties or within the trade in which they are engaged creates a common basis for interpreting their expressions or conduct under the contract.

The Commercial Code requires the express terms of an agreement and any applicable course of dealing or usage of trade to be construed, whenever reasonable, as consistent with each other. If that construction is unreasonable, express terms control course of performance, course of dealing, and usage of trade; course of performance prevails over course of dealing and usage of trade; and course of dealing prevails over usage of trade. Com C §1303(e) (former Com C §1205(4)). See *Wilson v Brawn of Cal., Inc.* (2005) 132 CA4th 549, 558, 33 CR3d 769.

For further discussion of these concepts, see California UCC Sales and Leases, chap 4 (Cal CEB 2002).

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§5.57 1. Course of Dealing Defined (Com C §1303(b))

"Course of dealing" focuses on the parties' relationship based on prior transactions. It is defined as "a sequence of conduct concerning previous transactions between the parties to a particular transaction that is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." Com C §1303(b) (former Com C §1205(1)). It is an inference of the parties' common knowledge, understanding, and intent, and it is a question of fact. See *Expeditors Int'l v Official Creditors Comm. of CFLC, Inc. (In re CFLC, Inc.)* (9th Cir 1999) 166 F3d 1012 (pre-printed invoice terms did not create security interest, either explicitly or through course of dealing analysis under Article 2 or Article 9 of UCC).

Finding a course of dealing requires the court to determine whether there is any indication of the *common* knowledge and understanding of the parties. This requires conduct by both parties, not the unilateral action of only one by, *e.g.,* sending a form with printed terms on it. 166 F3d at 1017; *Transwestern Pipeline Co. v Monsanto Co.* (1996) 46 CA4th 502, 516, 53 CR2d 887 ("Common sense tells us the mere exchange of forms containing inconsistent terms, for however long a period, cannot establish a common understanding between the parties as to which set of conflicting terms is part of their contract"). See also *Insurance Co. of N. Am. v NNR Aircargo Serv. (USA), Inc.* (9th Cir 2000) 201 F3d 1111 (prior receipt of 47 shipping invoices with limitation of liability provision constituted course of dealing that could be used in interpreting oral contract; court noted that receipt of as few as three to four bills of lading has been held to establish course of dealing).

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§5.58 2. Usage of Trade Defined (Com C §1303(c))

"Usage of trade" focuses on the industry in which the parties operate, as distinct from the parties' past conduct. Usage of trade is defined as "any practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question." Com C §1303(c) (former Com C §1205(2)).

The existence and scope of a usage of trade are issues of fact. If the usage is embodied in a written trade code or other writing, the interpretation of the writing is a question of law. Com C §1303(c) (former Com C §1205(2)). Evidence of usage of trade is considered so that the true understanding of the parties can be learned—the theory being that the parties took for granted usage of trade when their contract was prepared, and, unless expressly negated, usage of trade should be understood as a part of and incorporated into the words used. *Heggblade-Marguleas-Tenneco, Inc. v Sunshine Biscuit, Inc.* (1976) 59 CA3d 948, 954, 131 CR 183. See also *National Am. Ins. Co. v Certain Underwriters at Lloyd's London* (9th Cir 1996) 93 F3d 529. As the California Supreme Court stated in *California Lettuce Growers, Inc. v Union Sugar Co.* (1955) 45 C2d 474, 482, 289 P2d 785 (pre-Commercial Code case):

> [W]hen there is a known usage of the trade, persons carrying on that trade are deemed to have contracted in reference to the usage unless the contrary appears; that the usage forms a part of the contract, and that evidence of usage is always admissible to supply a deficiency or as a means of interpretation where it does not alter or vary the terms of the contract.

The usage of trade in the place where part of the performance of the contract is to occur is the reference point for interpreting the contract with respect to that part of the performance. Com C §1303(d) (former Com C §1205(5)). Evidence of a relevant usage of trade offered by one party is not admissible unless and until that party has given the other party such notice as the court finds sufficient to prevent unfair surprise. Com C §1303(g) (former Com C §1205(6)). Courts will impute the knowledge of experienced persons who are agents of an entity to the entity itself, even if other officers or agents of the entity are inexperienced and credibly claim ignorance of the trade usage. *Heggblade,* 59 CA3d at 956.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.59 B. Course of Performance (Com C §1303(a))

§5.59 B. Course of Performance (Com C §1303(a))

Another Commercial Code rule of interpretation focuses on the parties' conduct in performing the contract at issue. For contracts that are performed over time, the parties' earlier acts of performance, acceptance of performance, or objection to performance can be used to interpret the contract. A course of performance is defined as (Com C §1303(a) (former Com C §2208(1)))

> a sequence of conduct between the parties to a particular transaction that exists if:
> (1) the agreement of the parties with respect to the transaction involves repeated occasions for performance by a party; and
> (2) the other party, with knowledge of the nature of the performance and opportunity for objection to it, accepts the performance or acquiesces in it without objection.

In other words, in some cases, actions speak louder than words. See *Comerica Bank v Whitehall Specialties, Inc.* (CD Cal 2004) 352 F Supp 2d 1077 (parties' course of performance resulted in forum selection clause in printed invoices being part of parties' oral agreement). Multiple acts or instances of conduct are necessary to establish a "course" of performance. A single act is not sufficient. Official Comment 4 to former UCC §2-208.

Among other things, the parties' course of performance may be relevant to show a waiver or modification of any term inconsistent with that course of performance. Com C §1303(f) (former Com C §2208(3)). See §§5.81-5.89 for further discussion of modification, rescission, and waiver. Modification and waiver of contracts for the sale of goods under the Commercial Code are also subject to the rules of Com C §2209.

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§5.60 C. Gap-Filling Rules

Recognizing the practical realities of the commercial world, the Commercial Code includes a number of rules designed to fill gaps and ambiguities left by the parties in contracts for the sale of goods subject to Division 2 of the Commercial Code. These rules, discussed in §§5.61-5.69, supplement the obligation of good faith imposed in every contract subject to the Commercial Code by Com C §1304 (former Com C §1203). For additional discussion of the gap-filling rules, see California UCC Sales and Leases, chap 4 (Cal CEB 2002).

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§5.61 1. Course of Dealing; Usage of Trade; Course of Performance (Com C §1303(d))

Once a court has found that a contract has been formed, the court may refer to any course of performance or course of dealing between the parties, or usage of trade in the parties' vocation or trade, to "give particular meaning to specific terms of the agreement, and may supplement or qualify the terms of an agreement." Com C §1303(d) (former Com C §1205(3)). These concepts are discussed in §§5.56-5.59.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.62 2. Open Price Term (Com C §2305)

§5.62 2. Open Price Term (Com C §2305)

Division 2 of the Commercial Code allows a court to fill in a blank price term in a contract for the sale of goods rather than dismiss the alleged contract as a mere agreement to agree. If the parties so intend, a contract for the sale of goods can be formed, even if the price is not yet agreed on. The price will be deemed to be a reasonable price at the time of delivery of the goods if (Com C §2305(1)):

- Nothing is said as to price;
- The price is left to be agreed by the parties and they fail to agree; or
- The price is to be fixed with reference to some agreed market or other standard set by a third person or agency and it is not so set.

If the price is left to be fixed by the seller or the buyer, the price must be determined in good faith. Com C §2305(2); *Lazar v Hertz Corp.* (1983) 143 CA3d 128, 191 CR 849. If the price is left to be fixed other than by the parties' agreement, but the price is not fixed as a result of one party's fault, the other party may either treat the contract as canceled or fix a reasonable price. Com C §2305(3). There is no contract, however, if the parties intend not to be bound unless the price is fixed or agreed to and the price is not fixed or agreed to. Com C §2305(4).

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3. Open Quantity Term

§5.63 a. Output and Requirements Contracts (Com C §2306(1))

An output contract is a contract under which the quantity of goods to be sold is measured by the seller's output. Usually, the seller is required to sell its entire output to the buyer. In a requirements contract, the quantity of goods to be sold is measured by the buyer's needs. Determination of the quantity of goods to be sold under an output or requirements contract is subject to a rule of reasonableness. The contract will be limited to estimated or normal amounts as contemplated by the parties at the time of contracting. Commercial Code §2306(1) provides:

> A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.

See, *e.g., Shea-Kaiser-Lockheed-Healy v Department of Water & Power* (1977) 73 CA3d 679, 140 CR 884. The issues surrounding output and requirements contracts, including interpretation of Com C §2306(1), are discussed at length in California UCC Sales and Leases, chap 4 (Cal CEB 2002).

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.64 b. Exclusive Dealing Arrangements (Com C §2306(2))

§5.64 b. Exclusive Dealing Arrangements (Com C §2306(2))

Exclusive dealing provisions may be included in distribution agreements between manufacturers and wholesalers, or wholesalers and retailers. Often, the agreement will also include territorial limitations or limitations on the reseller's ability to carry competing product lines. Commercial Code §2306(2) addresses exclusive dealing arrangements. The statute implies a duty on the part of the seller to use best efforts to supply the goods and a duty on the part of the buyer to use best efforts to promote resale of the goods:

> A lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale.

Exclusive dealing agreements raise issues under federal and state franchise and antitrust laws, which are discussed more fully in California UCC Sales and Leases, chap 4 (Cal CEB 2002).

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4. Open Delivery Terms

§5.65 a. Number of Deliveries (Com C §2307)

Unless otherwise agreed, all goods due under a contract for sale must be tendered in a single delivery, and payment is due only on such tender. Com C §2307. This rule includes an exception: "but where the circumstances give either party the right to make or demand delivery in lots the price if it can be apportioned may be demanded for each lot." In *CT Chems. (U.S.A.) Inc. v Vinmar Impex, Inc.* (1993) 597 NYS2d 284, 613 NE2d 159, a sales contract for 1000 tons of goods was later modified to double the order and provide for delivery in two lots. The court found that the total purchase price was properly payable in two installments, one each upon delivery of each lot. See also *Neil Norman, Ltd. v William Kasper & Co.* (1983) 149 CA3d 942, 197 CR 198 (Com C §2307 provided buyer with right to bring two lawsuits on contract payable in two installments without violating prohibition on splitting causes of action).

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§5.66 b. Place of Delivery (Com C §2308)

Commercial Code §2308 provides a gap-filling rule for contracts for the sale of goods that do not specify a place for delivery of the goods sold. Unless the parties agree otherwise (Com C §2308):

- The place for delivery of goods is the seller's place of business, or if he or she has none, then his or her residence.
- If the goods have been identified to the contract but are in another place known to the parties at the time of contracting, that place is the place for their delivery.
- Documents of title may be delivered through customary banking channels.

Commercial Code §2308 has proved useful in analysis of jurisdictional issues. In *Rocklin de Mexico v Superior Court* (1984) 157 CA3d 91, 203 CR 547, the court used Com C §2308, together with Com C §2401 (concerning passage of title to goods sold) to support a finding of personal jurisdiction over a Mexican defendant in a contract dispute concerning lumber purchased from a California company.

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§5.67 5. Contract Duration: Time for Delivery or Other Performance (Com C §2309)

If the parties to a contract for the sale of goods do not specify a time for shipment or delivery or for performance of any other obligation under the contract, and Division 2 of the Commercial Code does not provide otherwise, the time for performance is deemed to be a reasonable time. Com C §2309(1). If the contract provides for successive performances but is indefinite in duration, it is valid for a reasonable time. Unless otherwise agreed, however, such a contract may be terminated at any time by either party. Com C §2309(2). Note that this rule is only applicable if the contract is truly indefinite in duration. It is not necessary that the contract specify a termination date to take it out of the ambit of §2309(2). Any event or condition that will terminate the contract, even one within the control of one of the parties such as an event of default, will do so. See *Zee Med. Distrib. Ass'n v Zee Med., Inc.* (2000) 80 CA4th 1, 13 n7, 94 CR2d 829.

Commercial Code §2309(3) provides that "[t]ermination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable." See generally *Centigram Argentina, S.A. v Centigram Inc.* (ND Cal 1999) 60 F Supp 2d 1003, 1010. If a contract is silent with regard to its duration so that it may be considered a contract-at-will as a matter of law, that does not end the inquiry. See *Varni Bros. Corp. v Wine World, Inc.* (1995) 35 CA4th 880, 890, 41 CR2d 740. The contract may continue to be indefinite in duration and at-will until it is terminated by one or both of the parties for good cause. Custom and trade usage are admissible to prove that termination only for good cause is a term implied in the agreement. 35 CA4th at 891; *Bert G. Gianelli Distrib. Co. v Beck & Co.* (1985) 172 CA3d 1020, 1040, 219 CR 203.

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§5.68 6. Open Payment Terms (Com C §2310)

Often, a seller delivers goods to a shipper, who in turn delivers the goods to the buyer. As a result, there may be a gap between the time when the seller parts with its goods and the time when the goods are received by the buyer. The issue then becomes, when and where does the seller get paid? When the seller delivers the goods to the shipper, or when the buyer receives them? The parties may specify the time and place of payment in the contract, in which case the contract will govern. If they do not so specify, the Commercial Code default rule is that payment is due at the time and place at which the buyer is to receive the goods, even if the place of shipment is the place of delivery. Com C §2310(a). This ensures that the buyer has an opportunity to inspect the goods in accordance with Com C §2513 before paying for them. See Cal Comment 1 to Com C §2310.

Commercial Code §2310(b) authorizes the seller to ship goods under reservation, provided that the seller is authorized to send the goods and unless the parties agree otherwise. If the seller does so, it may tender the documents of title, but the buyer may inspect the goods after their arrival under Com C §2513 and before payment is due, unless inspection is inconsistent with the terms of the contract. Com C §2310(b). If delivery is authorized and made by way of documents of title, rather than by shipment under reservation, payment is due at the time and place at which the buyer is to receive the documents, regardless of where the goods are to be received. Com C §2310(c). If the seller is required or authorized to ship the goods on credit, the credit period runs from the time of shipment, but postdating the invoice or delaying its dispatch will correspondingly delay the starting of the credit period. Com C §2310(d).

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§5.69 7. Details of Performance (Com C §2311)

Commercial Code §2311 allows the parties to a contract for the sale of goods to leave certain details regarding performance open, to be completed by either one of them, without having the contract fail for indefiniteness. Official Comment 1 to UCC §2-311. It provides that a contract for sale that is otherwise sufficiently definite (see Com C §2204(3); §4.36) to be a contract is not made invalid merely because it leaves particulars of performance to be specified by one of the parties. If the parties do leave some details to be specified later on, the party who fills in the details must do so in good faith and within the limits of commercial reasonableness. Com C §2311(1). See *In re Crummie* (Bankr ND Cal 1996) 194 BR 230.

Unless otherwise agreed, the buyer has the right and option to make specifications relating to assortment of the goods, and (except as otherwise provided in Com C §2319(1)(c) and (3), concerning F.O.B. or F.A.S. deliveries) the seller has the right and option to make specifications or arrangements concerning shipment. Com C §2311(2).

Under Com C §2311(3), if specifications concerning the assortment of goods or shipment would materially affect the other party's performance but are not seasonably made, or if one party's cooperation is necessary to the other party's performance but is not seasonably forthcoming, in addition to all other remedies the other party (Com C §2311(3)):

- Is excused for any resulting delay in his or her own performance; and
- May also either (1) proceed to perform in any reasonable manner, or (2) after the time for a material part of his or her own performance, treat the failure to specify or to cooperate as a breach by failure to deliver or accept the goods.

In other words, although a nonbreaching party is entitled to respond to the breach by terminating further performance, it is not required to do so and may also continue to partially perform reasonably and then sue for partial breach. *Clark Oil Trading Co. v J. Aron & Co.* (App Div 1998) 683 NYS2d 12, 14.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/ V. SEVERABILITY/ §5.70 A. General Rules Concerning Severance of Unenforceable Terms (CC §1599)

V. SEVERABILITY

§5.70 A. General Rules Concerning Severance of Unenforceable Terms (CC §1599)

Whether specific unenforceable provisions can be severed from a contract and the remainder of the contract enforced depends on the language of the contract and its subject matter. Severability is a matter to be determined by the court consistent with the intent of the contracting parties. *Keene v Harling* (1964) 61 C2d 318, 38 CR 513. Courts will look to the contract's language as well as the surrounding circumstances to determine those intentions. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 122, 99 CR2d 745 (citing *Keene v Harling, supra*):

> Whether a contract is entire or separable depends upon its language and subject matter, and this question is one of construction to be determined by the court according to the intention of the parties. If the contract is divisible, the first part may stand, although the latter is illegal.… [if] the good part of the consideration can be separated from that which is bad, the Courts will make the distinction.

Once a court determines that part of a contract is illegal or otherwise unenforceable, the question becomes what effect this has on the balance of the contract. The California Supreme Court has enunciated two reasons to sever offensive terms rather than invalidate the whole contract. One is to conserve contractual relationships if to do so would not amount to condoning an illegal scheme. The other is to prevent parties from gaining undeserved benefit or suffering undeserved detriment as a result of voiding the entire agreement, particularly if some or all of the contract has already been performed. "The overarching inquiry is whether 'the interests of justice… would be furthered' by severance." *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 1074, 130 CR2d 892, quoting *Armendariz,* 24 C4th at 123. See also *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 416, 29 CR3d 881.

In the absence of a severability clause in the contract, CC §1599 provides that if a contract has several distinct objects and at least one is lawful but another is not, the contract is void only regarding the unlawful part. In other words, there is a presumption of severability for contracts having multiple purposes. Although CC §1599 authorizes a court to void an illegal portion of a contract, it does not require the court to do so. The decision whether to sever the illegal term of a contract is informed by equitable considerations. *Yoo v Robi* (2005) 126 CA4th 1089, 1105, 24 CR3d 740. See also CC §1643, discussed in §5.11, which requires California courts to interpret a contract so as to make it effective, if this can be done without violating the parties' intentions.

Similarly, if a court finds that a contract provision is unconscionable (see §§5.75-5.79), CC §1670.5(a) allows the court to sever the unconscionable clause and enforce the remainder of the contract. A court need not invalidate the entire contract if the offending provision can be severed or restricted. *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 652, 9 CR3d 422. In *Abramson,* the court discussed several factors relevant to severance, including (1) whether the agreement contains more than one objectionable term; (2) whether these terms permeate the balance of the agreement with illegality and unconscionability; (3) whether striking the challenged provision will remove the taint from the agreement; (4) whether the contractual relationship can be preserved without condoning an illegal scheme; and (5) whether the parties would either gain undeserved benefit or suffer undeserved detriment if the entire contract were voided. 115 CA4th at 666. See also *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 1074, 130 CR2d 892, and *Marathon Entertainment, Inc. v Blasi* (2008) 42 C4th 974, 70 CR3d 727 (portions of personal management contract concerning services required to be performed by licensed talent agent (soliciting and procuring employment) could be severed from portions concerning services that did not require license (advice and counseling), thus enabling unlicensed talent manager to partially enforce contract).

The issue of severance often arises in cases weighing the enforceability of arbitration clauses. See, *e.g., Little v Auto Stiegler, Inc., supra* (clause severed); *Armenderiz v Foundation Health Psychare Servs., Inc., supra* (clause not severable, entire agreement unenforceable); *Ontiveros v DHL Express (USA), Inc*. (2008) 164 CA4th 494, 79 CR3d 471 (entire agreement unenforceable); *Abramson v Juniper Networks, Inc., supra* (entire agreement unenforceable).

The issue also arises in other contexts. For example, in *Birbrower, Montalbano, Condon & Frank, P.C. v Superior Court* (1998) 17 C4th 119, 70 CR2d 304, the court was faced with a professional services agreement providing for a

New York law firm to be paid for work done in both California and New York. The court found that the fee agreement was unenforceable insofar as it concerned fees for services performed in California by attorneys not admitted to practice law in California, but that portion of the contract could be severed, and the portion relating to fees generated by practicing law in New York could be enforced. In *Whorton v Dillingham* (1988) 202 CA3d 447, 452, 248 CR 405, the parties had agreed that the plaintiff was to be the defendant's advisor, companion, chauffeur, bodyguard, and lover. The defendant's defense on the grounds that the agreement was an illegal contract for sex failed because that term could be severed from the contract and the balance of the contract enforced. In contrast, in *Duffens v Valenti* (2008) 161 CA4th 434, 74 CR3d 311, the court held that a dating services contract that stated that payments were nonrefundable, contrary to the express language required by CC §1694.3, was void in its entirety. The nonoffending portions of the contract, including the arbitration clause, could not be severed and enforced.

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§5.71 B. Severability Issues in Contract Drafting

It is important for contracting parties to indicate whether provisions of their agreement are severable, whether the agreement has multiple "objects" under CC §1599, and whether it should stand or fall as a unit. To accomplish this, a severability clause such as the one following may be included:

> ***Severability.*** **If any provision of this agreement is held invalid or unenforceable, the remainder of this agreement shall nevertheless remain in full force and effect.**

Alternatively, to protect against enforcement of the contract in the face of invalidation of a key term of the contract, the provision may state:

> ***Severability.*** **If any provision of this agreement is held invalid or unenforceable, the remainder or this agreement shall nevertheless remain in full force and effect; provided however that this provision shall not be applied so as to defeat the primary intent of the parties, which is _ _**[*describe the heart of the transaction from both points of view*]**_ _.**

The severability clause may also designate particular clauses, such as the main elements of consideration, that are not considered to be severable.

Precision in contract drafting with regard to severability issues is important. Sometimes lawyers insert provisions that may be unenforceable under contract law doctrines such as unconscionability. See §§5.75-5.79. In so doing, they may assume that if a court invalidates the term, it will strike out only the narrowest affected portion of the contract. See, *e.g., Oakland-Alameda County Coliseum Auth. v CC Partners* (2002) 101 CA4th 635, 124 CR2d 363, disapproved on other grounds in *Cable Connection, Inc. v DirectTV, Inc.* (2008) 44 C4th 1334, 1361, 82 CR3d 229. This assumption is not always correct, however. See *Gutierrez v Autowest, Inc.* (2003) 114 CA4th 77, 7 CR3d 267 (mandatory arbitration agreement in automobile lease found unconscionable, both procedurally and substantively, and thus unenforceable; court noted that unconscionable term may permeate other terms or whole contract, rendering term not severable, and that single unconscionable term drafted in bad faith could render entire contract unenforceable); *D'Sa v Playhut, Inc.* (2000) 85 CA4th 927, 102 CR2d 495 (employment contract with invalid covenant not to compete not severed but held wholly unenforceable despite severance clause, because covenant violated fundamental policy of the state). See also CC §1670.5(a) (if faced with unconscionable contract clause, court may refuse to enforce entire contract). Attorneys should take particular care in drafting substantive provisions of consumer contracts or contracts that may implicate fundamental public policies, to avoid inadvertently giving courts a license to rewrite the contract if one or more provisions are found unenforceable.

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VI. ADHESION CONTRACTS

§5.72 A. What Is an Adhesion Contract?

Contracts between consumers and commercial businesses present a special set of problems in interpretation. The relationship between the consumer and a commercial business may be marked by a dramatic difference in knowledge, information, and negotiating leverage. Many businesses offer goods, services, or credit on only one set of terms—on a "take it or leave it" basis. The terms may be embodied in a standard, preprinted form. Such contracts are commonly referred to as "adhesion contracts," and special rules may apply to their interpretation.

An adhesion contract is a standardized contract, drafted and imposed by a party having superior bargaining strength on the other party without giving that party a chance to negotiate its terms. The other party has "only the opportunity to adhere to the contract or reject it." *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 113, 99 CR2d 745; *Pardee Constr. Co. v Superior Court* (2002) 100 CA4th 1081, 1086, 123 CR2d 288. The weaker party's lack of choice typically results not only from an inability to negotiate terms with the stronger party, but also because the weaker party is not in a position to shop around—either because the stronger party is the only source of needed goods or services or because all sources in the industry use the same or substantially similar form contracts. See *Steven v Fidelity & Cas. Co.* (1962) 58 C2d 862, 882 n11, 27 CR 172; *Dean Witter Reynolds, Inc. v Superior Court* (1989) 211 CA3d 758, 769, 259 CR 789. Adhesion contracts are therefore not limited to consumer contexts, but may also be found in business-to-business settings. *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 127 CR2d 847.

NOTE: Adhesion contracts need not involve preprinted forms. The term includes all contracts offered on a "take it or leave it" basis, when the other party has no meaningful opportunity to negotiate the terms of the contract or no reasonable choice in the matter. See generally Note, *Contracts*: *Graham v Scissor-Tail, Inc*.: *Unconscionability of Presumptively Biased Arbitration Clauses Within Adhesion Contracts*, 70 Cal L Rev 1014, 1017 (July 1982).

Whether a contract is an adhesion contract is determined on a case-by-case basis by examining the facts and circumstances. *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 818, 171 CR 604.

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§5.73 B. Enforceability of Adhesion Contracts

Adhesion contracts are not per se unenforceable. An adhesion contract is a valid and existing contract. *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 201, 127 CR2d 847. Once the court has determined that a contract is adhesive, the question becomes whether other factors are present that render it unenforceable under established legal rules. *Jaramillo v JH Real Estate Partners, Inc.* (2003) 111 CA4th 394, 3 CR3d 525. See also *Roman v Superior Court* (2009) 172 CA4th 1462, 1470, 92 CR3d 153 (adhesive nature of agreement not dispositive). A finding of adhesion simply begins another inquiry—whether a particular contract term should be denied enforcement on grounds that it defeats the reasonable expectations of the weaker party or that it is unduly oppressive or unconscionable. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 113, 99 CR2d 745; *Intershop Communications AG*, 104 CA4th at 201. As the California Supreme Court in *Armendariz* stated (24 C4th at 113, citations omitted):

> Generally speaking, there are two judicially imposed limitations on the enforcement of adhesion contracts or provisions thereof. The first is that such a contract or provision which does not fall within the reasonable expectations of the weaker or "adhering" party will not be enforced against him.… The second—a principle of equity applicable to all contracts generally—is that a contract or provision, even if consistent with the reasonable expectations of the parties, will be denied enforcement if, considered in its context, it is unduly oppressive or "unconscionable".… Subsequent cases have referred to both the "reasonable expectations" and the "oppressive" limitations as being aspects of unconscionability.

Unconscionability is discussed in §§5.75-5.79. Another consequence of a finding of adhesion is that the rule that ambiguities will be enforced against the party drafting the contract (see CC §1654, discussed in §5.22) will be applied with particular force. *Badie v Bank of America* (1998) 67 CA4th 779, 79 CR2d 273; *Neal v State Farm Ins. Cos.* (1961) 188 CA2d 690, 695, 10 CR 781.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.74 C. Examples of Adhesion Contracts

§5.74 C. Examples of Adhesion Contracts

California courts have found the following types of contracts, among others, to be contracts of adhesion:

- Bank signature cards. *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 924, 216 CR 345. See also *Badie v Bank of America* (1998) 67 CA4th 779, 79 CR2d 273 (account agreements).
- Stock option agreements. *Intershop Communications, AG v Superior Court* (2002) 104 CA4th 191, 127 CR2d 847.
- Standard form concert promotion contract between concert promoter and musicians. *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 171 CR 604.
- Arbitration agreements that are a mandatory condition of employment. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745; *Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153; *Martinez v Master Protection Corp.* (2004) 118 CA4th 107, 12 CR3d 663.
- Arbitration clause and class action waiver in credit cardholder agreement. *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76.
- Trust deed "dragnet clause" that included all after-acquired collateral. *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162. See also *Wilson v San Francisco Fed. Sav. & Loan Ass'n* (1976) 62 CA3d 1, 132 CR 903 (deeds of trust with impound provisions).
- Employment agreements. *Neal v State Farm Ins. Cos.* (1961) 188 CA2d 690, 10 CR 781.
- Equipment rental agreements. *Marin Storage & Trucking, Inc. v Benco Contracting & Eng'g, Inc.* (2001) 89 CA4th 1042, 107 CR2d 645.
- Loan agreements for small amounts signed by consumers of modest means, containing arbitration clauses. *Patterson v ITT Consumer Fin. Corp.* (1993) 14 CA4th 1659, 18 CR2d 563.

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VII. UNCONSCIONABILITY

§5.75 A. Generally (CC §1670.5)

The doctrine of unconscionability is a defense to contract enforcement; it can be used to invalidate a contract provision or even an entire contract. *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 655, 9 CR3d 422; *Jones v Wells Fargo Bank* (2003) 112 CA4th 1527, 5 CR3d 835. It is a common law doctrine, which has been codified in California as follows (CC §1670.5):

> (a) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.
> (b) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.

A finding of unconscionability involves a two-step analysis. To be unenforceable by reason of unconscionability, the clause or clauses at issue must have been both procedurally unconscionable and substantively unconscionable at the time the contract was made. *Discover Bank v Superior Court* (2005) 36 C4th 148, 160, 30 CR3d 76; *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471; *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 955, 85 CR3d 817. See §§5.76-5.77.

Although both procedural and substantive unconscionability must be present for a court to find a provision unconscionable, they need not be present in the same degree. That is, "the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745; *Roman v Superior Court* (2009) 172 CA4th 1462, 1469, 92 CR3d 153. A sliding scale is used in the analysis: As more of one type of unconscionability is found, less of the other type is required to invalidate the clause. See *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892; *Donovan v RRL Corp.* (2001) 26 C4th 261, 109 CR2d 807; *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818; *Mercuro v Superior Court* (2002) 96 CA4th 167, 116 CR2d 671 (defendant's highly oppressive conduct in securing plaintiff's consent to agreement meant that plaintiff need make only minimal showing of substantive unconscionability).

NOTE: Finding that a contract is an adhesion contract is *not* a prerequisite for applying the doctrine of unconscionability. *Harper v Ultimo* (2003) 113 CA4th 1402, 1409, 7 CR3d 418. Rather, the first step in the two-step unconscionability analysis (procedural unconscionability) may be, and often is, satisfied by a finding that the contract is a contract of adhesion. 113 CA4th at 1410 (contract unenforceable because it was unconscionable, despite lack of a finding of adhesion due to plethora of market alternatives). See also *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 583 n7, 61 CR3d 344 (service agreement was contract of adhesion despite existence of customer choice; issue is "whether the existence of market choice negates the issue of oppression, not whether choice renders a contract non-adhesive"); *Gutierrez v Autowest, Inc.* (2003) 114 CA4th 77, 7 CR3d 267.

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§5.76 B. Procedural Unconscionability

Procedural unconscionability exists when the manner in which the contract was negotiated subjected the beleaguered party to oppression and surprise. *Discover Bank v Superior Court* (2005) 36 C4th 148, 160, 30 CR3d 76; *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 1071, 130 CR2d 892; *Roman v Superior Court* (2009) 172 CA4th 1462, 1469, 92 CR3d 153.

Oppression may be found in unequal bargaining power between the parties and an absence of real negotiation or meaningful choice by the weaker party. For example, a dispute resolution policy distributed to low-wage employees that required arbitration was held procedurally unconscionable in *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65. The court cited the inequality in bargaining power and the fact that the policy description, written in English and Spanish, inaccurately described the policy as requiring mediation rather than arbitration. Moreover, the policy itself appeared in much smaller type and only in English. 173 CA4th at 450. Compare *Nyulassy v Lockheed Martin Corp.* (2004) 120 CA4th 1267, 1281 n11, 16 CR3d 296 (procedural unconscionability when plaintiff had no opportunity for negotiation, even though he was able to consult with counsel before signing), with *D.C. v Harvard-Westlake Sch.* (2009) 176 CA4th 836, 98 CR3d 300 (absent evidence of unequal bargaining power, arbitration and attorney fee provisions in private school enrollment contract were not procedurally unconscionable).

Surprise is found when the challenged terms are hidden in a form contract drafted by the stronger party. But surprise alone may not lead to a finding of procedural unconscionability, although oppression alone may. *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 656, 9 CR3d 422. For example, in *Wayne v Staples*, *Inc.* (2006) 135 CA4th 466, 482, 37 CR3d 544, the court rejected the argument that there was procedural unconscionability when there was clear price disclosure (no surprise) and meaningful alternatives (no oppression), stating:

> There can be no "oppression" establishing procedural unconscionability, even assuming unequal bargaining power and an adhesion contract, when the customer has meaningful choices.

But see *Shroyer v New Cingular Wireless Servs.* (9th Cir 2007) 498 F3d 976, 985 (procedural unconscionability found in phone company's "take-it-or-leave it" contract "even if customer has meaningful choice as to service providers").

Procedural unconscionability often takes the form of an adhesion contract, imposed and drafted by a party having superior bargaining power, relegating to the other party only the opportunity to accept or reject the contract. *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471 (one-page arbitration agreement in small type included in packet of hiring papers employee told to fill out, sign, and return in order to start work, held procedurally unconscionable). See also *Gentry v Superior Court* (2007) 42 C4th 443, 64 CR3d 773 (despite 30-day opt-out period, arbitration clause emphasizing employer's preference for arbitration found unconscionable); *Discover Bank v Superior Court* (2005) 36 C4th 148, 160, 30 CR3d 76. Nevertheless, a standard form contract that one party uses for many transactions is not necessarily procedurally unconscionable. *Crippen v Central Valley RV Outlet, Inc.* (2004) 124 CA4th 1159, 22 CR3d 189. See also *Roman v Superior Court* (2009) 172 CA4th 1462, 1471, 92 CR3d 153 (procedural unconscionability present in adhesive employment agreement did not render agreement unenforceable).

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§5.77 C. Substantive Unconscionability

Substantive unconscionability exists when the terms of the contract are so one-sided as to shock the conscience of the court asked to enforce them. See *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 1071, 130 CR2d 892; *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 61 CR3d 344; *Trend Homes, Inc. v Superior Court* (2005) 131 CA4th 950, 32 CR3d 411. Substantive unconscionability may take many forms, but can be described generally as "overly harsh" or "unfairly one-sided" contract terms. *Discover Bank v Superior Court* (2005) 36 C4th 148, 160, 30 CR3d 76; *Roman v Superior Court* (2009) 172 CA4th 1462, 1470, 92 CR3d 153. The key factor is lack of mutuality. See *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 656, 9 CR3d 422.

Many recent cases have focused on application of the unconscionability doctrine to arbitration clauses and other contract provisions that make it difficult or impossible for employees or customers to recover on valid claims. See, *e.g., Little v Auto Stiegler, Inc.,* 29 C4th at 1071 (provision allowing appeal only of arbitration awards of $50,000 or more held unduly one-sided in employer's favor); *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745 (arbitration clause so one-sided that it should not be enforced); *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65 (class action waiver in arbitration agreement substantively unconscionable because it benefited only employer, which was unlikely to sue employees in class action lawsuit); *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818 (arbitration clause designating "panel" of arbitrators that, in reality, consisted of only one arbitrator selected by employer was substantively unconscionable); *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471 (arbitration agreement that gave arbitrator exclusive authority to determine enforceability, required employee to pay portion of costs, and severely limited discovery held substantively unconscionable); *Martinez v Master Protection Corp.* (2004) 118 CA4th 107, 12 CR3d 663 (unconscionable employment arbitration agreement lacked mutuality, imposed unacceptable costs on employee, and imposed unfair 6-month limitation on assertion of claims); *O'Hare v Municipal Resource Consultants* (2003) 107 CA4th 267, 132 CR2d 116 (arbitration agreement was unconscionable when it required only employee, not employer, to arbitrate claims). But see *Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153 (arbitration clause that applied to "all disputes," whether initiated by employee or employer, not unconscionable); *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 955, 85 CR3d 817 (arbitration agreement providing for arbitration under NASD rules approved by SEC found not substantively unconscionable). The essence of substantive unconscionability is lack of mutuality; the central inquiry is whether the contract is so harsh or one-sided that it lacks fundamental fairness. *Abramson,* 115 CA4th at 658.

For further discussion of the doctrine of unconscionability as applied to arbitration agreements, see §§9.42-9.44.

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§5.78 D. Class Action Waivers

Waivers of the right to bring a class action are not necessarily unconscionable, but class action waivers have been ruled so in a number of cases involving consumer contracts of adhesion. See, *e.g., Shroyer v New Cingular Wireless Servs.* (9th Cir 2007) 498 F3d 976; *Murphy v Check'n Go* (2007) 156 CA4th 138, 67 CR3d 120; *Gatton v T-Mobile USA, Inc.* (2007) 152 CA4th 571, 61 CR3d 344. In *Discover Bank v Superior Court* (2005) 36 C4th 148, 162, 30 CR3d 76, the California Supreme Court held that a class action waiver in a credit card holder agreement was unenforceable on grounds of both procedural and substantive unconscionability. The court found an element of procedural unconscionability present when the consumer was given an amendment to a cardholder agreement in the form of a "bill stuffer" that the consumer would be deemed to have accepted if he or she did not close the account. The court ruled that class action waivers in such adhesion contracts may also be substantively unconscionable because they may have the effect of exculpatory clauses that are contrary to public policy under CC §1668. See §§3.40, 5.95. The court held (36 C4th at 162):

> We do not hold that all class action waivers are necessarily unconscionable. But when the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then, at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party "from responsibility for [its] own fraud, or willful injury to the person or property of another." (Civ. Code, §1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced.

Relying on the *Discover Bank* holding, the court of appeal in *Aral v Earthlink, Inc.* (2005) 134 CA4th 544, 36 CR3d 229, found that a class action waiver in a DSL service provider agreement was both procedurally and substantively unconscionable under California law. The agreement was presented on a "take it or leave it" basis, either in printed materials mailed with the DSL software or in connection with the software installation, with no chance for the consumer to opt out. Moreover, it was substantively unconscionable because the consumers were charged for the service as soon as they ordered it, even though the company knew that the service would not be accessible by the consumer until after the modem was delivered and installed, weeks later. See also *Cohen v DirecTV, Inc.* (2006) 142 CA4th 1442, 48 CR3d 813 (clause prohibiting class or representative claims unconscionable); *Klussman v Cross Country Bank* (2005) 134 CA4th 1283, 36 CR3d 728 (hidden waiver of right to bring classwide arbitration unconscionable).

Courts have also ruled on class action waivers in employment agreements. In *Gentry v Superior Court* (2007) 42 C4th 443, 64 CR3d 773, the California Supreme Court invalidated a class action waiver that interfered with employees' exercise of their statutory right to overtime pay. The court set forth factors for evaluating a class arbitration waiver, holding that the waiver must be invalidated if class arbitration is likely to be a significantly more effective means of vindicating the unwaivable rights of the affected employees than individual litigation or arbitration. 42 C4th at 463. See also *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65 (class action waiver in arbitration agreement substantively unconscionable as unfairly one-sided because it benefited only employer, which was unlikely to sue its employees in class action lawsuit).

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§5.79 E. Remedies

If one or more terms in a contract are found to be unconscionable, the court must then determine whether the unconscionable provisions are severable so that the remaining parts of the contract can be enforced. See CC §1670.5(a). If the unconscionable terms are severable, the court may proceed to sever them and enforce the rest of the contract as written. See, *e.g., Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892. If the court finds that the unconscionable provisions have tainted other sections of the contract, it may deny enforcement of the contract altogether. See *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 181, 90 CR3d 818 (arbitration agreement was "permeated by an unlawful purpose," thus entire agreement was unenforceable); *Nyulassy v Lockheed Martin Corp.* (2004) 120 CA4th 1267, 16 CR3d 296; *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 667, 9 CR3d 422. Finally, if the court finds that even a single unconscionable term of the contract was inserted in the contract in bad faith, it can deny enforcement of the entire contract without determining whether the term is severable or not. See *Little,* 29 C4th at 1076.

The principles concerning severance of unenforceable contract terms are discussed more fully in §§5.70-5.71.

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§5.80 VIII. FOREIGN LANGUAGE TRANSLATIONS (CC §1632)

Civil Code §1632 is a consumer protection statute designed to protect individuals who speak Spanish, Chinese, Tagalog, Vietnamese, or Korean as their primary language in their homes. It applies to certain credit sales contracts, automobile sales and lease financings, real estate leases, contracts for legal services, foreclosure consulting contracts, and other specified contracts executed as the result of written or oral negotiations primarily in one of these foreign language conducted by a person engaged in a business or trade. The statute requires that the business- or tradesperson deliver a translation of the contract in the language in which the contract was negotiated to the other party. See CC §1632. The translation must include every term and condition included in the contract, although certain elements such as names, titles, and addresses need not be translated. See CC §1632(b)(h)(i). In some cases, a translation of financial disclosures required by law or regulation provided by a bank, savings association, or credit union to the consumer before the negotiations may satisfy the statute. See CC §1632(e). For residential leases or rental contracts that will continue for more than a month, the statute imposes the additional requirement that the tenant or lessee be given a notice in the applicable foreign language when the rental agreement or lease is executed. CC §1632(d). Further, if the contract or agreement involves a consumer loan or other specified financial transaction (such as automobile sales and lease financings), the statute requires that a notice in the applicable foreign language be prominently displayed when and where the contract is executed. CC §1632(e). The notice must inform the consumer that the person with whom he or she is negotiating is required to furnish a translation of the contract or the disclosures required by law, as applicable.

The statute limits the term "contract" (and thus the statutory translation requirements) to the document creating the parties' rights and obligations and to any subsequent document making substantial changes to those rights and obligations. CC §1632(g). The translation requirements do not apply to items incorporated by reference or to subsequent documents such as sales slips or periodic statements of account that are contemplated or authorized by the original contract. The statute also exempts certain home improvement contracts and related security agreements. CC §1632(g). Finally, the statute does not apply when the consumer uses his or her own interpreter, *i.e.,* a person, not a minor, who is fluent in both the applicable foreign language and English, and who is not employed by, or whose service is not made available through, the person engaged in trade or business. CC §1632(h).

The terms of the contract or agreement executed in English determine the rights and obligations of the parties. CC §1632(j). If, however, there is a substantial difference between material terms and conditions of the contract in English and those in the translation, the translation may be offered as evidence that no contract was made.

A contract made in violation of the statute may be rescinded by the aggrieved party. CC §1632(k). If the contract is for a consumer credit sale or lease, however, and the contract has been assigned to a financial institution, the consumer must make restitution to and seek restitution from the person with whom he or she made the contract, and also give notice of the rescission to the assignee. In these cases, even if the contract was assigned without recourse, the assignment will be deemed rescinded and the assignor must repurchase the contract from the assignee. CC §1632(k).

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IX. CONTRACT MODIFICATIONS, WAIVERS, RELEASES

§5.81 A. Non-Commercial Code Contracts

When the parties' performance under a contract extends over a period of time, circumstances may demand that the terms of the contract be changed. This is commonly achieved through an amendment or modification, a supplemental agreement, a rescission, a waiver, or a novation. See Drafting Business Contracts: Principles, Techniques & Forms §19.2 (Cal CEB 1994). These concepts are interrelated and easily can be confused with one another.

NOTE: If one party's obligations under a contract have been guaranteed by a third party, any change to the original contract made without consent or a waiver of consent by the guarantor may exonerate the guarantor. See CC §2819. Similarly, in secured transactions, changes to the loan agreement or security document that operate to the detriment of a junior secured creditor may result in a loss of priority for a senior secured creditor. See 5 Miller & Starr, California Real Estate §11.96 (3d ed 2000).

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1. Amendments or Modifications

§5.82 a. Generally

Amendments or modifications change the contract by adding or deleting terms with the parties' consent. In effect, an amendment constitutes an agreement to replace certain provisions of the original contract with new ones, and the same elements necessary to the validity of the original contract must be present. *Carlson, Collins, Gordon & Bold v Banducci* (1967) 257 CA2d 212, 223, 64 CR 915. Amendments can be made orally (subject to the statute of frauds) or can be implied from the parties' subsequent conduct. *Diamond Woodworks, Inc. v Argonaut Ins. Co.* (2003) 109 CA4th 1020, 135 CR2d 736. See §§5.83-5.84. When an effective amendment to a contract is made, the original contract is subsumed into the amended agreement, but the parties' obligations under the original contract continue except to the extent modified by the amendment. See *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 38 CR2d 521.

It is important to distinguish a contract amendment or modification from a novation. Unlike a novation, a contract modification does not extinguish or terminate the entire existing contract, bur rather only those provisions subject to the amendment. See *Davies Mach. Co. v Pine Mountain Club, Inc.* (1974) 39 CA3d 18, 113 CR 784; *Eluschuk v Chemical Eng'rs Termite Control, Inc.* (1966) 246 CA2d 463, 54 CR 711. An amendment typically does not operate to release a party from his or her obligations under the contract. See *Wells Fargo Bank v Bank of America*, *supra*. For further discussion of contract novations, see §5.88.

Civil Code §§1697-1698 set forth rules for modification of contracts (see §§5.83-5.84). In *Diamond Woodworks, Inc. v Argonaut Ins. Co.*, *supra,* the court ruled that a modification of the parties' written agreement would be implied when their subsequent conduct was inconsistent with and contrary to the terms of the written contract.

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§5.83 b. Oral Contracts (CC §1697)

Amendments or modifications of oral contracts are governed by CC §1697, which provides that "[a] contract not in writing may be modified in any respect by consent of the parties, in writing, without a new consideration, and is extinguished thereby to the extent of the modification." See *Healy v Brewster* (1967) 251 CA2d 541, 59 CR 752 (oral modification of contract enforceable when there was adequate consideration and party relying on modification had fully performed); *Eluschuk v Chemical Eng'rs Termite Control, Inc.* (1966) 246 CA2d 463, 54 CR 711 (employee's oral agreement was fully performed; it was therefore a modification, rather than a novation, of the original written contract).

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§5.84 c. Written Contracts (CC §1698)

Amendments or modifications of written contracts are subject to CC §1698. A written contract can be amended or modified either (1) by another writing (CC §1698(a)); (2) by an oral agreement to the extent that the oral agreement is performed by the parties (CC §1698(b)); or (3) unless the contract provides otherwise, and subject to the statute of frauds (CC §1624), by an oral agreement supported by new consideration (CC §1698(c)). Further, CC §1698(d) indicates that contract modifications can be effected by "application of rules of law concerning estoppel, oral novation and substitution of a new agreement, rescission of a written contract by an oral agreement, waiver of a provision of a written contract, or oral independent collateral contracts." See, *e.g., Nguyen v Calhoun* (2003) 105 CA4th 428, 129 CR2d 436 (borrowers' finding responsible buyer at lender's request constituted good consideration for lender's promise to postpone foreclosure sale); *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518 (written agreement may be modified by executed oral agreement; written agreement remains in effect except to extent it has been modified). See also *Peak-Las Positas Partners v Bollag* (2009) 172 CA4th 101, 90 CR3d 775 (real property seller's refusal to extend escrow when buyer had paid most of purchase price and incurred about $5 million in costs to obtain lot line adjustment was unreasonable and violated covenant of good faith and fair dealing).

Oral modifications of written agreements are ineffective if there is no consideration or if the written agreement requires amendments to be in writing. See *Conley v Matthes, supra; Beggerly v Gbur* (1980) 112 CA3d 180, 169 CR 166. The original contract may specify the procedures for later revision, and, if it does, those procedures control. *Busch v Globe Indus.* (1962) 200 CA2d 315, 19 CR 441 (noting CC §1698 has no application when contract is revised in accordance with its own terms; in such case, "modification is in accordance with the terms of the contract"). This technique can, of course be taken too far, rendering the later revision ineffective. See *Badie v Bank of America* (1998) 67 CA4th 779, 791, 79 CR2d 273 (credit card and account documents containing authorization for bank to unilaterally change or add provisions was limited to modifications, the general subject matter of which was anticipated when contract was entered into). Oral modifications may also be restricted by the statute of frauds. See *Hastings v Matlock* (1985) 171 CA3d 826, 217 CR 856 (oral settlement agreement that rescinded written contract for purchase and sale of real estate was enforceable).

What constitutes adequate consideration is discussed in §§3.42-3.54.

NOTE: Federal law allows oral modifications of collective bargaining agreements even if the agreement provides that it may only be modified in writing, and thus preempts CC §1698. *Mechanical Contractors Ass'n v Greater Bay Area Ass'n* (1998) 66 CA4th 672, 78 CR2d 225.

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§5.85 2. Supplemental Agreements

Supplemental agreements are documents entered into after the original contract has been signed, although they may be referred to in the original contract. They may carry out specific provisions of the original contract, such as a note and deed of trust executed in connection with a loan agreement, or may serve to explain or clarify the original agreement. In these cases, no additional consideration is required to enforce the supplemental agreement. *Cutter Labs., Inc. v Twining* (1963) 221 CA2d 302, 34 CR 317. Similarly, no new consideration is required if the supplemental agreement substitutes new reciprocal rights between the parties in place of reciprocal rights under the original contract that are relinquished by the parties in the supplement. *House v Lala* (1963) 214 CA2d 238, 243, 29 CR 450. However, if the supplement adds to or varies the terms of the original agreement, imposing new burdens on one of the parties and effectively modifying it, consideration is required for the supplemental agreement to be enforceable. *Cutter Labs., Inc.,* 221 CA2d at 311; *Krobitzsch v Middleton* (1946) 72 CA2d 804, 808, 165 P2d 729.

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§5.86 3. Rescission; Cancellation

Rescission is a judicial or extrajudicial remedy that operates to extinguish altogether the obligations of the parties under the contract. See generally CC §1688; §§11.46-11.58. A contract that has been rightfully rescinded ceases to exist. *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1344, 96 CR3d 813; *Larsen v Johannes* (1970) 7 CA3d 491, 86 CR 744. Rescission not only terminates all further liability of the parties under the contract, but also restores the parties to their respective positions as they existed at the time the contract was made, by requiring them to return any consideration already received. *Tippett v Terich* (1995) 37 CA4th 1517, 44 CR2d 862. It is available only in the circumstances specified in the Civil Code. See CC §§1689-1695.17. Only the parties to the contract may rescind it; the right does not extend to third party beneficiaries. *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 959, 23 CR3d 233. Rescission is discussed more fully at §§11.46-11.58.

At least in the context of insurance policies, California courts distinguish between rescission, which may be effective retroactively to the time of the making of the contract, and cancellation, which terminates the contract only prospectively. *Escobedo v Estate of Snider* (1997) 14 C4th 1214, 1225, 60 CR2d 722; *Imperial Cas. & Indem. Co. v Sogomonian* (1988) 198 CA3d 169, 182, 243 CR 639. Outside the insurance context, the term cancellation most often refers to an equitable remedy to declare a written instrument void. See CC §§3412-3415, discussed in §§11.59-11.60. Civil Code §§1699-1700 address extrajudicial cancellation of a written contract. Under CC §1699, cancellation of a contract will extinguish it for all parties consenting to the cancellation. Civil Code §1700 provides that the intentional destruction or cancellation of a written contract by a party entitled to a benefit under it extinguishes all executory obligations that run in his or her favor, as against parties who do not consent to the act.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.87 4. Waiver

§5.87 4. Waiver

Courts have used the term "waiver" to refer to several different concepts. *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 314, 24 CR2d 597. In general, waiver is the voluntary relinquishment of a known right with knowledge of the facts. *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 44 CR2d 370; *Old Republic Ins. Co. v FSR Brokerage, Inc.* (2000) 80 CA4th 666, 678, 95 CR2d 583. But it can also mean the loss of an opportunity or a right as a result of a party's failure to perform an act, regardless of the party's intent to waive or relinquish the right. *Platt Pac., Inc.,* 6 C4th at 314; *Chase v Blue Cross* (1996) 42 CA4th 1142, 1148, 50 CR2d 178. The party claiming waiver must prove that claim by clear and convincing evidence that does not leave the matter to speculation, and, if the matter is doubtful, the case will be decided against the waiver. *Waller v Truck Ins. Exch., Inc., supra*; *Cathay Bank v Lee* (1993) 14 CA4th 1533, 1539, 18 CR2d 420. As stated by the court in *Utility Audit Co. v City of Los Angeles* (2003) 112 CA4th 950, 959, 5 CR3d 520 (citations omitted):

> Waiver requires an existing right, benefit, or advantage, actual or constructive knowledge of the right's existence, and either an actual intention to relinquish it or conduct so inconsistent with any intent to enforce the right as to induce a reasonable belief that it has been relinquished.… The waiver of a legal right cannot be established without a clear showing of intent to give up such right.… The burden is on the party claiming the waiver to prove it by clear and convincing evidence that does not leave the matter doubtful or uncertain.

See also *Litton Gen. Eng'g Contractor, Inc. v United Pac. Ins.* (1993) 16 CA4th 577, 593, 20 CR2d 200.

A contracting party does not have the unilateral right to waive any term of a contract, but rather only those provisions that were included for that party's sole benefit. *Wyler Summit Partnership v Turner Broad. Sys., Inc.* (9th Cir 2000) 235 F3d 1184; *Sabo v Fasano* (1984) 154 CA3d 502, 201 CR 270.

Waiver is often used to modify an existing contract, and contracts often expressly state how waivers can be made. For example, an asset purchase agreement may include many conditions to closing, such as receipt of opinions of counsel or regulatory approval. The party who would benefit from fulfillment of the conditions (typically, the buyer) may waive one or more of these conditions and proceed to closing without their satisfaction. See, *e.g., Rincon Ctr. Assocs. v Chrysler MacNalley Corp.* (ND Cal, July 13, 1998, No. C 97-2840 CRB) 1998 US Dist Lexis 11097; *Doryon v Salant* (1977) 75 CA3d 706, 712, 142 CR 378. See generally Drafting Business Contracts: Principles, Techniques & Forms, chap 17 (Cal CEB 1994). See also *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 122 CR2d 267 (waiver of condition precedent may be retracted and condition restored at any time, in absence of consideration or estoppel).

A waiver may be either express, based on a party's words, or implied, based on conduct indicating an intent to relinquish the right. *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 44 CR2d 370. See *Biren v Equality Emergency Med. Group, Inc.* (2002) 102 CA4th 125, 125 CR2d 325 (by their conduct, parties waived contract provision requiring amendments to be in writing). The parties' conduct or course of performance may be relevant to show a waiver or modification of any term inconsistent with that conduct or course of performance. See Com C §1303(f) (former Com C §2208(3)). To negate this inference, many contracts—particularly ones providing for payments over time—expressly provide that no delay or failure to exercise any right or remedy by one party shall be construed as a waiver of any breach or default by the other party, and that any waiver must be in writing. Following is an example of such a provision:

> **No delay or omission to exercise any right, power, or remedy accruing to Lender under this Agreement shall impair any right, power, or remedy of Lender, nor shall it be construed as a waiver of, or acquiescence in, any breach or default. Any waiver or consent by Lender regarding any provision of this Agreement shall be in writing, and no waiver of, or consent to, any single breach or default shall be construed as a waiver of any other breach or default.**

A waiver may also occur by estoppel. *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518 (although escrow instructions prohibited oral modifications to agreement, lender accepted benefits of modification and was therefore estopped from asserting that modification was unenforceable).

It is important to note that waiver refers to the act (or the legal consequences of an act) of only one party. Waiver

depends on the intention of the party who allegedly relinquished the known legal right and does not require any act or conduct by the other party. "California courts will find waiver when a party intentionally relinquishes a right or when that party's acts are so inconsistent with an intent to enforce the right as to induce a reasonable belief that such right has been relinquished." *Old Republic Ins. Co. v FSR Brokerage, Inc.* (2000) 80 CA4th 666, 678, 95 CR2d 583 (citations omitted).

Civil Code §2856 sets forth a series of interpretive rules generally validating waivers of suretyship rights and defenses in guaranty or suretyship contracts. The statute applies to waivers executed on or after January 1, 1997. CC §2856(f). No particular language or phrases in the contract or references to statutes or judicial decisions are required. CC §2856(b). The statute includes a model form of waiver, while clarifying that any other language expressing an intent to waive may be used. See CC §2856(c)-(d). There is an exception for guaranties of loans secured by purchase money deeds of trust on residential real estate. CC §2856(e).

NOTE: Before enactment of CC §2856, California courts recognized that suretyship defenses could be waived by a guarantor, but differed on interpretation of contract language that would be adequate to constitute an effective waiver. There is an issue regarding the continuing validity of pre-CC §2856 case law. See generally State Bar of California, Business Law Section, Report on Third-Party Remedies Opinions, App 10, B-18-B-20 (2007).

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§5.88 5. Novation (CC §§1530-1532)

A novation is the substitution of a new contractual obligation for an existing one. CC §1530; *Paykar Construction, Inc. v Spilat Construction Corp.* (2001) 92 CA4th 488, 494, 111 CR2d 863. It completely extinguishes the existing contract, and substitutes either a new obligor, a new obligee, a new obligation, or a combination of these in place of what the original contract provided. CC §1531; *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 38 CR2d 521; *Howard v County of Amador* (1990) 220 CA3d 962, 269 CR 807. Unlike an assignment, a novation operates as a complete release with regard to the party or the obligation being substituted out. See *Wells Fargo Bank,* 32 CA4th at 432.

A novation is made either (1) by the substitution of a new obligation between the same parties with intent to extinguish the old obligation; (2) by the substitution of a new debtor in place of the old one with intent to release the latter; or (3) by the substitution of a new creditor in place of the old one with intent to transfer the rights of the old to the new. CC §1531; *Paykar Construction, Inc. v Spilat Construction Corp.* (2001) 92 CA4th 488, 494, 111 CR2d 863. It must clearly appear that the parties intended to extinguish the prior contract and not merely modify it. *Wells Fargo Bank,* 32 CA4th at 432.

A novation requires an express release by the party entitled to enforce an obligation. *Vallely Invs., L.P. v Bancamerica Commercial Corp.* (2001) 88 CA4th 816, 106 CR2d 689. When a novation to substitute a new debtor is attempted, the release of the old obligor constitutes sufficient consideration to support the novation and the new debtor's obligation. Both the creditor *and* the former debtor must consent to the former debtor's release. *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 433, 38 CR2d 521. See also *Grand Ave. Partners, L.P. v Goodan* (9th Cir 1998) 160 F3d 580 (assignment did not constitute novation because assignee was not completely relieved of liability by language in original lease providing that lessee-assignor shall be released from "all direct liability hereunder accruing" after assignment).

NOTE: A novation in which a new debtor is substituted for the original debtor and the original debtor is released of its obligations is similar to, if not essentially the same as, an enforceable delegation of duties under a contract. Delegation is discussed further in §§7.31-7.36.

One early case identified four essential elements of a novation: (1) a prior valid obligation, (2) an agreement by all affected parties to a new contract, (3) extinguishment of the old contract, and (4) the validity of the new contract. *United States Gypsum Co. v Snyder-Ashe Co.* (1934) 139 CA 731, 34 P2d 767. A novation can be shown by the acts or conduct of the parties alone; express words are not required. *Hunt v Smyth* (1972) 25 CA3d 807, 101 CR 4. In *Hunt,* the court emphasized that bargained-for consideration is critical to support a finding of a novation. Consideration will be present if the original contract is at least partially executory on both sides, so that both parties suffer a legal detriment through cancellation of their original contract rights. *People ex rel Department of Pub. Works v Metcalf* (1978) 79 CA3d 1, 8, 144 CR 657.

The burden of proof regarding all elements of a novation is on the party asserting the existence of a novation. *Davies Mach. Co. v Pine Mountain Club, Inc.* (1974) 39 CA3d 18, 113 CR 784 (finding no novation where there was no evidence of intent to extinguish existing purchase contract). If the party asserting the novation is a third party, that burden is great. *Vallely Invs., L.P. v Bancamerica Commercial Corp.* (2001) 88 CA4th 816, 106 CR2d 689.

Once a novation has occurred, the rights and duties of the parties are governed by the new agreement. Any failure to perform the terms of the new agreement does not rescind it or operate to revive the parties' obligations under the old extinguished agreement. *Alexander v Angel* (1951) 37 C2d 856, 860, 236 P2d 561.

There are limited statutory rights of rescission of novations, detailed in CC §1533.

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§5.89 B. Modification, Rescission, and Waiver Under Commercial Code (Com C §§1306, 2209, 10208)

Commercial Code §1306 (former Com C §1107) provides generally that "[a] claim or right arising out of an alleged breach may be discharged in whole or in part without consideration by agreement of the aggrieved party in an authenticated record." Thus, an enforceable waiver of breach of a Commercial Code contract requires an agreement by the nonbreaching party, but does not require consideration. The term "agreement" is defined in Com C §1201(b)(3) (former Com C §1201(3)) as "the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade."

The Commercial Code has eliminated the requirement for additional consideration in order to modify a contract for the sale of goods: Commercial Code §2209(1) states that "[a]n agreement modifying a contract within this division needs no consideration to be binding." See also *PMC, Inc. v Porthole Yachts, Ltd.* (1998) 65 CA4th 882, 888, 76 CR2d 832 (Commercial Code does not require consideration to support modification of contract, but valid modifications still require proof of other elements essential to contract's validity, including mutual assent). Compare Com C §2209(1) with CC §1698 (requiring consideration to support modification of written non-Commercial Code contracts). See §§5.82-5.84.

When a contract governed by Division 2 of the Commercial Code provides that it can only be modified or rescinded in writing, this provision is strictly enforceable if the parties are merchants. If one of the parties is not a merchant, and the proposed modification is on a form supplied by the merchant, the party who is not a merchant must separately sign the provision in question. Com C §2209(2).

The statute of frauds (Com C §2201) must be satisfied if the contract as modified is subject to its provisions. Com C §2209(3). An attempted modification or rescission that does not satisfy the requirements of the statute of frauds may still operate as a waiver. Com C §2209(5).

A party who has waived executory portions of a contract for the sale of goods may retract the waiver by reasonable notice received by the other party that strict performance will be required, unless the retraction would be unjust because the other party has materially changed its position in reliance on the waiver. Com C §2209(5). When a secured party establishes a pattern or course of dealing of accepting late payments, it may not suddenly insist on prompt and timely payment or declare a forfeiture. *Battista v Savings Bank* (MD Spec App Md 1986) 507 A2d 203, 209. Waiver of timely performance can be effected by conduct, and retraction of such a waiver will require plain and reasonable notice to the other party of the intent to retract the prior waiver. 507 A2d at 209; *J.T. Jenkins v Kennedy* (1975) 45 CA3d 474, 483, 119 CR 578 (although there could not have been oral modification because it was not fully performed, the trial court committed reversible error in failing to determining existence of agreement that could form basis for claim of waiver). Even if the contract at issue contains a "no waiver" or "all waivers must be in writing" clause, a waiver by conduct may extend to these clauses, and retraction of the waiver will require reasonable notice and a lack of justifiable reliance on the prior waiver by the other party. *Battista,* 507 A2d at 209.

The rules for modification, rescission, and waiver of personal property leases subject to Division 10 of the Commercial Code are the same as those described above. See Com C §10208.

For further discussion of modification, rescission, and waiver in regard to contracts for the sale of goods, see California UCC Sales and Leases, chap 6 (Cal CEB 2002).

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C. Settlement Agreements; Releases

§5.90 1. Generally

Settlement agreements and releases of claims are contracts and are analyzed in the same manner as other contracts. *Stewart v Preston Pipeline, Inc.* (2005) 134 CA4th 1565, 1585, 36 CR3d 901; *Weddington Prods., Inc. v Flick* (1998) 60 CA4th 793, 810, 71 CR2d 265. A party asserting that a dispute is subject to a settlement agreement has the burden of proving each element of a contract, *i.e.,* parties with the capacity to enter into a contract, their mutual consent, a lawful object, and sufficient consideration. *Stewart v Preston Pipeline Inc., supra*. In general, the mutual intent of the parties is the controlling factor in interpretation. *Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 633, 119 CR 449; *McCall v Four Star Music Co.* (1996) 51 CA4th 1394, 59 CR2d 829. And like other contracts, releases will not be enforced if obtained through fraud, duress, or other unfair conduct (see *Casey v Proctor* (1963) 59 C2d 97, 102, 28 CR 307; *San Diego Hospice v County of San Diego* (1995) 31 CA4th 1048, 37 CR2d 501), or mutual mistake (see *Hess v Ford Motor Co.* (2002) 27 C4th 516, 117 CR2d 220). See also *Tarpy v County of San Diego* (2003) 110 CA4th 267, 1 CR3d 607.

Settlement agreements and releases are subject to some special requirements. Despite a strong public policy favoring settlement of private disputes (see generally Cordray, *Settlement Agreements and the Supreme Court*, 48 Hastings LJ 9 (Nov. 1996)), settlement agreements and releases may be given stricter scrutiny because of concerns about overreaching by sophisticated defendants against less sophisticated plaintiffs, such as involuntary tort creditors. Like insurance contracts, settlement agreements and releases normally are strictly construed against the drafter. *Solis v Kirkwood Resort Co.* (2001) 94 CA4th 354, 114 CR2d 265. See §5.22. Releases are subject to statutory limitations. See CC §§1541-1543, discussed in §§5.92-5.94. See also CCP §877 (effect of release of one of two or more co-obligors or joint tortfeasors).

Settlement offers may be made in accordance with the statutory procedures set forth in CCP §998, which are designed to induce the parties to reach agreement. See §5.96.

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§5.91 2. Covenants Not to Sue

Settlement agreements typically include covenants not to sue. A covenant not to sue is not a release, but rather a promise not to prosecute a lawsuit against the promisee. In contrast, a release is an abandonment or relinquishment of a right or claim in favor of the person against whom it might have been enforced, and has the effect of extinguishing the claim or cause of action. See CC §1541. Hence, it may be pleaded as a defense to the action. A covenant not to sue, however, is merely an agreement not to enforce an existing cause of action. It does not result in extinguishing the cause of action. *Pellett v Sonotone Corp.* (1945) 26 C2d 705, 711, 160 P2d 783. As between the parties to a settlement agreement, the distinction between a release and a covenant not to sue is entirely artificial. The end result is the same in both cases, namely, that there can be no further recovery from the defendant who enters into the settlement. *Mesler v Bragg Mgmt. Co.* (1985) 39 C3d 290, 298, 216 CR 443.

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§5.92 3. Releases of Existing Obligations (CC §1541)

A release by a creditor of a debtor's obligation is enforceable and extinguishes the obligation if the release is supported by consideration. No consideration is necessary if the release is given in writing. CC §1541. Like other contracts, however, a release is not enforceable if obtained by fraud, deception, misrepresentation, duress, or undue influence. *Tarpy v County of San Diego* (2003) 110 CA4th 267, 1 CR3d 607; *Skrbina v Fleming Cos.* (1996) 45 CA4th 1353, 1366, 53 CR2d 481. As stated in *Pellett v Sonotone Corp.* (1945) 26 C2d 705, 711, 160 P2d 783, a release is an

> abandonment, relinquishment or giving up of a right or claim to the person against whom it might have been demanded or enforced… and its effect is to extinguish the cause of action; hence it may be pleaded as a defense to the action.

To be enforceable, a release should be drafted so that it is clear and explicit with regard to its scope and legal effect. It should be simple enough for a layperson to understand, and it should give notice of its significance. *Hohe v San Diego Unified Sch. Dist.* (1990) 224 CA3d 1559, 1566, 274 CR 647. See also *Skrbina v Fleming Cos.* (1996) 45 CA4th 1353, 53 CR2d 481. In addition, a release must conform with CC §1542, discussed in §5.93. As the court in *Queen Villas Homeowners Ass'n v TCB Prop. Mgmt.* (2007) 149 CA4th 1, 5, 56 CR3d 528 noted, "drafting a legally valid release is no easy task. Courts have criticized and struck down releases if the language is oversimplified, if a key word is noted in the title but not the text, and if the release is too lengthy or too general, to name a few deficiencies." The intent of the parties as expressed in the release is controlling. *McCall v Four Star Music Co.* (1996) 51 CA4th 1394, 1400, 59 CR2d 829. Actual assent to the release is required. Unless the releasing party is estopped from doing so, he or she may seek to be relieved from the effect of his or her signature to a release (like any other contract) by showing that he or she did not really consent to it. *Tarpy v County of San Diego* (2003) 110 CA4th 267, 276, 1 CR3d 607.

If a release is obtained fraudulently, the release and settlement will only extend to the areas where the parties minds met without reference to the fraud. *King v Associated Constr. Corp.* (1960) 183 CA2d 818, 7 CR 182. There are three general situations in which a release may be avoided on account of fraud: (1) fraud in the inception, when the nature or contents of the document signed have been misrepresented; (2) nondisclosure by a fiduciary, when the release was obtained by a fiduciary without full disclosure of the relevant facts; and (3) fraud in concealment of claims, when the releasor was prevented from knowing about his claim. *San Diego Hospice v County of San Diego* (1995) 31 CA4th 1048, 1055 n2, 37 CR2d 501. In *Persson v Smart Inventions, Inc.* (2005) 125 CA4th 1141, 23 CR3d 335, the court held that a party who had been fraudulently induced to sell stock and to sign a mutual release of unknown claims (see §5.93) could nonetheless affirm the contract and sue for fraud damages.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.93 4. Scope of General Releases (CC §1542)

§5.93 4. Scope of General Releases (CC §1542)

California has a statute specifically addressed to a claimant's ability to waive known and unknown claims (CC §1542):

> A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.

As the California Supreme Court explained in *Casey v Proctor* (1963) 59 C2d 97, 28 CR 307, the intent of §1542 was to prevent the person releasing claims from inadvertently waiving unknown claims merely by signing a general release (59 C2d at 109):

> [Civil Code §1542] does not prevent all settlements for unknown claims. It was never intended to do so. Rather, its purpose was to prevent the mere recital in the release to that effect from barring a claim for injuries later discovered in the absence of a showing of a conscious understanding that if injuries were suffered which had not yet manifested themselves, they too would be discharged by the release.

See also *Winet v Price* (1992) 4 CA4th 1159, 1170, 6 CR2d 554.

Any settlement agreement or release that seeks to release both known and unknown claims should include a direct quote of CC §1542, an acknowledgment that the releasor has read and understands that section, and a clear statement that the release waives the statute's protections. This language is often called a "§1542 waiver." For examples of releases that were enforced, see *Israel-Curley v California Fair Plan* (2005) 126 CA4th 123, 129, 24 CR3d 1; *Randas v YMCA of Metro. Los Angeles* (1993) 17 CA4th 158, 21 CR2d 245; *Winet v Price* (1992) 4 CA4th 1159, 6 CR2d 554. See also Drafting Business Contracts: Principles, Techniques & Forms §11.50 (Cal CEB 1994).

Merely reciting that §1542 is waived or that the releasor intends to waive unknown claims is not sufficient for enforcement of a release. There must be independent evidence that the releasor specifically intended to release unknown claims. *McCray v Casual Corner, Inc.* (CD Cal 1992) 812 F Supp 1046 (citing *Casey v Proctor*, *supra*). See also *Leaf v City of San Mateo* (1980) 104 CA3d 398, 411, 163 CR 711. The contract drafter should include separate lines for initials or signatures by the parties to the waiver, indicating their acknowledgement of the §1542 waiver, along with a statement that the releasing party is aware of the meaning of the statute and intends, by signing the release, to assume the risk of then-existing but as yet unknown claims. A §1542 waiver may take the following form:

> ***Release Extends to Unknown Claims*. The parties understand that the releases of claims in _ _[*section reference*]_ _ of this Agreement applies to and includes all known and unknown and unexpected claims referred to in those _ _[*sections*]_ _. The parties further acknowledge that they have read California Civil Code §1542, which provides:**
>
> **A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.**
>
> **The parties hereby waive all rights and protections otherwise available to them under §1542, having had full opportunity to consult with counsel of their choosing regarding the matter.**
>
> _____ _____
>
> **Party A Initials** **Party B Initials**

NOTE: Civil Code §1542 applies only to "general" releases, which raises the question of what is or is not a "general" release. In *Brae Transportation, Inc. v Coopers & Lybrand* (9th Cir 1986) 790 F2d 1439, 1445, a release that applied to all claims arising out of a particular transaction was held to be a specific release rather than a general release; thus, CC §1542 was inapplicable.

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§5.94 5. Third Parties (CC §1543)

A release of one of multiple joint debtors does not extinguish the obligations of any of the others unless they are mere guarantors, nor does it affect their right to contribution, except as provided in CCP §877. CC §1543. Under CC §1543, release of one joint debtor does not extinguish obligation of any of other joint debtors to pay so much of debt as was not paid by released obligor. *McCall v Four Star Music Co.* (1996) 51 CA4th 1394, 1399, 59 CR2d 829. There can be only one satisfaction for any injury; hence, satisfaction of judgment by an execution sale or *full* payment by one or more of the joint obligors extinguishes the obligation and discharges the liability of all other obligors. Conversely, if fewer than all joint obligors satisfy less than the entire obligation, their satisfaction will not relieve the remaining obligors of their obligation pro tanto. 51 CA4th at 1399.

Releases are often drafted to extend to third persons who are not parties to the dispute being settled in connection with the release. Such a third person can enforce the release, but that person has the burden of showing that he or she was an intended third party beneficiary of the release. *Vahle v Barwick* (2001) 93 CA4th 1323, 113 CR2d 793. The release cannot be enforced by an independent wrongdoer with respect to an independent cause of action. *Leaf v City of San Mateo* (1980) 104 CA3d 398, 163 CR 711. In *General Motors Corp. v Superior Court* (1993) 12 CA4th 435, 15 CR2d 622, the court enforced a release in favor of an automobile manufacturer, even though the manufacturer was not expressly identified in the release. The release in question clearly extended to the liability of any person or entity arising from the same automobile accident, and there was no evidence presented of a contrary intent.

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Source: Business Law/California Law of Contracts/5 Contract Interpretation, Modification, Waiver/§5.95 6. Exculpation Agreements; Prospective Releases (CC §1668)

§5.95 6. Exculpation Agreements; Prospective Releases (CC §1668)

Civil Code §1668 provides:

> All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent are against the policy of the law.

See generally §3.40. Thus, if no public interest is implicated and no statute prohibits it, a contract exculpating a party from liability for his or her own simple (as distinct from gross) negligence is valid and enforceable. For example, exculpatory agreements from simple—but not gross—negligence in the recreational sports industry are routinely enforced. See, *e.g., Benedek v PLC Santa Monica, LLC* (2002) 104 CA4th 1351, 129 CR2d 197; *Lund v Bally's Aerobic Plus, Inc.* (2000) 78 CA4th 733, 93 CR2d 169; *YMCA of Metropolitan Los Angeles v Superior Court* (1997) 55 CA4th 22, 63 CR2d 612.

An exculpatory clause or prospective release, however, may be unenforceable under CC §1668 if it purposes to exempt a party from liability for a statutory violation or is otherwise contrary to the public interest. *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76; *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33; *Gavin W. v YMCA of Metropolitan Los Angeles* (2003) 106 CA4th 662, 131 CR2d 168. See also *Santa Barbara v Superior Court* (2007) 41 C4th 747, 62 CR3d 527 (in context of sports or recreation programs, releases of liability for future gross negligence are unenforceable as a matter of public policy).

In the *Discover Bank* case, the California Supreme Court held that a provision in a consumer adhesion contract waiving the right to bring a class action was contrary to public policy. In *Neubauer v Goldfarb* (2003) 108 CA4th 47, 133 CR2d 218, the court held that a waiver of the corporate directors' and majority shareholders' fiduciary duties to minority shareholders of a close corporation is against public policy; therefore, a settlement agreement between a minority shareholder and the corporation did not relieve the majority shareholders of their fiduciary duties. Similarly, prospective waivers of strict products liability have been held unenforceable. See *Westlye v Look Sports, Inc.* (1993) 17 CA4th 1715, 22 CR2d 781. The same is true of prospective waivers of violations of statutory or regulatory law. *Health Net of California, Inc. v Department of Health Servs.* (2003) 113 CA4th 224, 227, 6 CR3d 235; *Gavin W. v YMCA of Metropolitan Los Angeles* (2003) 106 CA4th 662, 670, 131 CR2d 168 (agreement purportedly exculpating child care provider from its own negligence void as against public policy).

In *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33, the court identified six factors to consider in evaluating whether an exculpatory contract involves the public interest, and thus whether it will be held invalid. It will be invalid if it exhibits some or all of the following characteristics (60 C2d at 98):

- "It concerns a business of a type generally thought suitable for public regulation.
- "The party seeking exculpation is engaged in performing a service of great importance to the public, which is often a matter of practical necessity for some members of the public.
- "The party holds himself out as willing to perform this service for any member of the public who seeks it, or at least for any member coming within certain established standards.
- "As a result of the essential nature of the service, in the economic setting of the transaction, the party invoking exculpation possesses a decisive advantage of bargaining strength against any member of the public who seeks his services.
- "In exercising a superior bargaining power the party confronts the public with a standardized adhesion contract of exculpation, and makes no provision whereby a purchaser may pay additional reasonable fees and obtain protection against negligence.
- "Finally, as a result of the transaction, the person or property of the purchaser is placed under the control of the seller, subject to the risk of carelessness by the seller or his agents."

Exculpatory clauses must be clear, unambiguous, and explicit to be enforceable. Any ambiguity must normally be construed against the drafter, in accordance with CC §1654. *Cohen v Five Brooks Stable* (2008) 159 CA4th 1476, 72

CR3d 471. In *Cohen,* the plaintiff alleged that the trail guide, by suddenly causing his horse to gallop, negligently caused her injuries. The court held that a release acknowledging certain inherent risks in horseback riding, including the risk that a horse could move unexpectedly in response to the movement of other horses or people, as well as "risks not specifically identified," did not unambiguously apply to negligent acts of the stable or its employees that increased the risks inherent in horseback riding. In *Leon v Family Fitness Ctr.* (1998) 61 CA4th 1227, 1231, 71 CR2d 923, the court held an exculpatory clause unenforceable because it was not distinguishable from the rest of the document—it was printed in the same typeface and was placed in the middle of the document where it was not likely to attract attention. See also *Benedek v PLC Santa Monica, LLC* (2002) 104 CA4th 1351, 1356, 129 CR2d 197; *Allabach v Santa Clara County Fair Ass'n* (1996) 46 CA4th 1007, 54 CR2d 330.

In the absence of extrinsic evidence, the scope of an exculpatory clause is determined by its express language. When a release expressly releases the defendant from any liability, it is not necessary that the plaintiff have specific knowledge of the particular risk that ultimately caused the injury in order for the release to be enforced. *Benedek v PLC Santa Monica, LLC* (2002) 104 CA4th 1351, 129 CR2d 197. An exculpatory release will be construed against the drafter if it was passively accepted by the other party, *e.g.,* in a contract of adhesion. *Leon v Family Fitness Ctr.* (1998) 61 CA4th 1227, 1234, 71 CR2d 923. See also *Cohen v Five Brooks Stable* (2008) 159 CA4th 1476, 72 CR3d 471.

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§5.96 D. Statutory Offers to Compromise (CCP §998)

Code of Civil Procedure §998 sets forth procedures for making a statutory offer of compromise in connection with pending state court litigation or an arbitration proceeding. Under CCP §998, a party may make a formal written offer to allow a judgment or an award to be entered in accordance with terms specified by the party. If the other party refuses to accept the offer, and then fails to achieve a more favorable judgment at trial (or in arbitration), that party is subject to specified cost-shifting penalties. The purpose of CCP §998 is to encourage out-of-court settlement of litigation by penalizing the party who refuses to accept a reasonable settlement offer made by its opponent. *Elite Show Servs., Inc. v Staffpro, Inc.* (2004) 119 CA4th 263, 268, 14 CR3d 184; *Burch v Children's Hosp. of Orange County Thrift Stores, Inc.* (2003) 109 CA4th 537, 135 CR2d 404. See *Hartline v Kaiser Found. Hosps.* (2005) 132 CA4th 458, 471, 33 CR3d 713.

General contract principles govern the offer and acceptance process under the statute, unless application of those principles would conflict with or defeat the purpose of the statute. *T.M. Cobb Co., Inc. v Superior Court* (1984) 36 C3d 273, 280, 204 CR 143; *Elite Show Servs., Inc. v Staffpro, Inc., supra*; *Bias v Wright* (2002) 103 CA4th 811, 817, 127 CR2d 137. See also *One Star, Inc. v Staar Surgical Co.* (2009) 179 CA4th 1082, 102 CR3d 195 (when defendant made and then withdrew second settlement offer after first had lapsed, first offer was valid for purposes of awarding costs). Any offer under CCP §998 must be made in good faith in order to be valid as a basis for an award of costs under the statute. *Jones v Dumrichob* (1998) 63 CA4th 1258, 74 CR2d 607. The offer will be strictly construed in favor of the party against whom it would operate under CCP §998. Including nonmonetary terms and conditions in a CCP §998 offer does not necessarily make the offer invalid, but a CCP §998 offer must be unconditional to be enforceable. *Elite Show Servs., Inc.,* 119 CA4th at 268.

Offers under CCP §998 have been the subject of much litigation, especially on the question whether an offeree who refused to accept a CCP §998 offer has obtained a "more favorable judgment." See CCP §998(c)-(d). For an extensive discussion of the specific procedures and requirements for offers under CCP §998 as well as leading case decisions, see California Civil Procedure Before Trial, chap 47 (4th ed Cal CEB 2004).

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6

Representations, Warranties, Covenants, Conditions, Indemnities

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§6.1 I. INTRODUCTION

Contracts often include representations, warranties, conditions, and indemnities, and always include covenants or promises. As discussed in this chapter, each is a different type of contractual provision with a different legal effect.

A representation is a statement regarding a fact or circumstance, usually made to induce reliance and the undertaking of an act by the other party, such as entering into or closing a business transaction. See, *e.g., Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (false certificate of conformance to FAA specifications given by defendant in connection with helicopter parts supply contract). A false representation will not be actionable unless it is material, *e.g.,* unless it would affect the "intrinsic merits" of a business transaction. *Service by Medallion v Clorox Co.* (1996) 44 CA4th 1807, 1818, 52 CR 2d 650. Representations must be distinguished from puffery, or expressions of opinion or feelings. See *Shafer v Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 75, 131 CR2d 777. Representations are discussed further in §§6.2-6.6.

A warranty is a promise or an affirmation that a fact or circumstance is true, and may be express or implied by statute or case law. In a sales contract, a warranty usually relates to the character of, quality of, or title to goods. *Windham at Carmel Mountain Ranch Ass'n v Superior Court* (2003) 109 CA4th 1162, 1168, 135 CR2d 834. Unlike a representation, which is typically an antecedent statement made as an inducement to the other party to enter into the contract, a warranty forms part of the contract itself. *Rutherford v Standard Eng'g Corp.* (1948) 88 CA2d 554, 565, 199 P2d 354. A warranty is part of the basis of the bargain between the parties (see Com C §2313) and is in the nature of a guaranty. See *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 406, 7 CR3d 546. Warranties are discussed in §§6.7-6.31.

A covenant is a promise or agreement made by the promisor to the promisee to act or refrain from acting in a specified way, which the promisee understands as a commitment. See Restatement (Second) of Contracts §2 (1981). The terms "covenant" and "promise" are generally used synonymously. See, *e.g*., *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 373, 6 CR2d 467. Covenants are usually express, but may also be implied in certain limited circumstances. See *Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 804, 48 CR2d 747; §6.33. There is an implied covenant of good faith and fair dealing in every California contract. *Andrews v Mobil Aire Estates* (2005) 125 CA4th 578, 589, 22 CR3d 832. See §6.33-6.36.

A condition is an act or event that must occur (unless its nonoccurrence is excused) before performance under a contract will be due. Restatement (Second) of Contracts §224 (1981). See also *Marriage of Hasso* (1991) 229 CA3d 1174, 280 CR 919. Civil Code §1434 defines a conditional obligation as one "when the rights or duties of any party thereto depend upon the occurrence of an uncertain event." See, *e.g., Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 24 CR2d 597 (timely notice of demand to arbitrate was condition precedent to duty to arbitrate and could be waived by lack of timely satisfaction). Conditions are distinguishable from covenants in that nonoccurrence of the condition will excuse performance of a conditional obligation, while breach of a covenant will give rise to a right of action for damages, but will not necessarily extinguish the obligation of performance. *In re Spirtos* (BAP 9th Cir 1993) 154 BR 550, 555, aff'd (9th Cir 2000) 232 F3d 896. Conditions are discussed more fully in §§6.38-6.50.

An indemnity is an obligation of one party to pay or otherwise make good a loss or damage incurred by another party. An indemnity obligation may be express or implied, and is not limited to reimbursement of third party claims. *PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 84 CR2d 455; *Dream Theater, Inc. v Dream Theater* (2004) 124 CA4th 547, 21 CR3d 322. Indemnities are discussed further in §§6.48-6.55.

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II. REPRESENTATIONS AND WARRANTIES

A. Representations

§6.2 1. Generally

A representation is a statement about existing facts that is intended to induce reliance and action by a party, such as entering into a contract. See, *e.g., Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (false certificate of conformance to FAA specifications given by defendant in connection with helicopter parts supply contract); *Sandercock v Minnis* (1956) 138 CA2d 883, 292 P2d 618 (representations regarding capacity of ranch to support livestock).

Representations are usually intended to give a party some reassurance or comfort that certain facts are true, and operate to shift the risk that a stated fact is untrue to the party making the representation. Express representations in written contracts typically include the statements concerning the authority of the entities to enter into the contract, the accuracy of financial statements, and the existence of adverse claims, breached or defaulted contracts, liens, encumbrances, and legal actions. See generally Model Asset Purchase Agreement with Commentary 69 (ABA 2001).

In general, except in special contexts such as fiduciary relationships or securities offerings where a party may owe independent statutory duties to third party investors, a party has no obligation to look behind representations in a contract. A party to whom a representation has been made has no duty to employ any means of knowledge open to that party that could reveal the falsity of the representation. *Linden Partners v Wilshire Linden Assocs.* (1998) 62 CA4th 508, 73 CR2d 708 (noting that this rule can lead to harsh results and must be applied carefully). If, however, a party becomes aware of facts that would make a reasonably prudent person suspicious, the party does have a duty to investigate further, and will be chargeable with knowledge of matters that would have been revealed by such an investigation. *Miller v Bechtel Corp.* (1983) 33 C3d 868, 875, 191 CR 619.

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§6.3 2. Actionable Misrepresentations

Depending on the circumstances, a misrepresentation that is fraudulent may support both a contract action for damages or rescission and a tort action for damages, although double recovery for the same items of damage is not allowed. The elements of the intentional tort of fraud are (1) a misrepresentation (false representation, concealment, or nondisclosure), (2) knowledge of falsity (or scienter), (3) intent to induce reliance, (4) justifiable reliance, and (5) resulting damage. *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (economic loss rule does not limit recovery for fraudulent misrepresentation to contract damages when tort of fraud is shown independent of action on contract); *Small v Fritz Cos.* (2003) 30 C4th 167, 173, 132 CR2d 490 (allowing action for fraud and negligent misrepresentation by shareholder induced not to sell stock based on company's false financial report); *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 294, 37 CR3d 364. A misrepresentation made negligently may also be actionable in both contract and tort. See *Quality Wash Group V, Ltd. v Hallak* (1996) 50 CA4th 1687, 1696, 58 CR2d 592 (when party makes false statement honestly, believing it to be true, he may be liable for negligent misrepresentation, a form of deceit); *Continental Airlines, Inc. v McDonnell Douglas Corp.* (1989) 216 CA3d 388, 404, 264 CR 779 (negligent misrepresentation as form of fraud).

Representations that later prove false and that may support an action for damages or rescission are not limited to express representations in a written contract; they include representations made outside the four corners of the document. See, *e.g., Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739 (misrepresentations regarding content of document to be signed); *Ron Greenspan Volkswagen, Inc. v Ford Motor Land Dev. Corp.* (1995) 32 CA4th 985, 38 CR2d 783 (contract provision stating that all representations are contained therein does not prevent action for fraud). Evidence of such a misrepresentation is not barred by the parol evidence rule even if a merger clause stating that the contract is fully integrated is present. But this should not be taken to mean that to cry "fraud" will always create an exception to the parol evidence rule. Although extrinsic evidence will be allowed in the face of an integrated agreement to show that the contract was *induced* by fraud or mistake, it will not be admitted to contradict the express terms of the contract. *Pacific State Bank,* 110 CA4th at 389.

Unless otherwise stated, a written representation usually speaks as of the date of execution of the document in which it is contained. A cause of action may therefore arise as of that time, and this may occur before closing of the transaction that is the subject of the contract. Preclosing representations generally merge with the deed or other transfer document at closing by operation of law unless the contract specifies that they survive the closing. A survival clause specifying the time limit on survival may reduce the statutory statute of limitations, but it will be construed strictly against the party seeking to enforce it. *Herring v Teradyne, Inc.* (9th Cir 2007) 242 Fed Appx 469 (unpublished opinion) (survival clause lacked "clear and unequivocal language" necessary to demonstrate parties' desire to reduce statute of limitations from 4 years to 1 year).

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§6.4 3. Financial Statements

Representations concerning a company's financial condition or its financial statements have been at issue in many disputes alleging fraud or misrepresentation, particularly in securities litigation. "Based on generally accepted accounting principles (GAAP), the financial statements are implied or expressed representations by management." *Amdahl Corp. v County of Santa Clara* (2004) 116 CA4th 604, 616, 10 CR3d 486, citing State Bd of Equalization, Assessors' Handbook, Assessment of Personal Property and Fixtures §504 (2000). See, *e.g., Small v Fritz Cos.* (2003) 30 C4th 167, 173, 132 CR2d 490 (action for fraud and negligent misrepresentation based on company's false quarterly financial report); *Murphy v BDO Seidman* (2003) 113 CA4th 687, 6 CR3d 770 (false financial statements issued in connection with merger).

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§6.5 4. Insurance Contracts

Contracts of insurance provide a fertile ground for misrepresentation litigation. An insurance company has the right to select persons that it will insure and to rely on them to disclose information relevant to the underwriting determination. *Mitchell v United Nat'l Ins. Co.* (2005) 127 CA4th 457, 469, 25 CR3d 627. The California Insurance Code imposes "heavy burdens of disclosure" on both parties to an insurance contract, and any material misrepresentation or failure to provide requested information (whether intentional or unintentional) allows the injured party to rescind the policy. 127 CA4th at 468; *Imperial Cas. & Indem. Co. v Sogomonian* (1988) 198 CA3d 169, 179, 243 CR 639. For example, Ins C §332 requires each party to an insurance contract to "communicate to the other, in good faith, all facts within his knowledge which are or which he believes to be material to the contract… and which the other has not the means of ascertaining." These disclosure obligations are specifically directed to the formation of the insurance contract. *Mitchell,* 127 CA4th at 468.

Materiality is determined under the Insurance Code by "the probable and reasonable influence of the facts upon the party to whom the communication is due." Ins C §334. "The test for materiality is whether the information would have caused the underwriter to reject the application, charge a higher premium, or amend the policy terms, had the underwriter known the true facts." This test is subjective and focuses on the particular insurer, rather than an "average reasonable insurer." *Mitchell,* 127 CA4th at 474. An insurer may rescind the policy if the insured made a materially false representation at the time of, or before, issuance of the policy. Ins C §359. See also *TIG Ins. Co. v Homestore, Inc.* (2006) 137 CA4th 749, 755, 40 CR3d 528. Similarly, if an insured conceals material facts, the insurer may rescind the policy, even if the act of concealment was unintentional. Ins C §331. See Ins C §330. Insurance Code §332 requires each party to an insurance contract to communicate to the other in good faith all facts within his or her knowledge that are or are believed to be material and that the other party would be unable to discover. Thus, for example, if an applicant for life insurance misrepresents his or her history as a smoker in order to obtain a nonsmoking rate, the insurer may rescind the policy. *O'Riordan v Federal Kemper Life Assur.* (2005) 36 C4th 281, 286, 30 CR3d 507. See also *Lunardi v Great-West Life Assur. Co.* (1995) 37 CA4th 807, 44 CR 2d 56 (insurance application conditioned policy effectiveness on insured's continuing good health; insured had duty to inform insurer of leukemia diagnosis received after application submitted but before policy was issued).

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§6.6 5. Statements of Opinion Distinguished

Certain statements, such as statements concerning price or value, are considered statements of opinion or hyperbole —a reflection of the speaker's state of mind—and not statements of fact. As such, they are not actionable if incorrect. *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 37 CR3d 364 (action for fraud must be based on statement of fact, not opinion; statements concerning future actions by some third party are deemed nonactionable opinions). Whether a statement should be characterized as either fact or opinion depends on whether it is reasonably apparent that the person to whom the statement is made would regard the statement as a statement of fact or merely as an expression of the state of mind of the speaker. The outcome depends on the surrounding circumstances, including the parties' relationship, their sophistication, how plausible the statement is on its face, the phrasing of the statement, other communications of the parties, and trade or community practices. *Shafer v Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 75, 131 CR2d 777. See also *Keith v Buchanan* (1985) 173 CA3d 13, 21, 220 CR 392.

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B. Contractual Warranties

§6.7 1. Generally

Although often associated with contracts for the sale of goods, warranties are also found in other types of contracts, including contracts for services. *Gagne v Bertran* (1954) 43 C2d 481, 486, 275 P2d 15. A contractual warranty is a promise or commitment that certain facts relating to the title, character, quality, identity, or condition of the property or services that are the subject of the transaction are or will be correct. "The purpose of the law of warranty is to determine what it is that the seller has in essence agreed to sell." *Keith v Buchanan* (1985) 173 CA3d 13, 20, 220 CR 392. See also *Weinstat v Dentsply Int'l, Inc.* (2010) 180 CA4th 1213, 1228, 103 CR3d 614; *Windham at Carmel Mountain Ranch Ass'n v Superior Court* (2003) 109 CA4th 1162, 1168, 135 CR2d 834.

> Warranties serve to allocate the risk of loss in a transaction arising from the existence or non-existence of a fact. They are intended to place the risk of loss on one of the parties, to mirror the anticipated defects and risks that are already reflected in the price being paid for the goods or services sold.

Weise, *Bringing Further Clarity to Agreements: The Use of Warranties, Guaranties, and Indemnities*, 9 CEB Cal Bus L Prac 73, 76 (Spring 1994).

Warranties differ from representations in that warranties form part of the basis of the bargain—part of the contract itself—and create a contractual obligation on the part of the warrantor to ensure that the matters warranted are true. See *Corporation of Presiding Bishop of Church of Jesus Christ of Latter Day Saints v Cavanaugh* (1963) 217 CA2d 492, 504, 32 CR 144. Representations, however, are generally not construed as guaranties but rather as preliminary statements intended to induce the other party to enter into the transaction. An action for misrepresentation normally requires proof of scienter or at least negligence by the person making the representation and justifiable reliance by the person to whom the representation is made. See §6.3. A cause of action for breach of warranty, however, may arise even if the person who made the warranty did so in good faith. See generally Drafting Business Contracts: Principles, Techniques & Forms, chap 7 (Cal CEB 1994). The following contractual provision at issue in *Quality Wash Group V, Ltd. v Hallak* (1996) 50 CA4th 1687, 1693, 58 CR2d 592, draws a distinction between the representation concerning title to assets and the seller's warranty that the representation is true:

> **Seller makes the following representations regarding the assets:**
>
> **a. The title to all assets of the business [is] vested in the corporation … and [is] free from any liens and/or encumbrances.… Seller and corporation warrant that all the above representations are true and hereby [hold] buyer harmless from any damage resulting from their falsity. This warranty shall be true as of the close and shall survive the close.**

Contractual warranties may be express or implied. Implied warranties may be created by statute or case law. *Windham at Carmel Mountain Ranch Ass'n v Superior Court* (2003) 109 CA4th 1162, 135 CR2d 834. A statement made in an advertisement that a buyer read and relied on before purchasing a product or service may constitute an express warranty, although not contained in the sales contract itself. *Carrau v Marvin Lumber & Cedar Co.* (2001) 93 CA4th 281, 290, 112 CR2d 869.

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§6.8 2. Implied Warranties in Residential Real Estate Leases and New Construction

There is a warranty of habitability implied by law in all residential real property leases in California. *Green v Superior Court* (1974) 10 C3d 616, 637, 111 CR 704; *Fairchild v Park* (2001) 90 CA4th 919, 924, 109 CR2d 442. The warranty is codified in CC §§1941-1941.1. Under this warranty, a residential landlord promises that the leased premises will be maintained in a habitable state for the term of the lease. The warranty does not require a landlord to ensure that the premises will be in perfect condition, but it does mean that minimum living standards must be maintained. In most situations, substantial compliance with building and housing code standards that materially affect health and safety will be sufficient to meet the landlord's obligations. *Green,* 10 C3d at 637. Civil Code §1941.1 includes a list of minimum requirements for habitability. An action based on the implied warranty of habitability is an action on the contract authorizing recovery of attorney fees if the contract includes an attorney fee clause. *Fairchild v Park* (2001) 90 CA4th 919, 925, 109 CR2d 442. See also CCP §1174.2; *Espinoza v Calva* (2008) 169 CA4th 1393, 87 CR3d 492. Breach of the implied warranty of habitability may be asserted as a defense to an unlawful detainer action. *Green v Superior Court* (1974) 10 C3d 616, 619, 111 CR 704. See, *e.g., Hyatt v Tedesco* (2002) 96 CA4th Supp 62, 117 CR2d 921. See generally California Landlord-Tenant Practice, chap 3 (2d ed Cal CEB 1997).

In 1974, the California Supreme Court recognized an implied warranty in new construction to protect property owners against construction defects. See *Pollard v Saxe & Yolles Dev. Co.* (1974) 12 C3d 374, 379, 115 CR 648. The court in *Pollard* found that builders or sellers of new real estate construction (like manufacturers of goods) make implied representations that they have used reasonable skill and judgment in constructing the building. Accordingly, they are held to what they have impliedly represented, *i.e.,* that the completed structure has been designed and constructed in a reasonable, workmanlike manner. 12 C3d at 379.

Civil Code §§895-945.5 ("Requirements for Actions for Construction Defects") applies to construction defects in new residential units when the purchase agreement with the buyer was signed by the seller on or after January 1, 2003. CC §938. These statutes establish minimum standards for construction of individual dwelling units (see CC §896) and require builders to provide homeowners with a minimum 1-year express warranty covering the fit and finish of certain building components (CC §900). A builder may offer enhanced warranty protection, but may not limit application of the minimum standards set forth in CC §896 or lower its protection by contract with the homeowner. CC §901. A homeowner may sue for (1) specific violations of the statutory standards in CC §896, and (2) any other "function or component of [the] structure," to the extent not addressed by these standards, that causes damage. CC §897; *Lantzy v Centex Homes* (2003) 31 C4th 363, 2 CR3d 655 (also discussing statutes of limitations for construction defect claims and application of doctrine of equitable tolling).

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§6.9 3. Disclaimer of Warranties

Contracts may include express provisions intended to disclaim all express or implied warranties except as specifically provided in the agreement, *e.g.,* "There are no warranties that extend beyond the description on the face of this agreement." See Drafting Business Contracts: Principles, Techniques & Forms §7.10 (Cal CEB 1994). As a general rule, disclaimers of statutorily implied warranties are ineffective unless expressly permitted by the statute and made in accordance with any statutory requirements. See the discussion of UCC warranty disclaimers in §6.17 and of waivers of consumer warranties under the Song-Beverly Consumer Warranty Act in §6.24.

The phrase "as is" is often used to characterize a sale of property as a sale of the property in its then-existing condition. In general, use of the phrase "as is" relieves a seller of real estate that is not newly constructed (see §6.9) from liability for existing defects. *Shapiro v Hu* (1986) 188 CA3d 324, 333, 233 CR 470. "[T]he buyer takes the property in the condition visible to or observable by him." *Wilson v Century 21 Great W. Realty* (1993) 15 CA4th 298, 304, 18 CR2d 779. See also *Hinesley v Oakshade Town Ctr.* (2005) 135 CA4th 289, 37 CR3d 364. Nonetheless, "as is" language will not shield a seller from liability for affirmative or negative fraud. If a seller affirmatively misrepresents the condition of the property or intentionally conceals material defects in the property that are not otherwise visible or observable by the buyer and that affect the value or desirability of the property, the seller cannot escape liability through an "as is" provision. *Wilson v Century 21 Great W. Realty, supra*. Similarly, "as is" or other warranty disclaimer language will not protect a seller against other potential tort or statutory liability, such as negligence, strict products liability, or environmental law contribution claims. See Weise, *Bringing Further Clarity to Agreements: The Use of Warranties, Guaranties, and Indemnities*, 9 CEB Cal Bus L Prac 73, 76 (Spring 1994).

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§6.10 4. Survival of Warranties

A breach of warranty claim based on a warranty that is untrue as of the closing of a transaction normally accrues at the time of closing. See Weise, *Bringing Further Clarity to Agreements: The Use of Warranties, Guaranties, and Indemnities*, 9 CEB Cal Bus L Prac 73 (1994). If, however, a seller has expressly agreed to warrant its product or service for a specified period of time into the future, a cause of action for breach will accrue on discovery of the breach. Such a warranty is referred to as a warranty of future performance. See *Mills v Forestex Co.* (2003) 108 CA4th 625, 642, 134 CR2d 273.

In general, contracting parties may modify the length of the California statute of limitations otherwise applicable to a transaction, whether the contract lengthens or shortens the limitations period, although a provision shortening the applicable statute will be strictly construed against the party invoking it. *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 1547, 46 CR2d 33; §9.5. See also *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947 (ambiguous survival clause specified only when breach of representations and warranties might occur, not when action must be filed); *ABF Capital Corp. v Berglass* (2005) 130 CA4th 825, 836, 30 CR3d 588. Sales contracts governed by the Commercial Code, however, cannot extend the statute of limitations beyond the statutory 4-year period, and cannot shorten the statute of limitations to a period that is less than 1 year. Com C §2725(1). Unless Com C §2725(1) or another statutory restriction applies, if a seller expressly warrants a product for a specified period of time, by that fact the seller is explicitly warranting the future performance of the product for that period, and the regular statute of limitations is not applicable. Express warranties that do not specify any survival period extend until, but not beyond, the applicable statute of limitations. *Carrau v Marvin Lumber & Cedar Co.* (2001) 93 CA4th 281, 290, 112 CR2d 869.

In analyzing questions relating to survival of warranties, it is important to distinguish contract provisions that operate as contractual statutes of limitations, within which any action for breach must be commenced, from contract provisions that set forth a period of time within which a breach can occur, which in turn triggers the running of the applicable statutory limitations period for an action for breach of warranty. See, *e.g., Herring v Teradyne, Inc.* (SD Cal 2002) 256 F Supp 2d 1118, rev'd on other grounds (9th Cir 2007) 242 Fed Appx 469 (holding that 1-year survival clause operated as contractual statute of limitations).

Representations and warranties in business merger or acquisition agreements that are executed in advance of a closing date normally operate differently than warranties in contracts for the sale of products or services that are entered into concurrently with the sales transaction. If a business merger or acquisition agreement does not provide that representations and warranties survive the closing, they normally merge with the deed or other transfer documents executed and delivered at closing and are extinguished on the closing date. Thereafter, they cannot give rise to any claim of liability. 256 F Supp 2d at 1137. If such an agreement provides that representations and warranties do survive the closing (or if the representations and warranties are incorporated in the deed or other transfer documents executed at closing) but without setting forth a time period, they will survive until the applicable statute of limitations. But if the survival clause specifies a fixed period of time for survival, a party generally can not bring an action for breach of warranty once that time period has elapsed. *Herring v Teradyne, Inc., supra*.

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§6.11 5. Common Law Requirement for Privity of Contract

Unless a statutory or judicially developed exception exists, privity of contract between a plaintiff seeking to enforce a warranty and the defendant is required in any action for breach of an express or implied warranty, and privity of contract does not exist between an original seller and a subsequent purchaser who was not a party to the original sale. *Burr v Sherwin Williams Co.* (1954) 42 C2d 682, 695, 268 P2d 1041; *Windham at Carmel Mountain Ranch Ass'n v Superior Court* (2003) 109 CA4th 1162, 1169, 135 CR2d 834. If the plaintiff's complaint for breach of an express or implied warranty does not disclose the existence of privity of contract, the court will sustain a demurrer. *Anthony v Kelsey-Hayes Co.* (1972) 25 CA3d 442, 448, 102 CR 113.

Exceptions to the common law requirement of privity have been established in cases involving foodstuffs, drugs, and pesticides and for employees injured while using dangerous products purchased by their employers. See *Windham at Carmel Mountain Ranch Ass'n v Superior Court, supra,* and cases cited therein. Further, privity is not a requirement in actions for breach of an express UCC warranty. *Hauter v Zogarts* (1975) 14 C3d 104, 115, 120 CR 681. See §6.18. Moreover, as noted in §6.12, the tort law doctrine of strict liability for defective products has eliminated the need to establish privity in personal injury cases.

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§6.12 C. Commercial Code Warranties

In the context of a sale of goods governed by Division 2 of the Commercial Code, a warranty is a contract provision that relates to the character, identity, quality, condition, or title to the goods. The Commercial Code recognizes three types of warranty: (1) express, (2) implied, and (3) statutory. See generally California UCC Sales and Leases §3.2 (Cal CEB 2002). Express warranties are created by the seller's words or conduct and become part of the basis of the bargain. It is not necessary for a plaintiff-buyer to prove reliance on the seller's words. See *Hauter v Zogarts* (1975) 14 C3d 104, 115, 120 CR 681. The Commercial Code addresses express warranties in Com C §2313, which is discussed in §6.13. An implied warranty is one created by operation of law on the assumption that it is so essential to the bargain of the parties that it is implicit in their transaction. See Official Comment 11 to former UCC §2-314 (Official Comment 13 to UCC §2-314 (2003)). A statutory warranty is a special category under the Commercial Code used to describe the warranties of title and against infringement found in Com C §2312, discussed in §6.16. These warranties are not referred to as "implied" warranties so that they will be protected against broad disclaimers of "all implied warranties." See Official Comment 6 to UCC §2-312.

Actions for breach of Commercial Code warranties involving personal injury have been largely superseded by the tort law doctrine of strict liability for defective products, which does not depend on privity of contract. See generally California Tort Guide §§11.62-11.72 (4th ed Cal CEB 2009). Of course, if a buyer is damaged economically by a product but suffers no personal injury or property damage, tort law does not provide an avenue for relief and the buyer must seek to recover under a breach of warranty theory. Privity of contract between buyer and seller is required for actions based on breach of an implied UCC warranty, although not for actions based on an express UCC warranty. *Hauter v Zogarts* (1975) 14 C3d 104, 115, 120 CR 681; *Mills v Forestex Co.* (2003) 108 CA4th 625, 636, 134 CR2d 273. See §6.18.

NOTE: California courts have affirmed that a blood transfusion is a service, not a sale, and therefore the UCC warranties implied in sales transactions (as well as the tort doctrine of strict products liability) are inapplicable to the provision of blood. See, *e.g., Hyland Therapeutics v Superior Court* (1985) 175 CA3d 509, 220 CR 590; *Shepard v Alexian Bros. Hosp., Inc.* (1973) 33 CA3d 606, 109 CR 132. See also Health & S C §1606; *Cryolife, Inc. v Superior Court* (2003) 110 CA4th 1145, 1152, 2 CR3d 396 (tissue bank provides service, not product)

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§6.13 1. Express Warranties by Affirmation, Promise, Description, or Sample (Com C §2313)

Under Com C §2313(1), a seller may create an express warranty regarding goods sold in one of three ways:

- "Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise." Com C §2313(1)(a).
- "Any description of the goods which is made part of the basis of the bargain creates an express warranty that the goods shall conform to the description." Com C §2313(1)(b).
- "Any sample or model which is made part of the basis of the bargain creates an express warranty that the whole of the goods shall conform to the sample or model." Com C §2313(c).

Sellers can create express warranties though their words or conduct, and need not have a specific intention to make a warranty. Formal language such as "warrant" or "guarantee" is not required. Com C §2313(2). In general, statements concerning the value of the goods sold and statements of the seller's opinion or recommendation (mere "puffing" or sales talk) do not create a warranty. Com C §2313(2). Determining what is and is not a statement of opinion is a question of fact, dependent on the surrounding circumstances when the statement was made. *Keith v Buchanan* (1985) 173 CA3d 13, 220 CR 392. See also *Weinstat v Dentsply Int'l, Inc.* (2010) 180 CA4th 1213, 1234, 103 CR3d 614. Courts construe unqualified statements liberally in favor of injured consumers, however, thus narrowing the defense that a statement is merely an opinion. *Hauter v Zogarts* (1975) 14 C3d 104, 112, 120 CR 681.

The requirement that the statement or act at issue be "part of the basis of the bargain" is not onerous. All of the seller's statements become part of the basis of the bargain, unless good reason is shown to the contrary. Official Comment 8 to former UCC §2-313 (Official Comment 10 to UCC §2-313 (2003)). See also *Weinstat v Dentsply Int'l, Inc.* (2010) 180 CA4th 1213, 1234, 103 CR3d 614. In effect, there is a presumption that the seller's statements or actions are part of the basis of the bargain and were relied on by the buyer as an inducement to enter into the contract. The burden is on the seller to prove otherwise. *Keith v Buchanan* (1985) 173 CA3d 13, 23, 220 CR 392; Official Comment 8 to former UCC §2-313 (Official Comment 10 to UCC §2-313 (2003)). See also *Hauter,* 14 C3d at 115 (buyer's reliance need not be shown). But see *Brown v Superior Court* (1988) 44 C3d 1049, 1071, 245 CR 412 (in dicta, reliance "may" still be required element of proof).

NOTE: In addition to Com C §2313, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), discussed in §6.24, applies to written warranties given in transactions in which consumer goods are used or bought for use primarily for personal, family, or household purposes. In the event of a conflict between the Consumer Warranty Act and the Commercial Code, the rights guaranteed to buyers of consumer goods under the Consumer Warranty Act prevail. CC §1790.3; *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 7 CR3d 546.

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§6.14 2. Implied Warranty of Merchantability (Com C §2314)

Unless excluded or modified in accordance with Com C §2316, if a seller is a merchant with respect to goods of the kind at issue, a warranty that the goods shall be merchantable is implied in a contract for their sale. Com C §2314(1). Because the warranty of merchantability is implied by operation of law, a seller's liability under the warranty does not depend on any specific conduct or promise on the seller's part, but instead on whether the seller's product is "merchantable" under the Commercial Code. *Hauter v Zogarts* (1975) 14 C3d 104, 117, 120 CR 681. "Merchantable" is defined to mean that the goods, at a minimum (Com C §2314(2)):

- Pass without objection in the trade under the contract description;
- In the case of fungible goods, are of fair average quality within the description;
- Are fit for the ordinary purposes for which the goods are used;
- Run, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved;
- Are adequately contained, packaged, and labeled as the agreement may require; and
- Conform to the promises or affirmations of fact made on the container or label, if any.

Other implied warranties may arise from the parties' course of dealing or usage of trade. Com C §2314(3). Merchantability does not require that the goods precisely fulfill the expectations of the buyer; it merely imposes a minimum level of quality. *American Suzuki Motor Corp. v Superior Court* (1995) 37 CA4th 1291, 1296, 44 CR2d 526. The implied warranty of merchantability is breached when the goods do not conform to the promises or affirmations contained on the container or label or are not fit for the ordinary purposes for which the goods are used. *Martinez v Metabolife Int'l, Inc.* (2003) 113 CA4th 181, 189, 6 CR3d 494.

NOTE: The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), discussed in §6.24, incorporates the provisions of Com C §§2314-2315 (discussed in §6.15) in sales of consumer products. It supplements the Commercial Code by broadening a consumer's remedies to include costs, attorney fees, and civil penalties. *American Suzuki Motor Corp.,* 37 CA4th at 1295. See also *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 7 CR3d 546.

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§6.15 3. Implied Warranty of Fitness for Particular Purpose (Com C §2315)

Unless disclaimed or modified in accordance with Com C §2316, when a seller of goods has reason to know at the time of contracting that the goods are required for a particular purpose and the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is an implied warranty in every contract that the goods will be fit for that purpose. Com C §2315. A "particular purpose" differs from an ordinary purpose in that it envisions a specific use by the buyer that is peculiar to the nature of the buyer's business, while the ordinary purposes for which goods are used are those envisioned by the concept of merchantability and go to uses that are customarily made of the goods at issue. *Mills v Forestex Co.* (2003) 108 CA4th 625, 636, 134 CR2d 273. See §6.14. A claim for breach of the implied warranty of fitness is based on the nature and effect of the product itself, not on injuries attributable to the seller's statements or marketing efforts. The warranty is breached if the goods are not reasonably fit for the intended purpose and result in injury or other damage. *Martinez v Metabolife Int'l, Inc.* (2003) 113 CA4th 181, 189, 6 CR3d 494. See also *Brown v Superior Court* (1988) 44 C3d 1049, 1071, 245 CR 412.

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§6.16 4. Warranty of Title; Warranty Against Infringement (Com C §2312)

Unless excluded or modified in accordance with Com C §2312(2), there is a warranty by the seller in every contract for the sale of goods that (Com C §2312(1)(a)-(b)):

- The title conveyed shall be good, and its transfer rightful; and
- The goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge.

The warranty of title can be excluded or modified only by specific language or by circumstances that give the buyer reason to know that the person selling does not claim title or that he or she is purporting to sell only such title or right as he or she (or a third person) may have. Com C §2313(2). Unless otherwise agreed, if the seller is a merchant who regularly deals in goods of the kind at issue, the seller warrants that the goods will be delivered free of the rightful claim of any third person of infringement or the like, but a buyer who gives specifications to the seller must hold the seller harmless against any such claim that arises from the seller's compliance with the specifications. Com C §2312(3). A "rightful claim" under §2312(3) is a nonfrivolous claim of infringement that significantly and adversely affects the buyer's ability to make use of the goods purchased; the likelihood of success in litigation is not relevant to whether a claim is "rightful." *Pacific Sunwear of Cal., Inc. v Olaes Enterpr., Inc.* (2008) 167 CA4th 466, 482, 84 CR3d 182 (finding triable issue of fact regarding whether third party infringement claim based on similar T-shirt designs was rightful).

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§6.17 5. Exclusion or Modification of Commercial Code Warranties (Com C §2316)

A disclaimer or modification of a Commercial Code warranty must meet the requirements of Com C §2316 to be effective. Words or conduct that tend to limit or negate a warranty are to be construed (if reasonable) as consistent with any words or conduct relevant to the creation of an express warranty—but, subject to the parol evidence rule, any purported limitation or negation is inoperative to the extent that such construction is unreasonable. Com C §2316(1). Any disclaimer or modification of warranty will be strictly construed against the seller. *Hauter v Zogarts* (1975) 14 C3d 104, 120 CR 681.

Subject to Com C §2316(3), any disclaimer or modification of all or any part of the implied warranty of merchantability must mention merchantability, and must, if written, be conspicuous. Com C §2316(2). Similarly, any disclaimer or modification of the implied warranty of fitness must be in writing and be conspicuous. Com C §2316(2). Under Com C §1201(10), a contract term is "conspicuous" if it is written so that "a reasonable person against whom it is to operate ought to have noticed it." A heading that is printed in capitals qualifies as conspicuous. Language in a form is conspicuous if it is in a larger or contrasting typeface or is in color. Com C §1201(10). See, *e.g., Siemens Credit Corp. v Newlands* (ND Cal 1994) 905 F Supp 757; *A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114; *Dorman v International Harvester Co.* (1975) 46 CA3d 11, 120 CR 516. As the California Supreme Court in *Hauter v Zogarts* (1975) 14 C3d 104, 119, 120 CR 681, explained (citations omitted):

> [S]ection [2316] is designed principally to deal with those frequent clauses in sales contracts which seek to exclude "all warranties, express or implied." It seeks to protect a buyer from unexpected and unbargained language of disclaimer by denying effect to such language when inconsistent with language of express warranty and permitting the exclusion of implied warranties only by conspicuous language or other circumstances which protect the buyer from surprise.

See also Official Comment 1 to UCC §2-316.

Unless the circumstances indicate otherwise, the seller may exclude all implied warranties by using expressions such as "as is," "with all faults," or words to similar effect that call the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty. Com C §2316(3)(a). In ordinary commercial usage, such terms are understood to mean that the buyer assumes the entire risk with respect to the quality of the goods involved. Official Comment 7 to former UCC §2-316 (Official Comment 5 to UCC §2-314 (2003)). However, "as is" language will not shield a seller from liability for affirmative or negative fraud. See *Wilson v Century 21 Great W. Realty* (1993) 15 CA4th 298, 18 CR2d 779 (real estate sales contract).

If, before entering into the contract, a buyer has examined the goods or a sample or model as fully as desired, or has been given an opportunity to do so but has declined, there is no implied warranty with respect to defects that should have been disclosed by such an examination. Com C §2316(3)(b). Merely accepting defective goods with knowledge of their defects, however, does not cut off a buyer's right of action for breach of an express warranty. *Southern Pac. Co. v Unarco Indus.* (1974) 42 CA3d 142, 150, 116 CR 847.

Implied warranties can also be excluded or modified by course of dealing, course of performance, or usage of trade. Com C §2316(3)(c).

Remedies for breach of warranty can be limited in accordance with Com C §§2718-2719, discussed in §§12.91-12.96. Com C §2316(4).

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§6.18 6. Privity of Contract

Express warranties. Although there is language to the contrary in some court of appeal cases (see, *e.g., Arnold v Dow Chem. Co.* (2001) 91 CA4th 698, 739, 110 CR2d 722; *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 369, 62 CR2d 701), the California Supreme Court has stated on at least two occasions that privity of contract is not required for an action based on an express warranty. *Hauter v Zogarts* (1975) 14 C3d 104, 115 n8, 120 CR 681; *Seely v White Motor Co.* (1965) 63 C2d 9, 14, 45 CR 17. See also *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 143, 87 CR3d 5.

Implied warranties. Privity of contract is a requirement for actions based on the implied warranties of merchantability or fitness for a particular purpose. *Hauter,* 14 C3d at 115 n8; *All W. Electronics, Inc. v M-B-W, Inc.* (1998) 64 CA4th 717, 75 CR2d 509. In general, there is no privity between the original manufacturer or seller and a subsequent purchaser who is not a party to the original sales contract. *Arnold,* 91 CA4th at 739. Exceptions to the privity requirement have been recognized (1) when there is a familial relationship between the purchaser and the plaintiff (*Hauter v Zogarts* (1975) 14 C3d 104, 115, 120 CR 681); (2) when the plaintiff's decision to purchase the product was made in reliance on the manufacturers' written representations in labels or advertising materials (*Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 369, 62 CR2d 701); (3) in cases involving food or drugs intended for human consumption (*Arnold,* 91 CA4th at 720); (4) in cases when an inherently dangerous instrumentality causes harm to a purchaser's employee (*Arnold,* 91 CA4th at 740); and (5) in "direct dealings" cases, *e.g.,* when a successor manufacturer or supplier adopts and benefits from the initial party's contract negotiations and participates in numerous direct dealings (*Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 143, 87 CR3d 5; *U.S. Roofing, Inc. v Credit Alliance Corp.* (1991) 228 CA3d 1431, 279 CR 533).

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§6.19 7. Conflict of Warranties (Com C §2317)

Commercial Code §2317 provides that both express and implied warranties are to be construed as consistent with each other and as cumulative, but, if that construction is unreasonable, the intention of the parties will determine which warranty controls. The following rules apply in ascertaining the parties' intent (Com C §2317(a)-(c)):

- Exact or technical specifications displace an inconsistent sample or model or general language of description.
- A sample from an existing bulk displaces inconsistent general language of description.
- Express warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose.

See *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 409, 7 CR3d 546 (applying Com C §2713 to construe implied warranty of merchantability under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) and the implied warranty of merchantability under the Commercial Code).

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8. Leases of Goods

§6.20 a. Generally

In a transaction involving a financing lease, there are typically three parties: a supplier-seller, a lessor-buyer, and a lessee. The lessor is a party to the transaction merely to provide financing, and although it takes title to the goods, it usually does not ever take possession. Typically, there are representations, and warranties in the supplier's contract with the lessor that in an ordinary two-party sales transaction would run in favor of the end user, here the lessee. The Commercial Code recognizes the third party beneficiary nature of the sales contract and extends all the covenants, representations, and warranties of the seller to the lessee as a matter of law. Com C §10209(a). This extension of benefits does not impose any duty on the lessee (Com C §10209(b)); the lessee retains all its rights against the lessor, and there is no novation by operation of law (Com C §10209(a)).

In the case of a true, rather than a financing, lease (see Com C §10103(a)(7)), there is an implied warranty of merchantability (see Com C §10212) and an implied warranty of fitness (see Com C §10213), each defined by the same standards applicable in sales transactions. The same rules relating to conflict of warranties applicable in sales transactions (see §6.19) apply in lease transactions. Com C §10215.

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§6.21 b. Implied Warranties Against Interference and Infringement (Com C §10211)

Leases of goods also contain an implied warranty that, for the term of the lease, no person has a claim to or interest in the leased property arising from an act or omission of the lessor (other than a claim for infringement or the like) that would interfere with the lessee's enjoyment of its leasehold interest in the property. Com C §10211(a). In nonfinancing leases, if the lessor is a merchant regularly dealing in goods of the type leased, there is a warranty that the goods are being delivered free of the rightful claim of any person for infringement or the like. Com C §10211(b). Lessees that furnish specification to a lessor or a supplier must hold the lessor and the supplier harmless against any claim by way of infringement or the like that arises out of compliance with the specifications. Com C §10211(c).

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D. Consumer Protection Warranties

§6.22 1. Generally

State and federal consumer warranty laws afford protection to consumer purchasers in addition to what is provided by the Uniform Commercial Code. These laws recognize that the consumer often has little or no power to negotiate a warranty or its limitations and must buy products under whatever terms the seller dictates. Typically, the legislation does not apply to transactions between merchants or to transactions involving nonconsumer goods (*i.e.,* goods that are not sold for personal, family, or household use).

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2. California Law

§6.23 a. Consumers Legal Remedies Act (CC §§1750-1784)

California has legislation specifically addressed to consumer warranties in Titles 1.5 and 1.7 of the Civil Code (CC §§1750-1784, 1790-1797.96). This legislation consists of seven major categories, discussed in §§6.23-6.29. First is the Consumers Legal Remedies Act (CC §§1750-1784), which provides damages, injunctive, and other relief for consumers injured by certain unfair methods of competition or unfair or deceptive practices in the sale of consumer goods. See *Bardin v DaimlerChrysler Corp.* (2006) 136 CA4th 1255, 1275, 39 CR3d 634; *Wilens v TD Waterhouse Group, Inc.* (2003) 120 CA4th 746, 753, 15 CR3d 271. The prohibited practices are listed in CC §1770(a) and include:

- Representing that goods or services have sponsorship, approval, characteristics, ingredients, uses, benefits, or quantities that they do not have.
- Representing that goods are original or new if they have deteriorated unreasonably or are altered, reconditioned, reclaimed, used, or secondhand.
- Representing that goods or services are of a particular standard, quality, or grade, or that goods are of a particular style or model, if they are of another style or model.
- Disparaging the goods, services, or business of another by false or misleading representation of fact.
- Advertising goods or services with intent not to sell them as advertised.
- Advertising goods or services with intent not to supply reasonably expected demand, unless the advertisement discloses a limitation of quantity.
- Making false or misleading statements of fact concerning reasons for, existence of, or amounts of price reductions.
- Misrepresenting the authority of a salesperson, representative, or agent to negotiate the final terms of a transaction with a consumer.
- Inserting an unconscionable provision in the contract.
- Selling or leasing goods in violation of the provisions of the Civil Code commencing with CC §1797.8, relating to "grey market" goods.
- Charging an unreasonable fee to advise on or help secure public social services.

The Consumers Legal Remedies Act applies to transactions for the sale or lease of goods "primarily for personal, family or household purposes" or for services "for other than a commercial or business use, including services furnished in connection with the sale or repair of goods." CC §1761(a)-(b). A contract is not a prerequisite for bringing an action. CC §1761(e). The unfair or deceptive acts or statements may be oral or in writing. *Wang v Massey Chevrolet* (2002) 97 CA4th 856, 869, 118 CR2d 770.

Plaintiffs may not recover for prospective violations of the Act. In *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 88 CR3d 859, the plaintiffs alleged that Sprint's arbitration agreement and other contract provisions were unconscionable under the Act, but did not allege that these provisions had been enforced against them or otherwise damaged them. The court ruled that "a plaintiff has no standing to sue under the CLRA without some allegation that he or she has been damaged by an alleged unlawful practice." 45 C4th at 638.

Remedies available under the Act include actual and punitive damages, injunctive relief, and restitution. In addition, if the consumer is a senior citizen or is disabled, he or she may be awarded an additional sum if he has suffered substantial physical, emotional, or economic damage as a result of the defendant's conduct. CC §1780(a)-(b). Remedies under the Act are discussed further in §§10.49-10.52.

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§6.24 b. Song-Beverly Consumer Warranty Act (the "Lemon Law"; CC §§1790-1795.8)

The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), popularly known as the "lemon law," is a detailed consumer protection measure imposing covenants and warranties in sales of consumer goods that take place in California. It was intended to broaden the remedies available under the Commercial Code. *Mexia v Rinker Boat Co.* (2009) 174 CA4th 1297, 95 CR3d 285; *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 7 CR3d 546. It does not apply to sales made out-of-state to California residents. *Cummins, Inc. v Superior Court* (2005) 36 C4th 478, 30 CR3d 823; *Davis v Newmar Corp.* (2006) 136 CA4th 275, 278, 38 CR3d 690. The term "consumer goods" is defined as "any new product or part thereof that is used, bought, or leased for use primarily for personal, family, or household purposes, except for clothing and consumables." CC §1791(a). See *Mitchell v Blue Bird Body Co.* (2000) 80 CA4th 32, 95 CR2d 81. It does not include fixtures. *Atkinson v Elk Corp.* (2003) 109 CA4th 739, 135 CR2d 433 (damaged roof shingles are not "consumer goods").

Among other things, the Act includes implied warranties of merchantability and fitness, and restrictions on a seller's ability to disclaim warranties. It requires express warranties to be made in "simple and readily understood language," and mandates express warranties for certain types of products such as medical devices and wheelchairs. It also imposes service and repair obligations on manufacturers, distributors, and retailers. See CC §§1792-1793.4; *Gavaldon v DaimlerChrysler Corp.* (2004) 32 C4th 1246, 13 CR3d 793 (distinguishing service contracts from express warranties under the Act). Any purported waiver or disclaimer of the provisions of the Act by a buyer of consumer goods is against public policy and unenforceable (except as otherwise provided in the Act). CC §1790.1.

Of interest to motorists are the provisions of CC §§1793.2-1793.25, which impose additional specific duties on manufacturers and sellers of motor vehicles, including requirements concerning express warranties, duties of service and repair, vehicle replacement obligations, and dispute resolution procedures. See, *e.g., Jiagbogu v Mercedes-Benz USA* (2004) 118 CA4th 1235, 13 CR3d 679 (car manufacturer had no right of equitable offset for buyer's use of car following buyback request after failed repair attempts); *Oregel v American Isuzu Motors, Inc.* (2001) 90 CA4th 1094, 109 CR2d 583 (requiring dealer to repurchase car with persistent oil leak). The Act also provides for recovery of attorney fees and possible treble damages. See CC §1794. Prejudgment interest under CC §3287(a) is also available for violations of Act. *Doppes v Bentley Motors, Inc.* (2009) 174 CA4th 1004, 1006, 94 CR3d 797. Although the Commercial Code gives sellers a right to cure and re-tender goods under Com C §2508, exercise of this right may nullify the buyer's right to cancel the sale. Under the Song-Beverly Consumer Warranty Act, sellers have no similar right to cure or repair in the event of a breach of implied warranties. *Mocek v Alfa Leisure, Inc.* (2003) 114 CA4th 402, 407, 7 CR3d 546.

The provisions of the Song-Beverly Consumer Warranty Act supplement rather than supersede the Commercial Code. *Murillo v Fleetwood Enters., Inc.* (1998) 17 C4th 985, 989, 73 CR2d 682. When the Act and the Code conflict, the Act prevails. CC §1790.3; *Mexia v Rinker Boat Co.* (2009) 174 CA4th 1297, 1303, 95 CR3d 285.

For additional discussion of the Song-Beverly Consumer Warranty Act, including remedies provided for breach of express warranty, see §12.43.

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§6.25 c. Motor Vehicle Warranty Adjustment Programs (CC §§1795.90-1795.93)

Title 1.7 of the Civil Code also includes legislation regulating motor vehicle warranty adjustment programs. See CC §§1795.90-1795.93. This legislation provides that motor vehicle dealers (CC §1795.91) and manufacturers (CC §1795.92) have specified duties to provide notice and disclosures regarding adjustment programs that expand the consumer's warranty period for certain performance-related repairs.

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§6.26 d. Standards for Warranty Work (CC §§1796, 1796.5)

Title 1.7 further mandates standards for warranty work. See CC §§1796, 1796.5. These statutes establish statutory standards of care for installation (CC §1796) and service or repair (CC §1796.5) of consumer goods. Essentially, these provisions require that the installation, service, or repair be done in a workmanlike manner. See *Gavaldon v DaimlerChrysler Corp.* (2004) 32 C4th 1246, 1260, 13 CR3d 793.

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§6.27 e. Mobilehome Warranties (CC §§1797-1797.7)

Warranties on new mobilehomes and manufactured homes are imposed by CC §§1797-1797.7. The warranties apply to the manufacturer as well as the contractor or dealer who sells the mobile home to the buyer, and cover all of the electrical, plumbing, heating, cooling, fire safety, and structural systems, and all appliances installed by the manufacturer, contractor, or dealer. CC §1797.2. A series of specific express written warranties are required to be given, and may not be disclaimed or waived. See CC §§1797.3-1797.4.

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§6.28 f. Grey Market Goods (CC §§1797.8-1797.86)

Grey market goods are regulated by CC §§1797.8-1797.86. Grey market goods are consumer goods imported through channels other than the manufacturer's authorized U.S. distributor that bear a trademark but are unaccompanied by the manufacturer's usual express written warranties. CC §1797.8. A retail seller of grey market goods is required to disclose in a conspicuous manner the fact that the manufacturer's express warranties are not valid as to the goods, along with any other incompatibility or nonconformity with domestic standards. CC §1797.81. A violation of these disclosure requirements constitutes unfair competition (see Bus & P C §17200) and is grounds for rescission of the sale and a refund to the consumer. CC §§1797.85-1797.86. The seller may avoid the express warranty disclosure requirement if it gives the buyer an equal or better warranty and certain other statutory conditions are met. CC §1797.81(b).

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§6.29 g. Home Roof Warranties (CC §§1797.90-1797.96)

Home roof warranties are addressed in CC §§1797.90-1797.96. These statutes do not impose warranties, but instead require, among other things, that any home roof warranty covering materials or workmanship be in writing, and be transferable to successive homeowners (unless the contract includes a clear and conspicuous provision limiting transferability of the warranty). CC §§1797.91-1797.92, 1797.94.

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3. Federal Law

§6.30 a. Magnuson-Moss Warranty—Federal Trade Commission Improvement Act

The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) applies to all consumer products covered by a written warranty that are distributed in interstate commerce and to service contracts for maintenance or repair of consumer products. Consumer products include items used for personal, family, or household purposes, and also items such as automobiles that are used for both personal and commercial purposes. See 16 CFR §700.1(a). The Act does not require sellers to give particular warranties, but rather applies whenever a written warranty has been given. *Milicevic v Fletcher Jones Imports, Ltd.* (9th Cir 2005) 402 F3d 912, 917. The Act is inapplicable to warranties covering products such as drugs, medical devices, cosmetics, and pesticides, the manufacture and labeling of which is regulated by other federal laws. See 15 USC §2311; *Kanter v Warner-Lambert* (2002) 99 CA4th 780, 798, 122 CR2d 72.

The term "written warranty" has a specific meaning for purposes of the Act's application (15 USC §2301(6)):

> The term "written warranty" means —
>
> (A) any written affirmation of fact or written promise made in connection with the sale of a consumer product by a supplier to a buyer which relates to the nature of the material or workmanship and affirms or promises that such material or workmanship is defect free or will meet a specified level of performance over a specified period of time, or
>
> (B) any undertaking in writing in connection with the sale by a supplier of a consumer product to refund, repair, replace, or take other remedial action with respect to such product in the event that such product fails to meet the specifications set forth in the undertaking, which written affirmation, promise, or undertaking becomes part of the basis of the bargain between a supplier and a buyer for purposes other than resale of such product.

See also 16 CFR §701.1(c). A statement that qualifies as an express warranty under the Uniform Commercial Code may not fall within the definition of a written warranty under the Act. For example, a written statement of fact about a product or a written promise that it will perform in a particular manner must relate to a specific period of time to be considered a "written warranty" within the foregoing definition. 16 CFR §700.3.

The Act also applies to "service contract[s]," which are defined as "a contract in writing to perform, over a fixed period of time or for a specified duration, services relating to the maintenance or repair (or both) of a consumer product." 15 USC §2301(8).

The Act creates a private right of action for a warrantor's failure to honor a written warranty. Attorney fees may be awarded in the discretion of the federal district court if the plaintiff prevails. *Milicevic v Fletcher Jones Imports, Ltd.* (9th Cir 2005) 402 F3d 912, 917. See 15 USC §2310(d). The amount in controversy must exceed $50,000 in order for the federal courts to have subject matter jurisdiction over a Magnuson-Moss claim. Generally, damages for personal injury are not recoverable under the Act, unless the warranty places limitations on consequential damages that are not conspicuously displayed. *Kelly v Fleetwood Enters., Inc.* (9th Cir 2004) 377 F3d 1034, 1037.

For further discussion of the Act, see California UCC Sales and Leases, chap 3 (Cal CEB 2002).

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§6.31 b. FTC Regulations Concerning Written Consumer Warranties

The Federal Trade Commission has promulgated regulations under the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) that govern how a written warranty covering consumer products must be titled, what must be included in the warranty, and how the warranty must be made available to a consumer. See 16 CFR pts 700-703. See generally http://www.ftc.gov/bcp. A warrantor must designate the written warranty as either "full" or "limited" according to the definitions of those terms in the Act. See 15 USC §2303; 16 CFR §700.6. The warrantor must state certain specified information about the coverage of the warranty in a single, easy-to-read document. See 16 CFR pt 701. Finally, the warrantor or seller must ensure that warranties are available where the warranted products are sold so that consumers can read them before buying. See 16 CFR pt 702. For further discussion of the FTC rules, see California UCC Sales and Leases, chap 3 (Cal CEB 2002).

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III. COVENANTS

A. Generally

§6.32 1. Express Covenants

"Covenant" is another word for a contractual promise. "Promise" is defined in the Restatement (Second) of Contracts §2 (1981) as "a manifestation of intention to act or refrain from acting in a specified way, so made as to justify a promisee in understanding that a commitment has been made." An express covenant is normally understood as a promise stated in words. See CC §1620; *Youngman v Nevada Irrig. Dist.* (1969) 70 C2d 240, 74 CR 398.

Covenants are distinct from conditions. An express condition precedent to one party's performance does not impose a duty on either party to fulfill the condition, unless the contract also includes an express covenant or undertaking to do so. *Britschgi v McCall* (1953) 41 C2d 138, 144, 257 P2d 977 (specific performance denied because condition precedent was not satisfied and defendant was under no affirmative obligation to satisfy condition). Unlike the nonoccurrence of a condition, a breach of a covenant or promise to perform will give rise to a right of action for damages, but will not necessarily extinguish the obligation of performance. *Spirtos v Moreno (In re Spirtos)* (BAP 9th Cir 1993) 154 BR 550, 555. Courts sometimes refer to the nonoccurrence of a condition as a "breach" (see, *e.g., Wiz Technol., Inc. v Coopers & Lybrand LLP* (2003) 106 CA4th 1, 12, 130 CR2d 263), but an analysis of these cases generally reveals that the condition at issue was the performance by one party of a contractual duty and the other party's duty to perform did not arise until after the first party had performed. Whether a contract provision is a condition or a covenant is determined from the language of the entire document, its purpose, and the intentions of the parties. *Pacific Allied v Century Steel Prods., Inc.* (1958) 162 CA2d 70, 327 P2d 547.

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§6.33 2. Implied Covenants

In general, implied covenants or terms are not favored and will be found only in limited circumstances when necessary to give effect to the expressed intent of the parties. "To effectuate the intent of the parties, implied covenants will be found if after examining the contract as a whole it is so obvious that the parties had no reason to state the covenant, the implication arises from the language of the agreement, and there is a legal necessity." *Ben-Zivi v Edmar Co.* (1995) 40 CA4th 468, 473, 47 CR2d 12 (citations omitted). California courts have stated five conditions that must exist before a covenant will be implied (*Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 804, 48 CR2d 747):

- The implication must arise from the language used or it must be indispensable to effectuate the intention of the parties;
- It must appear from the language used that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it;
- Implied covenants can only be justified on the grounds of legal necessity;
- A promise can be implied only when it can be rightfully assumed that it would have been made if attention had been called to it;
- There can be no implied covenant if the subject is completely covered by the contract.

See also *Frankel v Board of Dental Exam'rs* (1996) 46 CA4th 534, 545, 54 CR2d 128; §§5.23-5.24. See, *e.g., Ben-Zvi v Edmar Co., supra* (no implied covenant that distributor live abroad in contract granting foreign distributorship; performance was to be based merely on attaining sales goals, not residency); *PG&E v Superior Court* (1993) 15 CA4th 576, 609, 19 CR2d 295 (no implied covenant for party to take sufficient gas from well to prevent drainage or damage to other wells); *Kessler v General Cable Corp.* (1979) 92 CA3d 531, 542, 155 CR 94 (brief reference to listing on New York Stock Exchange in prospectus did not constitute *continuing* promise to avoid delisting, for whatever reason, for 25-year term of convertible debentures at issue); *Hinckley v Bechtel Corp.* (1974) 41 CA3d 206, 211, 116 CR 33 (no implied covenant to give notice of insurance conversion option); *Walnut Creek Pipe Distribs. v Gates Rubber Co. Sales Div.* (1964) 228 CA2d 810, 815, 39 CR 767 (no implied covenant to repurchase or give credit for materials purchased to perform job when exercising right to terminate contract).

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B. Implied Covenant of Good Faith and Fair Dealing

§6.34 1. Generally

It has long been recognized in California that "[t]here is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement." *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 400, 97 CR2d 151; *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1332, 96 CR3d 813; *Benavides v State Farm Gen. Ins. Co.* (2006) 136 CA4th 1241, 39 CR3d 650. The covenant imposes a duty on each party to do everything that the contract presupposes that they will do to accomplish its purpose. *Andrews v Mobil Aire Estates* (2005) 125 CA4th 578, 589, 22 CR3d 832. See also *Peak-Las Positas Partners v Bollag* (2009) 172 CA4th 101, 90 CR3d 775 (real property seller's refusal to extend escrow when buyer had paid most of purchase price and incurred about $5 million in costs to obtain lot line adjustment was unreasonable and violated covenant of good faith and fair dealing); *Lincoln Prop. Co., N.C. v Travelers Indem. Co.* (2006) 137 CA4th 905, 41 CR3d 39; *Pasadena Live, LLC v City of Pasadena* (2004) 114 CA4th 1089, 1094, 8 CR3d 233.

The covenant of good faith and fair dealing is not unique to California. The principle that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement" has been recognized in the majority of American jurisdictions, by the Restatement, and under the Uniform Commercial Code. *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 683, 254 CR 211 (citing Restatement (Second) of Contracts §205 (1981)); Com C §1304. See generally Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv L Rev 369 (1980).

Comment d to Restatement (Second) of Contracts §205 (1981) provides the following examples from judicial decisions of bad faith in contract performance: "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance." Comment e recites the following examples of bad faith in enforcement of a contract:

> dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts… taking advantage of the necessitous circumstances of the other party to extort a modification of a contract… without legitimate commercial reason… harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract.

The Restatement's approach to the covenant of good faith and fair dealing has been cited with approval by California state courts and the Ninth Circuit Court of Appeals. See, *e.g., Scribner v WorldCom, Inc.* (9th Cir 2001) 249 F3d 902, 910; *Elyaoudayan v Hoffman* (2003) 104 CA4th 1421, 1431, 129 CR2d 41. Under California law, however, breach of the covenant does not require dishonest conduct. *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 373, 6 CR2d 467 ("the covenant of good faith can be breached for objectively unreasonable conduct, regardless of the actor's motive"). See also *Lincoln Gen. Ins. Co. v Access Claims Administrators, Inc.* (ED Cal 2009) 596 F Supp 2d 1351.

The implied covenant of good faith and fair dealing is subject to the exception that "the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise have been forbidden" by the covenant. *Carma Developers*, 2 C4th at 374. This exception corresponds with the general rule that in interpretation of a contract, obligations should not be implied contrary to the clear and express words of the contract itself. See §§5.23-5.24; *Hinckley v Bechtel Corp.* (1974) 41 CA3d 206, 116 CR 33. If an act is authorized by the express provisions of the contract, a covenant of good faith and fair dealing cannot be implied to forbid the act. *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 374, 6 CR2d 467. See also *Pasadena Live, LLC v City of Pasadena* (2004) 114 CA4th 1089, 1094, 8 CR3d 233 (implied covenant "is limited to assuring compliance with the *express terms* of the contract, and cannot be extended to create obligations not contemplated by the contract"

(italics in original)). However, even conduct covered by an express provision must be within the parties' reasonable expectations. *IndyMac Fed. Bank v PMI Mortgage Ins. Co.* (ND Cal, Feb. 11, 2009, No. C 08-04303 WHA) 2009 US Dist Lexis 14837 at *7 ("The question is whether the parties would reasonably have expected that IndyMac would find and turn over 5,565 files in a single month period").

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§6.35 2. Requires a Contract

The prerequisite for any action based on the implied covenant of good faith and fair dealing is the existence of a contract between the parties. Without a contractual relationship, there can be no action for breach because the covenant is implied in the contract and does not exist apart from it. *Smith v City & County of San Francisco* (1990) 225 CA3d 38, 49, 275 CR 17. See also *Guz v Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 327, 100 CR2d 352; *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1339, 96 CR3d 813 ("Breach of the covenant of good faith and fair dealing is nothing more than a cause of action for breach of contract."). For example, if the contract does not include an express covenant to negotiate a contract modification, the implied covenant of good faith and fair dealing will not create a duty to negotiate where previously there was none. It cannot be used to add obligations that were not contemplated by the original contract. *Racine & Laramie, Ltd., Inc. v Department of Parks & Recreation* (1992) 11 CA4th 1026, 14 CR2d 335. It cannot contradict the express terms of a contract. *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 374, 6 CR2d 467; *The Lundin/Weber Co. LLC v Brea Oil Co.* (2004) 117 CA4th 427, 11 CR3d 768. Moreover, it does not create a fiduciary relationship. *Wolf v Superior Court* (2003) 107 CA4th 25, 31, 130 CR2d 860. "[T]he scope of conduct prohibited by the covenant of good faith is circumscribed by the purposes and express terms of the contract." *Carma Developers (Cal.), Inc.,* 2 C4th at 373. As the court of appeal in *Racine & Laramie, Ltd.* stated (11 CA4th at 1031, citations omitted, italics in original):

> The implied covenant of good faith and fair dealing rests upon the existence of some specific contractual obligation.... The covenant of good faith is read into contracts in order to protect the express covenants or promises of the contract, not to protect some general public policy interest not directly tied to the contract's purpose.... In essence, the covenant is implied as a *supplement* to the express contractual covenants, to prevent a contracting party from engaging in conduct which (while not technically transgressing the express covenants) frustrates the other party's rights to the benefits of the contract.

As a corollary, a breach of the covenant of good faith and fair dealing normally gives rise to contractual remedies only; tort remedies (including punitive damages) are generally not available for breach of the implied covenant. *Jonathan Neil & Assocs., Inc. v Jones* (2004) 33 C4th 917, 937, 16 CR3d 849; *Guz v Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 352, 100 CR2d 352 (no tort of bad faith breach of employment contract). See generally §10.32-10.34. There is an exception to this general rule in the insurance context: Recovery in tort may be allowed for breach of the implied covenant of good faith and fair dealing in insurance policies in some circumstances. *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 43, 86 CR2d 855. See §10.33. The exception is justified because insurance policies, unlike other contracts for goods or services, are characterized by elements of adhesion, unequal bargaining power, public interest, and fiduciary responsibility. The exception is narrow and does not extend to contracts arguably similar to insurance contracts, such as surety or performance bonds. 21 C4th at 59. See also *Jonathan Neil & Assocs., Inc.*, 33 C4th at 937 (tort recovery not allowed); *Rattan v United Servs. Auto. Ass'n* (2000) 84 CA4th 715, 101 CR2d 6. See §10.34.

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§6.36 3. In Exercise of Discretion

If a party is given absolute discretion in the express language of the contract to perform or not to perform and has furnished no other consideration, the implied covenant of good faith and fair dealing will limit that discretion as necessary to create mutuality of obligation and avoid a finding that the party's promise is illusory. *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 61, 122 CR2d 267; *Third Story Music, Inc. v Waits* (1995) 41 CA4th 798, 802, 48 CR2d 747. See generally §3.47. In *Locke v Warner Bros., Inc.* (1997) 57 CA4th 354, 365, 66 CR2d 921, the court held that when a contract gives one party a discretionary power affecting the rights of the other, there is a duty to exercise that discretion honestly, in good faith, and in accordance with fair dealing—even if the contract is supported by other consideration. See also *Peak-Las Positas Partners v Bollag* (2009) 172 CA4th 101, 106, 90 CR3d 775 (seller violated covenant of good faith and fair dealing by refusing to extend escrow when buyer had paid most of purchase price and incurred $5 million in costs to obtain lot line adjustment).

If, however, the agreement is supported by adequate consideration so that the grant of discretion does not render the agreement illusory, courts will not imply a covenant of good faith and fair dealing that is directly at odds with an express grant of absolute discretion. *Wolf v Walt Disney Pictures & Television* (2008) 162 CA4th 1107, 76 CR3d 585; *Storek & Storek, Inc. v Citicorp Real Estate, Inc., supra*. In *Wolf v Walt Disney, supra,* Disney entered into an agreement to acquire the rights to Wolf's novel, *Who Censored Roger Rabbit?* The agreement gave Disney the right to "promote the Roger Rabbit franchise" and exploit the characters from the book in a variety of ways, including producing motion pictures based on the book and making and selling representatives of characters in the book. 162 CA4th at 1112. The agreement provided that Disney was under no obligation to exercise any of the rights granted to it, and could assign any and all of the rights granted under the agreement "as it saw fit." In exchange, Disney agreed to pay Wolf 2.5 percent of any motion picture profits and 5 percent of the "gross receipts" it derived from its exploitation of Roger Rabbit characters. Wolf contended Disney had violated the implied covenant of good faith and fair dealing by entering into certain promotional agreements with third parties such as McDonalds for which it received no monetary consideration. The court rejected this contention, refusing to "recognize an implied term that would limit the unfettered discretion given to Disney to license the characters as it saw fit." 162 CA4th at 1123.

If the party's performance is conditional on his or her objectively reasonable satisfaction (see §6.46), the covenant of good faith and fair dealing need not be implied to constrain the party's ability to avoid performance. The promise is not illusory, and the contract is enforceable. *Storek & Storek, Inc. v Citicorp Real Estate, Inc., supra*.

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§6.37 4. Insurance Contracts

In the insurance context, the implied covenant of good faith and fair dealing has been recognized to require that the insurer settle in an appropriate case even if the language of the policy does not impose such a duty. *Comunale v Traders & Gen. Ins. Co.* (1958) 50 C2d 654, 658, 328 P2d 198. This duty can be enforced by a suit for breach of contract or, as noted in §6.35, by a tort action, but the tort suit must relate to the insurer's activities under the policy, not to a collateral contract. *Rattan v United Servs. Auto. Ass'n* (2000) 84 CA4th 715, 101 CR2d 6 (insurer's guarantee of repairs performed by contractor recommended by insurer was independent contract; no tort action for bad faith breach available).

The implied covenant of good faith and fair dealing requires that the insurer "give at least as much consideration to the interests of the insured as it gives to its own interests." *Wilson v 21st Century Ins. Co.* (2007) 42 C4th 713, 720, 68 CR3d 746. The insurer must fully inquire into possible bases that might support the insured's claim and may not ignore facts that support the claim and focus only on the facts that justify denying the claim. 42 C4th at 721. If there is a genuine legal or factual dispute regarding the existence or amount of coverage, an insurer cannot be liable in bad faith, even though it might be liable for breach of contract. However, the "genuine dispute rule" does not relieve an insurer from its duty to thoroughly and fairly investigate a claim. 42 C4th at 723. In other words, "the genuine dispute rule cannot be invoked to protect an insurer's denial or delay in payment of benefits unless the insurer's position was both reasonable and reached in good faith." *Brehm v 21st Century Ins. Co.* (2008) 166 CA4th 1225, 1238, 83 CR3d 410. See also *McCoy v Progressive W. Ins. Co.* (2009) 171 CA4th 785, 793, 90 CR3d 74 (affirming trial court's refusal to give separate jury instruction on genuine dispute doctrine when court properly instructed jury on reasonableness using CACI 2331 and 2332). Whether these criteria are met must be determined on a case-by-case basis, taking into account the parties' expectations. *Chateau Chamberay Homeowners Ass'n v Associated Int'l Ins. Co.* (2001) 90 CA4th 335, 346, 108 CR2d 776.

NOTE: The court in *Bosetti v United States Life Ins. Co.* (2009) 175 CA4th 1208, 96 CR3d 744, disagreed with *Brehm v 21st Century Ins. Co., supra,* to the extent the *Brehm* court intended to hold that there is a distinct subjective good faith requirement to the genuine dispute doctrine.

The breach of the implied covenant of good faith and fair dealing in the insurance context is referred to as "bad faith." *Major v Western Home Ins.* (2009) 169 CA4th 1197, 1209, 87 CR3d 556 ("The term 'bad faith' does not connote 'positive misconduct of a malicious or immoral nature' (citation); it simply means the insurer acted deliberately," quoting *Neal v Farmers Ins. Exch.* (1978) 21 C3d 910, 922, 148 CR 389).

Examples of breaches of the implied covenant of good faith and fair dealing by insurers include:

- Unreasonable refusal to pay benefits under a policy. *Major v Western Home Ins.*, *supra*; *Benavides v State Farm Gen. Ins. Co.* (2006) 136 CA4th 1241, 39 CR3d 650; *Buxbaum v Aetna Life & Cas. Co.* (2002) 103 CA4th 434, 442, 126 CR2d 682. But see *Fraley v Allstate Ins. Co.* (2000) 81 CA4th 1282, 1292, 97 CR2d 386 (refusal to pay benefits not bad faith if there is genuine issue concerning insurer's liability).
- Ignoring evidence supporting coverage. *Wilson v 21st Century Ins. Co., supra*; *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 93 CR2d 364; *Mariscal v Old Republic Life Ins. Co.* (1996) 42 CA4th 1617, 1624, 50 CR2d 224. But see *McMillin Scripps N. Partnership v Royal Ins. Co.* (1993) 19 CA4th 1215, 23 CR2d 243 (no duty to investigate if no covered loss has been suffered).
- Unreasonable failure to defend. *Campbell v Superior Court* (1996) 44 CA4th 1308, 52 CR2d 385. But see *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 44 CR2d 370 (no bad faith failure to defend if there is no potential for coverage).
- Failing to estimate reasonable claim reserve levels, leading to higher premiums and lower dividends. *Notrica v State Compensation Ins. Fund* (1999) 70 CA4th 911, 921, 83 CR2d 89; *MacGregor Yacht Corp. v State Compensation Ins. Fund* (1998) 63 CA4th 448, 456, 74 CR2d 473.
- Failing to inform an insured of arbitration rights and committing misleading acts and conduct. *Chase v Blue Cross*

(1996) 42 CA4th 1142, 1158, 50 CR2d 178; *Sarchett v Blue Shield* (1987) 43 C3d 1, 15, 233 CR 76; *Davis v Blue Cross* (1979) 25 C3d 418, 158 CR 828.

- An insurer's failure to disclose an applicable insurance policy pursuant to 10 Cal Code Regs §2695.4(a) may support an inference of lack of reasonableness, but will not in itself establish bad faith. *Safeco Ins. Co. v Parks* (2009) 170 CA4th 992, 88 CR3d 730.

See generally Kornblum, *Insurance "Bad Faith" Basics, Parts I and II* (24 CEB Cal Bus L Prac 96 (Summer 2009) and 24 CEB Cal Bus L Prac 123 (Fall 2009)).

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§6.38 C. Covenants Not to Compete

Covenants not to compete may be found in connection with a sale or transfer of a business or in an employer-employee relationship. California strongly disfavors covenants not to compete. In the absence of a statutory exception, the general rule is that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." Bus & P C §16600. See *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818. This general rule is subject to several statutory exceptions, but there is no "narrow restraint" or general reasonableness exception under California law that courts may apply. *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 949, 81 CR3d 282. To be enforceable, the covenant must fall within one of the statutory exceptions set forth below. It must have been obtained in connection with one of the following:

- The sale of goodwill of a business by the person who agrees not to compete. Bus & P C §16601.
- The sale or other disposition of all the covenantor's ownership interest in a business entity or its subsidiary. Bus & P C §16601. See *Hill Med. Corp. v Wycoff* (2001) 86 CA4th 895, 103 CR2d 779 (noncompetition agreement in connection with sale of minority interest in medical corporation invalid); *Hilb, Rogal & Hamilton Ins. Servs. v Robb* (1995) 33 CA4th 1812, 39 CR2d 887; *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 6 CR2d 602.
- The sale of all or substantially all the operating assets, together with the goodwill of a business entity or its subsidiary or division. Bus & P C §16601. The parties must have "valued or considered goodwill as a component of the sales price." *Hill Med. Corp. v Wycoff, supra,* 86 CA4th at 903.
- The dissociation of a partner from a partnership, or the disposition of a partner's interest in a partnership. Bus & P C §16602. See *Howard v Babcock* (1993) 6 C4th 409, 25 CR2d 80; *South Bay Radiology Med. Assocs. v Asher* (1990) 220 CA3d 1074, 269 CR 15.
- The dissolution of a partnership. Bus & P C §16602.
- The dissolution of a limited liability company or a sale of an individual's interest in a limited liability company. Bus & P C §16602.5.

In these situations, a covenant not to compete in all or part of a specified geographical area in which the business has been carried on, during the time the seller continues to do business there, is permitted. Bus & P C §§16601-16602.5.

Before *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, courts grappled with the question of whether a *partial* restraint would be enforceable in the absence of a transaction supporting application of one of the statutory exceptions described above. Partial restrictions could be framed as geographical restrictions, temporal restrictions, or restrictions applicable to only certain customers or clients. The Ninth Circuit Court of Appeals had previously adopted a "narrow restraint" exception to §16600 in *Campbell v Trustees of Leland Stanford Jr. Univ.* (9th Cir 1987) 817 F2d 499. See also *General Commercial Packaging, Inc. v TPS Package Eng'g, Inc*. (9th Cir 1997) 126 F3d 1131, 1132. In the *Edwards* case, however, the California Supreme Court expressly rejected the Ninth Circuit's narrow-restraint exception, stating that §16600 "represents a strong public policy of the state which should not be diluted by judicial fiat." 44 C4th at 949.

In *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 102 CR3d 1, relying on *Edwards*, the court held that a broadly worded 18-month noncompete clause was void and unenforceable as a matter of law. The court rejected the defendant's argument that the clause should be enforced based on a (nonstatutory) trade secrets exception to §16600. See Wilka, *How to Avoid Liability and Protect Trade Secrets When Hiring and Losing Employees*, 24 CEB Cal Bus L Prac 1 (Winter 2009); Trade Secrets Practice in California §11.41 (Cal CEB 1996).

For further discussion of the enforceability of different types of covenants not to compete in California, see California Business Litigation, chap 3 (Cal CEB 2002). See also Advising California Employers and Employees §2.60 (Cal CEB 2005).

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Source: Business Law/California Law of Contracts/6 Representations, Warranties, Covenants, Conditions, Indemnities/ §6.39 D. Covenants in Contracts Regulated by Civil Code

§6.39 D. Covenants in Contracts Regulated by Civil Code

Part 4 of the Civil Code includes specific requirements for contracts utilized in many different types of California businesses, mainly (but not exclusively) involving consumer transactions. In addition to requiring specific contract terms and disclosures, the statutes regulate other business practices and sometimes provide a right of civil action to redress statutory violations, which may include injunctive relief, rescission or cancellation rights, damages, and attorney fees. Some statutes include restrictions on contractual limitations of liability. Many statutes provide that any purported waiver of the statutory provisions is void, although CC §3268 provides generally that the parties may waive the benefits of any statutes in Part 4 "[e]xcept where it is otherwise declared" or unless the waiver would be against public policy. To the extent that the regulated transactions involve sales of goods, these Civil Code requirements operate in addition to the requirements of Division 2 of the Commercial Code.

Further, Title 5 of Part 2 of the Civil Code (CC §§1689.2-1695.17) grants special rescission or cancellation rights under—and regulates other terms and conditions of—a number of particular types of contracts, most of which are consumer-related. See §11.58.

Following is a list of the types of contracts regulated in Title 5 of Part 2 and in Part 4 of the Civil Code. Attorneys addressing contracts for these types of businesses should review the applicable statutes carefully for specific requirements. Note that Part 4 also includes many statutes addressed to general business practices (*e.g.,* debt collection, credit granting, confidentiality of personal records, landlord-tenant matters, and lien foreclosures) which are not listed below. Note further that the contracting practices of California businesses that are regulated under other California codes (such as attorneys, construction contractors, health care providers, banks and other financial institutions, and insurance companies) may be subject to statutory requirements that are beyond the scope of this discussion.

Type of Contract or Business	Civil Code Sections
Endless Chain (Pyramid) Scheme	§1689.2
Dental Contract or Plan	§1689.3
Home Solicitation Contract or Offer	§§1689.5-1689.15
Seminar Sales Solicitation Contracts	§§1689.20-1689.24
Dating Service Contracts	§§1694-1694.4
Weight Loss Contracts	§§1694.5-1694.9
Home Equity Sales Contracts	§§1695-1695.17
Consignment of Fine Art	§§1738-1738.9
Independent Wholesale Sales Representatives	§§1738.10-1738.17
Sale and Manufacture of Political Items	§§1739-1739.4
Autographed Sports Memorabilia	§1739.7
Sale of Fine Prints	§§1740-1745.5
Violent Video Games	§§1746-1746.5
Credit Cards, Charge Cards, Debit Cards	§§1747-1748.32
Layaway Practices	§§1749-1749.4
Gift Certificates	§§1749.45-1749.6
Supermarket Club Cards	§§1749.60-1749.66

Consumer Credit Reporting Agencies	§§1785.1-1785.36
Commercial Credit Reports	§§1785.41-1785.44
Investigative Consumer Reporting Agencies	§§1786-1786.60
Credit Services Organizations	§§1789.10-1789.26
Check Cashers	§§1789.30-1789.38
Service Contracts	§§1794.4-1794.41
Consumer Loans With Precomputed Interest	§§1799.5-1799.6
Residential Real Estate Loans with Precomputed Finance Charges	§§1799.8-1799.85
Consumer Credit Contracts	§§1799.90-1799.104, 1799.200-1799.207
Retail Installment Sales	§§1801-1812.20
Contracts for Dance Studio Lessons and Other Services	§§1812.50-1812.69
Contracts for Health Studio Services	§§1812.80-1812.97
Contracts for Lease or Rental of Athletic Facilities	§1812.97
Contracts for Discount Buying Services	§§1812.100-1812.129
Contracts for Seller-Assisted Marketing Plans	§§1812.200-1812.221
Membership Camping Contracts	§§1812.300-1812.316
Credit Disability Insurance Contracts	§§1812.400-1812.410
Employment Agency, Employment Counseling, Job Listing Services, Nurses Registries, Long-Term Care Facilities	§§1812.500-1812.544
Auctioneer and Auction Companies	§§1812.600-1812.609
Consumer Rental-Purchase Contracts	§§1812.620-1812.649
Depositary Contracts	§§1814-1858.3, 1878
Innkeepers	§§1859-1867
Private Bulk Storage of Grain	§§1880-1881.2
Utility Services	§§1882-1882.6
Loans (including Long-Term Loans to Museums, Loans for Exchange, Loans of Money, Usury, Shared Appreciation Loans, Loans of ERISA Pension Funds, Shared Appreciation Loans for Seniors, Mortgage Loans, Reverse Mortgages)	§§1884-1923.10
Bailments and Leases (including Hiring in General, Rental Car Companies, Leasing Land and Dwellings, Commercial Rental Control, Residential Rent Control, Bailment of Personalty, Assignment and Sublease)	§§1925-1995.340
Agency Agreements, Factoring Contracts	§§2019-2030
Residential Real Estate Broker Contracts	§§2079-2079.24
Common Carriers Contracts	§§2085-2209

Recording Artists Contracts	§§2500-2501
Pharmaceutical Services	§§2527-2528
Indemnity Agreements	§§2772-2784.5
Suretyship Agreements	§§2787-2856
Mortgages	§§2920-2967
Automobile Sales Finance Contracts	§§2981-2984.5
Real Property Sales Contracts	§§2985-2985.6
Vehicle Leasing Contracts	§§2985.7-2992
Real Estate Escrows	§2995
Works of Improvement (Construction Contracts)	§§3082-3267

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Source: Business Law/California Law of Contracts/6 Representations, Warranties, Covenants, Conditions, Indemnities/ §6.40 E. Attorney Fee Agreements (Bus & P C §6148)

§6.40 E. Attorney Fee Agreements (Bus & P C §6148)

Business and Professions Code §6148 requires an attorney to have a written fee contract with a client in any case in which it is reasonably foreseeable that total expenses will exceed $1000. The contract must contain the attorney's hourly rate, the general nature of the services to be provided, and the respective responsibilities of attorney and client. Bus & P C §6148(a)(1)-(3). An attorney who does not have malpractice coverage or who has not filed a written agreement with the state bar guaranteeing payment of established malpractice claims must also disclose that fact in the contract. Bus & P C §6148(a)(4).

NOTE: The written contract requirement does not apply to emergency situations, to a corporate client, or to a noncorporate client who in writing waives the necessity of a fee contract. Bus & P C §6148(d).

All bills for attorney fees must state the amount, rate, and basis for calculation of the fee due. All bills from the attorney for costs and expenses incurred must clearly identify the costs and expenses and the amount of each. Attorneys must provide bills requested by clients within specified times. Bus & P C §6148(b). If an attorney fails to comply with these procedures, the client has the option of voiding the agreement. If the contract is voided, the attorney is entitled to collect a reasonable fee (not the fee under the contract). Bus & P C §6148(c).

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IV. CONDITIONS

§6.41 A. Generally (CC §§1434-1435)

Civil Code §1434 provides that "[a]n obligation is conditional, when the rights or duties of any party thereto depend upon the occurrence of an uncertain event." As stated by the California Supreme Court in *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 313, 24 CR2d 597, "[u]nder the law of contracts, parties may expressly agree that a right or duty is conditional upon the occurrence or nonoccurrence of an act or event." Conditions must be distinguished from covenants. See §6.32.

Civil Code §1435 states that there are three types of conditions: conditions precedent, concurrent conditions, and conditions subsequent. In general, a condition precedent is an act or event, the occurrence or nonoccurrence of which triggers a duty of the promisor, and a condition subsequent is an act or event, the occurrence or nonoccurrence of which extinguishes a duty of the promisor. Conditions precedent, concurrent, and subsequent are discussed more fully in §§6.42-6.45.

The terms "condition precedent" and "condition subsequent" have sometimes generated confusion, and the Restatement (Second) of Contracts (1981) does not use them. Instead, it uses the term "condition" to refer exclusively to conditions precedent and addresses contract provisions that would otherwise be referred to as "conditions subsequent" in its rules on discharge. See Restatement (Second) of Contracts §224, Comment e (1981). Nevertheless, the terms "condition precedent" and "condition subsequent" continue to be used by California courts. See, *e.g., Conley v PG&E* (2005) 131 CA4th 260, 269, 31 CR3d 719; *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 30 CR3d 631.

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§6.42 B. Express and Implied Conditions

Conditions may either be express or implied. Express conditions are ones stated in the contract, and are determined by the intent of the parties as disclosed in their agreement. Contract provisions will not be construed as conditions precedent in the absence of language plainly requiring such a construction. *Sosin v Richardson* (1962) 210 CA2d 258, 264, 26 CR 610.

Implied conditions may be either "implied in fact," *i.e.,* arising from an interpretation of the parties' agreement and the surrounding circumstances, or "implied in law," *i.e.,* to avoid injustice, irrespective of the parties' intent. *Spirtos v Moreno (In re Spirtos)* (BAP 9th Cir 1993) 154 BR 550, 555. Implied-in-law conditions are sometimes also referred to as "constructive conditions." Courts generally find constructive conditions in two instances: First, in bilateral contracts when the duties of both parties are to be performed at the same time and place, the law will usually imply concurrent constructive conditions making each party's obligation to perform dependent on the other party's performance. Whether concurrent conditions will be implied depends on whether each party's promises are dependent or independent of each other, which in turn depends on the parties' intent as reflected in their agreement. Second, in bilateral contracts for an agreed exchange, when one party has failed to perform but the failure is excusable and therefore not a material breach justifying an action for damages, the other party's duty to perform is discharged. In this situation, the first party's failure to perform is deemed the failure of a constructive condition on the grounds that it is unjust to compel one party—who cannot recover damages on account of the other party's failure to perform—to perform anyway without the benefit of the other's performance. 154 BR at 555.

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C. Conditions Precedent, Concurrent, Subsequent

§6.43 1. Conditions Precedent (CC §§1436, 1439)

Civil Code §1436 provides that "[a] condition precedent is one which is to be performed before some right dependent thereon accrues, or some act dependent thereon is performed." As stated by the California Supreme Court in *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 313, 24 CR2d 597, "a condition precedent is either an act of a party that must be performed or an uncertain event that must happen before the contractual right accrues or the contractual duty arises." See also *William R. Clarke Corp. v Safeco Ins. Co.* (1997) 15 C4th 882, 885, 64 CR2d 578; *Realmuto v Gagnard* (2003) 110 CA4th 193, 198, 1 CR3d 569.

Whether a condition precedent exists depends on the parties' intent as expressed in the words they have used in the contract. 110 CA4th at 199. The words "subject to" are normally construed to impose a condition precedent. *Rubin v Fuchs* (1969) 1 C3d 50, 81, 81 CR 373. Contract provisions will not be construed as conditions precedent unless the language clearly requires such a construction. Instead, if possible, the courts will construe the contract terms at issue as bilateral promises that are mutually dependent and concurrent. *Rubin,* 1 C3d at 53; *Sosin v Richardson* (1962) 210 CA2d 258, 264, 26 CR 610. "[S]tipulations in an agreement are not to be construed as conditions precedent unless such construction is required by clear, unambiguous language; and particularly so where a forfeiture would be involved or inequitable consequences would result." *Alpha Beta Food Mkts. v Retail Clerks Union Local 770* (1955) 45 C2d 764, 771, 291 P2d 433. Moreover, conditions precedent are not favored and will be strictly construed against any party asserting that a contract provision is a condition precedent to that party's duty to perform. *Marriage of Hasso* (1991) 229 CA3d 1174, 1182, 280 CR 919; *Helzel v Superior Court* (1981) 123 CA3d 652, 176 CR 740. See also *RC Royal Dev. & Realty Corp. v Standard Pac. Corp.* (2009) 177 CA4th 1410, 1420, 100 CR3d 115 (provision stating that broker's commission would be paid "through escrow at closing" set time commission would be paid and did not create condition precedent to earning the commission).

Civil Code §1439 provides:

> Before any party to an obligation can require another party to perform any act under it, he must fulfill all conditions precedent thereto imposed upon himself; and must be able and offer to fulfill all conditions concurrent so imposed upon him on the like fulfillment by the other party, except as provided by [CC §1440 on anticipatory repudiation (see §§8.69, 8.73)].

Civil Code §1439 reflects the common law rule that breach or failure of a material condition precedent may excuse the other party from performance. A party cannot recover for the other party's breach of contract unless the first party has fulfilled his or her obligations. *Wiz Technol., Inc. v Coopers & Lybrand LLP* (2003) 106 CA4th 1, 12, 130 CR2d 263 (corporate auditor's resignation justified by corporation's failure to satisfy condition precedent to auditor's performance).

"California's common law of contracts has traditionally allowed for the equitable excusal or remediation of nonoccurrence of conditions precedent in contracts when such nonoccurrence works a forfeiture." *Root v American Equity Specialty Ins. Co.* (2005) 130 CA4th 926, 939, 30 CR3d 631 (citing *Henck v Lake Hemet Water Co.* (1937) 9 C2d 136, 69 P2d 849, among other authorities). There is also a statutory basis for an antiforfeiture rule in CC §3275 (130 CA4th at 940):

> Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful, or fraudulent breach of duty.

In fact, it was §3275 that the *Henck* case expressly relied on to excuse the condition in that case. *Root,* 130 CA4th at 940.

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§6.44 2. Concurrent Conditions (CC §§1437, 1439)

Civil Code §1437 provides: "Conditions concurrent are those which are mutually dependent, and are to be performed at the same time." A contract may provide that the certain promises are mutually dependent and that the promises of both parties must be performed at the same time. In such a case, the performance of one party's promise is a concurrent condition of the other party's promise. As stated by the court in *Pittman v Canham* (1992) 2 CA4th 556, 559, 3 CR2d 340:

> Concurrent conditions are conditions precedent which are mutually dependent, and the only important difference between a concurrent condition and a condition precedent is that the condition precedent must be performed before another duty arises, whereas a tender of performance is sufficient in the case of a concurrent condition.

A classic example of a contract involving concurrent conditions is a sales transaction in which buyer and seller each make reciprocal promises to deposit funds and transfer documents into escrow on or before the closing date. The performance of each party's promise is a concurrent condition of the other. See, *e.g., Ninety Nine Invs., Ltd. v Overseas Courier Serv. (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 6 CR3d 891. In *Ninety Nine Invs., Ltd.,* the court noted (113 CA4th at 1134):

> The deposit into escrow of the deed and other pertinent instruments necessary to complete the transaction by the seller, and the deposit into escrow of the purchase price by the buyer are generally considered to be mutually dependent concurrent conditions, such that neither party is in default until one party performs or tenders performance.

See also *Patel v Liebermensch* (2008) 45 C4th 344, 350, 86 CR3d 366 (in real estate sales contract, delivery of deed and payment of purchase price are dependent, concurrent conditions). As provided in CC §1439, "[b]efore any party to an obligation can require another party to perform any act under it, he … must be able and offer to fulfill all conditions concurrent so imposed upon him on the like fulfillment by the other party." When the obligations of the parties are concurrent conditions, neither party can put the other in default unless he or she is able to perform or to tender performance. *Fogarty v Saathoff* (1982) 128 CA3d 780, 785, 180 CR 484; *Groobman v Kirk* (1958) 159 CA2d 117, 125, 323 P2d 867.

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§6.45 3. Conditions Subsequent (CC §1438)

Civil Code §1438 provides: "A condition subsequent is one referring to a future event, upon the happening of which the obligation becomes no longer binding upon the other party, if he chooses to avail himself of the condition." See also *Langford v Eckert* (1970) 9 CA3d 439, 444, 88 CR 429. Conditions subsequent are contract provisions specifying that, on the happening of a certain event, an existing duty will terminate or will otherwise be modified. Conditions subsequent are often used in contract termination provisions. See, *e.g., Hartman v San Pedro Commercial Co.* (1944) 66 CA2d 935, 936, 153 P2d 212 (employment contract terminable on sale of business or employee's entry into military). *Lowe v Copeland* (1932) 125 CA 315, 321, 13 P2d 522 (patent license terminated on failure of manufacturer to sell target number of products). An intent to create a condition subsequent must appear expressly or by clear implication, although no precise words are necessary. *Langford,* 9 CA3d at 445.

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§6.46 D. Condition of "Satisfaction"

If a contract provides that one party's satisfaction or approval is a condition precedent to that party's obligation to perform, and that party does not perform, California courts recognize two different tests for evaluating whether that party has breached the contract. Which test applies depends on the parties' intent as expressed in the contract, or, in the absence of any expressed intent, on the facts and circumstances of the case. If the contract contemplates that the party will make a purely subjective decision, that decision must be made in good faith. If not, the decision must be made in accordance with an objective standard of reasonableness. Courts have a preference for the reasonableness standard in the absence of any other factors. *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 58, 122 CR2d 267. See also *Mattei v Hopper* (1958) 51 C2d 119, 123, 330 P2d 625; *Larwin-Southern Cal., Inc. v JGB Inv. Co.* (1979) 101 CA3d 626, 639, 162 CR 52. In *Storek,* the defendant lender's obligation to continue to fund a commercial real estate construction project was conditional on the lender's satisfaction that the project's budget was in balance, *i.e.,* that the undisbursed amount of the loan would be adequate to cover all construction costs. The court found that the contract condition in *Storek* involved objectively determinable financial calculations; therefore, Citicorp's decision to stop funding should be evaluated under the objective, reasonable person standard. See also *Kadner v Shields* (1971) 20 CA3d 251, 97 CR 742 (objective standard applied to condition that terms and conditions of note and deed of trust to be assumed by homebuyers were subject to their prior approval).

The *Storek* court emphasized that, in this context, reasonableness and good faith are distinct concepts. A decision is unreasonable if it is arbitrary or capricious or lacks an evidentiary foundation. An absence of good faith, however, suggests a moral quality, such as deceit, dishonesty, or unfaithfulness. If a party has the right under a contract to make a purely subjective decision, that decision must be made in good faith, but the courts will not examine its reasonableness. Conversely, if a party's satisfaction is to be evaluated under an objective test, the validity of the party's decision of satisfaction or dissatisfaction depends solely on the reasonableness of that decision, and the courts will not examine that party's good faith. *Storek,* 100 CA4th at 59; *Guntert v City of Stockton* (1974) 43 CA3d 203, 210, 117 CR 601. The *Storek* court contrasted the contract at issue in *Locke v Warner Bros., Inc.* (1997) 57 CA4th 354, 66 CR2d 921, which enabled the defendant studio to exercise its own subjective creative judgment whether to accept any of the plaintiff's film proposals. In *Locke,* the studio was required to make its decisions honestly and in good faith, while in *Storek,* the lender's good faith was irrelevant. The *Locke* case is discussed further in §6.36.

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§6.47 E. Condition of "No Material Adverse Change"

An express condition to closing often negotiated by the buyer in sophisticated acquisition agreements is the absence of any "material adverse change" in (or "material adverse effect" on) the financial condition, business, or operations of the seller between the time of entering into the agreement and the closing date. These clauses (sometimes referred to as "MAC" or "MAE" clauses) may contain exceptions for changes affecting the economy as a whole or a certain industrial sector or for adverse weather or market conditions. As noted by the court in *In re IBP Shareholders Litig. v Tyson Foods, Inc.* (Del Ch 2001) 789 A2d 14, if not qualified, such clauses may put the seller at risk of a variety of uncontrollable factors that might materially affect its overall business or results of operation as a whole.

To date, there appear to be no published California state court decisions analyzing material adverse change (or material adverse effect) clauses, although such clauses have been at issue in reported decisions from Delaware and other states. See generally Zerbe, *The Material Adverse Effect Provision*: *Multiple Interpretations & Surprising Remedies*, 22 J L & Com 17 (Fall 2002); Galil, *Survey: MAC Clauses in a Materially Adversely Changed Economy*, 2002 Colum Bus L Rev 846 (2002).

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§6.48 F. Waiver of Conditions

A condition may be waived by the party for whose benefit the condition exists. *Galdjie v Darwish* (2003) 113 CA4th 1331, 1339, 7 CR3d 178; *Sabo v Fasano* (1984) 154 CA3d 502, 505, 201 CR 270. By exercising its right to waive a condition, the waiving party transforms a pair of mutually dependent obligations—duties that are concurrent conditions of each other—into independent obligations. The waiver may be express or implied. The most common example of implied waiver of conditions is when one party accepts partial or nonconforming performance by the other without a reservation of rights. See, *e.g., Galdjie,* 113 CA4th at 1339 (by their conduct, real estate sellers waived contract deadline for buyer to obtain loan commitment).

In *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 24 CR2d 597, the contract provided that a demand for arbitration had to be made within a stated time. The plaintiff's failure to make the demand within that time constituted a waiver of its right to arbitrate the dispute. The California Supreme Court noted: "the term 'waiver,' as used in the context of the failure to timely demand arbitration, refers not to a voluntary relinquishment of a known right, but to the loss of a right based on a failure to perform an obligation." 6 C4th at 314.

"[U]nder general contract principles, in the absence of consideration or estoppel, a waiver of a condition precedent may be retracted and the condition may be restored at any time." *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 58, 122 CR2d 267. Waivers may be retracted up to the point at which the other party materially changes position in reliance on the waiver, at which point the waving party is estopped to retract the waiver. If a party by words or conduct justifies the other party in believing that the first party will perform despite the other party's failure to satisfy a condition, and the other party relies on the first party's words or conduct to his or her substantial detriment, the condition is deemed waived. *Sosin v Richardson* (1962) 210 CA2d 258, 26 CR 610.

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§6.49 G. Conditions Resulting in Forfeiture (CC §1442)

Civil Code §1442 provides: "A condition involving a forfeiture must be strictly interpreted against the party for whose benefit it is created." Forfeiture of contract rights is not favored, and conditions will be construed to avoid a forfeiture if at all possible. See *Chase v Blue Cross* (1996) 42 CA4th 1142, 50 CR2d 178. In general, any ambiguity will be resolved in favor of an interpretation that avoids a forfeiture. *City of Palm Springs v Living Desert Reserve* (1999) 70 CA4th 613, 82 CR2d 859. In the real estate context, however, a "time is of the essence" clause may change the result. If a buyer fails to deposit funds necessary to complete the purchase by the time specified in a contract that contains a "time is of the essence" clause, the clause will be strictly enforced even if this results in a forfeiture of the buyer's right to purchase. See *Galdjie v Darwish* (2003) 113 CA4th 1331, 1338, 7 CR3d 178. Similarly, a party's failure to timely demand arbitration will generally result in a forfeiture of that party's contractual right to compel arbitration. *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 24 CR2d 597.

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§6.50 H. Excuse of Conditions (CC §§1440-1441)

In some circumstances, the nonperformance or nonoccurrence of a condition may be legally excused. For example, unlawful conditions are void. Civil Code §1441 provides that "[a] condition in a contract, the fulfillment of which is impossible or unlawful,… or which is repugnant to the nature of the interest created by the contract, is void." Further, a creditor's stated refusal to perform an obligation will entitle the debtor to enforce the obligation without performing or offering to perform any conditions running in favor of the creditor. As CC §1440 provides:

> If a party to an obligation gives notice to another, before the latter is in default, that he will not perform the same upon his part, and does not retract such notice before the time at which performance upon his part is due, such other party is entitled to enforce the obligation without previously performing or offering to perform any conditions upon his part in favor of the former party.

If a condition is legally excused, the obligation of the other party to the contract becomes unconditional and may be enforced. *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 319, 24 CR2d 597. But if a party has failed to satisfy a condition that was within its power to perform, the fact that the party did not thereby intend to surrender any rights under the contract does not excuse that party's failure. As stated by the court in *Platt Pac.,* "[a] contrary conclusion would undermine the law of contracts by vesting in one contracting party the power to unilaterally convert the other contracting party's conditional obligation into an independent, unconditional obligation notwithstanding the terms of the agreement." 6 C4th at 314. See also CC §1439; *Wiz Technol., Inc. v Coopers & Lybrand LLP* (2003) 106 CA4th 1, 12, 130 CR2d 263. The basic principle is that a party may not take advantage of his or her own act or omission to escape liability. If a party prevents or renders impossible the performance or occurrence of a condition, the condition is excused and the other party may enforce the contract. *Jacobs v Tenneco W., Inc.* (1986) 186 CA3d 1413, 1418, 231 CR 351.

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V. INDEMNITY AGREEMENTS

§6.51 A. Generally (CC §2772)

Definition, examples. Civil Code §2772 defines "indemnity" as "a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person." It is the obligation of one party to make good a loss or damage that another party has incurred. *Crawford v Weather Shield Mfg., Inc.* (2008) 44 C4th 541, 79 CR3d 721; *E.L. White, Inc. v City of Huntington Beach* (1978) 21 C3d 497, 506, 146 CR 614. Insurance policies are perhaps the most common form of indemnity agreement. In addition, contracts in many business acquisition and licensing transactions include provisions under which a party agrees to indemnify and hold the other harmless against any breach of a representation or warranty given by the first party. Attorney fee clauses are yet another common example of express indemnity agreements. See, *e.g., Baldwin Builders v Coast Plastering Corp.* (2005) 125 CA4th 1339, 24 CR3d 9. Attorney fee clauses are discussed in §§9.10-9.27. Indemnity agreements are also common in the construction industry. See, *e.g., Crawford v Weather Shield Mfg., Inc.*, *supra.*

Sections 6.51-6.59 present a general overview of the law of indemnity, including statutes in the Civil Code (see §§6.52-6.59), but counsel addressing issues arising under insurance policies should also consult California Liability Insurance Practice: Claims & Litigation (Cal CEB 1991) or other insurance law treatises.

Second party or third party claims. The definition of "indemnity" in CC §2772 encompasses both agreements to indemnify against liability arising from the conduct of a party to the contract, as well as the liability of a contracting party to a third person. Indemnification agreements ordinarily cover third party claims, but are not limited to such claims if the parties use the term "indemnity" to include direct liability. Like other contracts, indemnity agreements are interpreted according to the language used as well as the parties' intent as expressed in the contract. *Dream Theater, Inc. v Dream Theater* (2004) 124 CA4th 547, 555, 21 CR3d 322 (indemnity agreement covered not only third party claims but also any breach of buyer's obligations to seller). *Queen Villas Homeowners Ass'n v TCB Prop. Mgmt.* (2007) 149 CA4th 1, 56 CR3d 528 (limiting indemnity agreement to third party claims despite use of both the terms "indemnity" and "hold harmless").

Express or implied contractual indemnity and equitable indemnity. In general, the obligation to indemnify may arise from either of two sources. First, it may be expressly provided for by contract. This is referred to as "express contractual indemnity." *Prince v PG&E* (2009) 45 C4th 1151, 1159, 90 CR3d 732. Second, it may be implied from a contract that does not specifically mention indemnity (so-called "implied contractual indemnity"; see, *e.g.*, *Bay Dev., Ltd. v Superior Court* (1990) 50 C3d 1012, 269 CR 720) or it may arise from equitable considerations in a particular case ("equitable indemnity"). *E.L. White, Inc. v City of Huntington Beach* (1978) 21 C3d 497, 506, 146 CR 614. Although the doctrines of implied contractual indemnity and equitable indemnity arose separately and are sometimes characterized as distinct categories of indemnity (see, *e.g., Rossmoor Sanitation, Inc. v Pylon, Inc.* (1975) 13 C3d 622, 628, 119 CR 449), the *Bay Dev*. court noted that implied contractual indemnity is really a species of equitable indemnity. *Bay Dev., Ltd.,* 50 C3d at 1029 n10. See also *Prince*, 45 C4th at 1157 ("Though not extinguished, implied contractual indemnity is now viewed simply as 'a form of equitable indemnity'"). Equitable indemnity is discussed in §6.58.

Indemnity against indemnitee's own negligence. Contracting parties may, by use of specific language in express indemnity provisions, establish a duty on the part of the indemnifying party to hold the indemnitee harmless from the results of even active negligence by the indemnitee. The contract language must be sufficiently specific, however, to alert the indemnitor of the full extent of its obligation. *Prince v PG&E, supra*; *Crawford v Weather Shield Mfg., Inc.* (2008) 44 C4th 541, 79 CR3d 721; *Bay Dev., Ltd.,* 50 C3d at 1033. In the absence of such language, the contract will be construed to provide indemnification to the indemnitee for only the passive negligence of the indemnitee. And even an indemnitee who has been only passively negligent may be prevented from being indemnified if the contract provides indemnity only for liabilities resulting from acts of the indemnitor and not from acts of others. *Bay Dev., Ltd. v Superior Court, supra*; *E.L. White, Inc. v City of Huntington Beach* (1978) 21 C3d 497, 507, 146 CR 614. Passive negligence is understood as "mere nonfeasance," while active negligence exists if the indemnitee personally participated in an

affirmatively negligent act, was associated with negligent acts or omissions through knowledge or acquiescence, or failed to perform an obligation that the indemnitee had agreed to perform. *Rooz v Kimmel* (1997) 55 CA4th 573, 64 CR2d 177. See also *Heppler v J.M. Peters Co.* (1999) 73 CA4th 1265, 87 CR2d 497.

Indemnity against liability or against loss. An indemnity against "liability" becomes collectible at the time when the indemnitee becomes legally liable to another. See CC §2778(1). The indemnitee need not prove that he or she has incurred an actual loss, but only that the indemnitee has become liable. In general, liability is established when a judgment is rendered against the indemnitee concerning the matter indemnified against, even though the judgment is unpaid. In contrast, an indemnity against items such as claims, demands, losses, or damages becomes collectible only after the indemnitee has paid the item, *i.e.,* incurred an actual out-of-pocket loss. See CC §2778(2). Both types of indemnity may be covered in the same agreement. *Alberts v American Cas. Co.* (1948) 88 CA2d 891, 898, 200 P2d 37. See also §6.55.

Interpretation of indemnity agreements. In general, indemnity agreements are construed in the same manner as other contracts. The primary objective is to give effect to the mutual intent of the parties as it existed at the time of contracting, and the parties' intent is determined in the first instance from the language of the entire contract. The scope of a party's obligation to indemnify is determined by the language of the contract. *Prince v PG&E, supra*; *Crawford v Weather Shield Mfg., Inc., supra.* The Civil Code includes a series of rules for interpreting indemnity agreements, which are discussed in §6.55. These rules are considered as much a part of the contract as the contractual language itself, unless a contrary intention is expressed. 44 C4th at 551; *Girbaldo, Jacobs, Jones & Assocs. v Agrippina Versicherunges A.G.* (1970) 3 C3d 434, 442, 91 CR 6. Outside the insurance context, ambiguities in indemnity agreements are generally construed against the indemnitee, who may often have superior bargaining power. However, ambiguities in insurance policies are construed against the insurer. *Crawford v Weather Shield Mfg., Inc*., 44 C4th at 552. See generally §5.17.

Example of express indemnity against breach of representation and warranty. Following is an example of an express contractual indemnity covering a seller's representations and warranties in an asset sale agreement, which was at issue in *Quality Wash Group V, Ltd. v Hallak* (1996) 50 CA4th 1687, 1693, 58 CR2d 592.

> **Seller makes the following representations regarding the assets:… The title to all assets of the business [is] vested in the corporation… and [is] free from any liens and/or encumbrances….**
>
> **Seller and corporation warrant that all the above representations are true and hereby [hold] buyer harmless from any damage resulting from their falsity. This warranty shall be true as of the close and shall survive the close. Seller and corporation agree to hold buyer harmless from all loss, liability, tax or expense arising out of any claim or other loss resulting directly or indirectly from the assertion against seller or corporation of any claim arising from facts existing before the transfer of the corporate stock provided by this agreement and not fully disclosed or expressly excepted by the provisions hereof.**

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B. Indemnity Agreements Under the Civil Code

§6.52 1. Agreements to Indemnify Against Past or Future Wrongful Acts (CC §§2773-2774)

Civil Code §2773 provides that "[a]n agreement to indemnify a person against an act thereafter to be done is void, if the act be known by such person at the time of doing it to be unlawful." In contrast, CC §2774 provides that "[a]n agreement to indemnify a person against an act already done, is valid, even though the act was known to be wrongful, unless it was a felony." These Civil Code provisions apply specifically to indemnity agreements and must be distinguished from CC §1668 (discussed in §3.40), which generally invalidates contracts by which a party seeks to escape liability to a victim who has suffered injury on account of that party's own unlawful conduct. See *Safeco Ins. Co. v Robert S.* (2001) 26 C4th 758, 767, 110 CR2d 844; *Lemat Corp. v American Basketball Ass'n* (1975) 51 CA3d 267, 279, 124 CR 388. If both past and future acts are covered by an indemnity agreement or if any part of an indemnity agreement involves a future act, CC §2773 applies to the exclusion of CC §2774. As stated by the court in *Lemat Corp.* (51 CA3d at 279; emphasis in original):

> Both section 2773 and section 2774 are intended to prevent the encouragement of illegal acts. Section 2773, concerned with future acts, involves a potential for *increased* damage to society from future unlawful acts. In section 2774, the act and any damage therefrom have been accomplished.

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§6.53 2. Extension to Acts of Agents (CC §2775)

Civil Code §2775 provides that "[a]n agreement to indemnify against the acts of a certain person, applies not only to his acts and their consequences, but also to those of his agents." As an example, if a subcontractor agrees to indemnify a general contractor for any damages to the project owner's property caused by the subcontractor's operations, the indemnity extends to acts or omissions of the subcontractor's employees as well as the subcontractor.

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§6.54 3. Multi-Party Indemnifications (CC §§2776-2777)

Civil Code §2776 provides that "[a]n agreement to indemnify several persons applies to each, unless a contrary intention appears." Civil Code §2777 provides that "[o]ne who indemnifies another against an act to be done by the latter is liable jointly with the person indemnified, and separately, to every person injured by such act."

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§6.55 4. Rules of Interpretation (CC §2778)

Civil Code §2778 sets forth a series of rules for interpretation of indemnity clauses. The rules apply unless a contrary intention is expressed in the agreement. *Crawford v Weather Shield Mfg., Inc.* (2008) 44 C4th 541, 79 CR3d 721; *Gribaldo, Jacobs, Jones & Assocs. v Agrippina Versicherunges A.G.* (1970) 3 C3d 434, 442, 91 CR 6. The rules are as follows:

- Civil Code §2778(1) states that "[u]pon an indemnity against liability, expressly, or in other equivalent terms, the person indemnified is entitled to recover upon becoming liable." As noted in §6.51, there are two types of indemnity agreements: indemnities against liability and indemnities against loss. Civil Code §2778(1) addresses the first type, under which an indemnitee need not prove actual out-of-pocket loss but only that he or she has become liable. Without having paid anything, the indemnitee may recover from the indemnitor as soon as liability is legally imposed. *Alberts v American Cas. Co.* (1948) 88 CA2d 891, 898, 200 P2d 37.
- Civil Code §2778(2) addresses the second type of indemnity, an indemnity against loss: "Upon an indemnity against claims, or demands, or damages, or costs, expressly, or in other equivalent terms, the person indemnified is not entitled to recover without payment thereof." Under this type of indemnity, the indemnitee must prove an actual loss incurred, typically an out-of-pocket payment to a third party. See *Gribaldo, Jacobs, Jones & Assocs. v Agrippina Versicherunges A.G.* (1970) 3 C3d 434, 91 CR 6; *Alberts v American Cas. Co.* (1948) 88 CA2d 891, 898, 200 P2d 37. Note that an indemnity for punitive damages is unenforceable. *Ford Motor Co. v Home Ins. Co.* (1981) 116 CA3d 374, 172 CR 59.
- Civil Code §2778(3) provides that "[a]n indemnity against claims, or demands, or liability, expressly, or in other equivalent terms, embraces the costs of defense against such claims, demands, or liability incurred in good faith, and in the exercise of a reasonable discretion." If the indemnity is only an indemnity against actual loss, then, under CC §2778(3), the indemnity covers only the costs of defense of claims actually paid by the indemnitee. *Gribaldo, Jacobs, Jones & Assocs.,* 3 C3d at 447. Absent language to the contrary in the agreement, a tender of defense is not a prerequisite to the duty to reimburse costs and fees incurred by the indemnitee in defending the action. *City of Watsonville v Corrigan* (2007) 149 CA4th 1542, 58 CR3d 458.
- Civil Code §2778(4) addresses the duty to defend. It states that "[t]he person indemnifying is bound, on request of the person indemnified, to defend actions or proceedings brought against the latter in respect to the matters embraced by the indemnity, but the person indemnified has the right to conduct such defenses, if he chooses to do so." In *Crawford v Weather Shield Mfg., Inc.* (2008) 44 C4th 541, 553, 79 CR3d 721, the court held that an indemnity agreement in which a subcontractor agreed to "defend any suit or action" against a developer founded on any claim "growing out of the execution of the [subcontractor's] work" required the subcontractor to provide a defense to a suit against the developer even if the subcontractor was found not to have been negligent. In *United States Elevator Corp. v Pacific Inv. Co.* (1994) 30 CA4th 122, 125, 35 CR2d 382, the court relied on CC §2778(4) in holding that, unless a contrary intention appears, an indemnitor is required to defend matters covered by the indemnity agreement on request of the indemnitee, or else to pay the indemnitee's defense costs. The indemnitor in *United States Elevator* did not avoid its duty by settling with the third party without liability or contribution by indemnitee.
- Civil Code §2778(5)-(7) address the potential lack of incentive in litigation of a defendant entitled to indemnification. A defendant entitled to be indemnified may or may not assert defenses with the same vigor as it would if it had no prospect of indemnification. Civil Code §2778(5) provides that "[i]f, after request, the person indemnifying neglects to defend the person indemnified, a recovery against the latter suffered by him in good faith, is conclusive in his favor against the former." The phrase "recovery… suffered" has been interpreted to mean only a recovery by judgment against the indemnitee, and not a stipulated settlement. *Peter Culley & Assocs. v Superior Court* (1992) 10 CA4th 1484, 1495, 13 CR2d 624.
- Civil Code §2778(6) provides that "[i]f the person indemnifying, whether he is a principal or a surety in the agreement, has not reasonable notice of the action or proceeding against the person indemnified, or is not

allowed to control its defense, judgment against the latter is only presumptive evidence against the former." In *California State Auto. Ass'n Inter-Ins. Bureau v Superior Court* (1990) 50 C3d 658, 268 CR 284, the insurer did receive notice and participated in the settlement negotiations, but the court noted that, under CC §2778(6), if the insurer had not received reasonable notice of the settlement, or had not been allowed to control the insured's defense, any stipulated judgment would only be presumptive evidence of the insured's liability. 50 C3d at 665 n5.

- Finally, CC §2778(7) provides that "[a] stipulation that a judgment against the person indemnified shall be conclusive upon the person indemnifying is inapplicable if he has a good defense upon the merits, which by want of ordinary care he failed to establish in the action."

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§6.56 5. Reimbursement (CC §2779)

Civil Code §2779 provides that "[w]here one, at the request of another, engages to answer in damages, whether liquidated or unliquidated, for any violation of duty on the part of the latter, he is entitled to be reimbursed in the same manner as a surety, for whatever he may pay." Like a surety, an indemnitor is entitled to reimbursement from the party who is primarily liable. There appear to be no cases interpreting CC §2779, but the reimbursement rights of sureties are addressed in CC §2847, which generally provides that a principal is obligated to reimburse a surety for all amounts disbursed by the surety (including necessary costs and expenses) in satisfaction of all or part of the principal's obligation, with or without legal proceedings.

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Source: Business Law/California Law of Contracts/6 Representations, Warranties, Covenants, Conditions, Indemnities/ §6.57 6. Indemnification Provisions in Construction and Hauling Contracts (CC §§2782-2784.5)

§6.57 6. Indemnification Provisions in Construction and Hauling Contracts (CC §§2782-2784.5)

The Civil Code also includes a series of statutes regulating indemnification provisions in construction contracts (see CC §§2782-2784) and hauling, truckage, or cartage contracts (see CC §2784.5). In general, these statutes declare that agreements purporting to indemnify a party against liability for damages for death or personal injury, property damage, or any other loss arising from the negligence or willful misconduct of that party or its agents are against public policy and void.

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§6.58 C. Equitable Indemnity

As noted in §6.51, California courts have identified two types of equitable indemnity. One arises from a contractual relationship (implied contractual indemnity) and the other arises in tort. The tort-based doctrine of equitable indemnity applies only among defendants who are jointly and severally liable in tort to a plaintiff, generally based on a duty owed to the plaintiff, although vicarious liability and strict liability also may provide a basis for application of equitable indemnity. It is essentially a claim for contribution among joint tortfeasors. See *Prince v PG&E* (2009) 45 C4th 1151, 1159, 90 CR3d 732; *BFGC Architects Planners, Inc. v Forcum/Mackey Constr., Inc.* (2004) 119 CA4th 848, 852, 14 CR3d 721.

Implied contractual indemnity is a form of equitable indemnity that is predicated on a breach of contract by the indemnitor. It is designed to apportion loss among contracting parties based on the principle that one who enters a contract agrees to perform the work carefully and to discharge foreseeable damages resulting from a breach. *Sehulster Tunnels/Pre-Con v Traylor Bros., Inc./Obayashi Corp.* (2003) 111 CA4th 1328, 1350, 4 CR3d 655. The *Sehulster Tunnels* case involved a sewage tunnel project for the City of San Diego. The subcontractor supplied the general contractor with precast concrete ring segments for lining the tunnel, but the segments had to be recast after the general contractor changed the tunnel design. The court of appeal affirmed a trial court judgment holding the general contractor liable for the subcontractor's cost overruns, but denied the general contractor a claim against the city based on an implied contractual indemnity theory. The court held that the city was not required to indemnify the general contractor because the city was not in breach of its prime contract with the general contractor. See also *Prince v PG&E, supra* ("implied contractual indemnity, like traditional equitable indemnity, is subject to comparative equitable apportionment of loss"); *Bay Dev., Ltd. v Superior Court* (1990) 50 C3d 1012, 269 CR 720 (implied contractual indemnity claim denied); *Garlock Sealing Technols., LLC v NAK Sealing Technols. Corp.* (2007) 148 CA4th 937, 56 CR3d 177 (implied contractual indemnity does not require negligent breach of contract).

As in the case of traditional equitable indemnity, implied contractual indemnity is subject to the rule "there can be no indemnity without liability." *Prince v PG&E, supra*. A defendant in an equitable indemnity action may utilize "whatever immunities or other limitations on liability would otherwise be available against the injured party." 45 C4th at 1161.

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§6.59 D. Guaranty and Suretyship Contracts Distinguished

An indemnification agreement is distinct from a guaranty or surety contract. Compare CC §2772 ("Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person") with CC §2787 ("A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor"). See also *First Nat'l Ins. Co. v Cam Painting, Inc.* (2009) 173 CA4th 1355, 93 CR3d 808. As the court in *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 1309, 37 CR3d 83, explained:

> A guarantor makes a direct promise to perform the principal's obligation in the event the principal fails to perform. An indemnitor does not make a direct promise to perform the principal's obligation, but promises to reimburse the indemnitee for losses suffered or to hold the indemnitee harmless.

In *Trust One Mortgage,* the court held that an indemnification provision of a broker's agreement with a real estate lender was an indemnity and not a loan guaranty, and therefore the antideficiency statute (CCP §580d) did not bar its enforcement following a judicial foreclosure on the borrowers' default. The indemnification clause at issue was not a direct promise by the broker to perform all of the borrowers' obligations, but rather only an agreement to indemnify losses or repurchase loans in the event of a borrower's early default or fraud on the loan application. It had been executed in a separate transaction well in advance of the loan at issue.

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7

Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations

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§7.1 I. INTRODUCTION

This chapter discusses the general principles of assignment and delegation as reflected in the Civil Code (see §§7.2-7.36), assignment and delegation of contracts for the sale or lease of goods (see §§7.37-7.60), third party beneficiaries (see §§7.61-7.68), and joint and several liabilities and rights arising under contracts (§§7.69-7.80).

The following specialized topics related to third party rights and liabilities are subject to special statutory regimes and are beyond the scope of this title: (1) assignment, delegation, and subleasing in the context of real estate leases (see California Landlord-Tenant Practice (2d ed Cal CEB 1997)); (2) assignments of rents, leases, and other contracts in real estate financing transactions, and assignments of deeds of trust and other real estate security documents (see California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009)); (3) assignments of negotiable instruments, letters of credit, documents of title, and investment securities, governed by Divisions 3, 5, 7, and 8 of the Commercial Code respectively; (4) grants of security interests in personal property and assignments of accounts or payment rights in commercial financing transactions governed by Division 9 of the Commercial Code (see §7.4; Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001)); and (5) guaranty and suretyship relationships (see CC §§2787-2856).

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II. ASSIGNMENT AND DELEGATION

§7.2 A. Definition of Assignment (CC §1039)

The term "assignment" is not used in the Civil Code in reference to assignments of contract rights or delegation of contractual obligations. Instead, the Civil Code uses the more general term "transfer." Civil Code §1039 defines "transfer" as "an act of the parties, or of the law, by which the title to property is conveyed from one living person to another." The statute authorizing transfers (assignments) of contract rights is CC §1458, which provides that "[a] right arising out of an obligation is the property of the person to whom it is due, and may be transferred as such." As stated by the court in *McCown v Spencer* (1970) 8 CA3d 216, 225, 87 CR 213, "[t]o 'assign' ordinarily means to transfer title or ownership of property." See also *Hudson Props. Co. v Governing Bd.* (1985) 168 CA3d 63, 72, 213 CR 909, stating that an assignment is the "*transfer* of title to any kind of property" (citations omitted).

The term "assignment" is sometimes used to refer to both assignment and delegation. Under both the Restatement (Second) of Contracts §328 (1981) and the Uniform Commercial Code (see Com C §§2210(5), 10303(e); §§7.43, 7.58), an assignment of "the contract" or of all of the assignor's "rights under the contract" or an assignment in similar general language constitutes an assignment of rights and a delegation of duties, unless the language of the assignment or the surrounding circumstances indicate otherwise. More commonly, however, the term "assignment" refers only to a transfer of contract rights, and the term "delegation" is used to refer to a transfer of contractual duties or obligations. See Restatement (Second) of Contracts §316, Comment c (1981). See, *e.g.*, *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 396, 21 CR3d 404. Delegation of contractual duties is discussed in §§7.30-7.34.

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B. Principles of Assignment

§7.3 1. Assignment of Contract Rights (CC §1458)

Civil Code §1458 provides generally for the transferability of contract rights, as follows: "A right arising out of an obligation is the property of the person to whom it is due, and may be transferred as such." California statutes "clearly manifest a policy in favor of the free transferability of all types of property, including rights under contracts." *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 222, 308 P2d 732 (citing CC §§954, 1044, 1458). See also CC §711; *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 396, 21 CR3d 404; *Robert H. Jacobs, Inc. v Westoaks Realtors, Inc.* (1984) 159 CA3d 637, 645, 205 CR 620. The general rule is designed "to facilitate the freest possible transfer of valuable contract rights, while at the same time respecting the parties' intentions." *Farmland Irrig. Co.,* 48 C3d at 222. In the *Farmland Irrig.* case, the California Supreme Court held that contract rights under a patent license agreement were freely transferable in the absence of an express provision in the contract against assignment, and that the assignment was not preempted by federal patent law. See also *Superbrace v Tidwell, supra*.

NOTE: California real estate mortgages and deeds of trust are governed by special Civil Code provisions (CC §§2920-2944.6), which are beyond the scope of this title. Assignments of real estate leases or rents as collateral security are regulated in detail by CC §2938. Civil Code §2936 provides that an assignment of a debt secured by a mortgage carries with it the security. See California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009) for further discussion of assignments of real estate security documents.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/ 2. Assignments of Rights to Payment; Nonnegotiable Instruments/§7.4 a. Relationship to UCC; Definition of 'Account' (Com C §§9102, 9109)

2. Assignments of Rights to Payment; Nonnegotiable Instruments

§7.4 a. Relationship to UCC; Definition of "Account" (Com C §§9102, 9109)

Assignments or transfers of rights to payment under executory or executed contracts may be governed by Division 9 of the Commercial Code or by the Civil Code and common law, depending on the nature of the right to payment. Commercial Code §9102(a)(2) defines "account" as

> a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred.... The term includes health care insurance receivables.

The term "account" therefore broadly includes any right to payment under a contract for property or services, whether the payment right arises from an obligation that has been performed or one that is yet to be performed. See Official Comment 5 to UCC §9-102. Note that this definition includes accounts and other payment rights arising under contracts such as software licenses that are not otherwise subject to the UCC. Among other things, however, the term "account" does not include rights to payment evidenced by chattel paper or an instrument. See Com C §9102(a)(2), (47).

NOTE: Assignments or transfers of negotiable instruments (as defined in Com C §3104), such as promissory notes or checks, are subject to Divisions 3 and 9 of the Commercial Code. See Com C §§3203, 9109(a)(3). Discussion of negotiable instruments, including rights acquired by transfer, is beyond the scope of this title. The term "chattel paper" includes receivables under leases of goods. See Com C §9102(a)(11). Lease financing transactions involving chattel paper are subject to Division 9. An in-depth discussion of lease financing is beyond the scope of this title. Assignments or transfers of rights and obligations under leases of goods are discussed generally in §§7.53-7.60.

By its terms, Division 9 of the Commercial Code applies generally to sales or assignments of accounts (as well as to sales of chattel paper, payment intangibles, and promissory notes). Com C §9109(a)(3). See also Com C §1201(b)(35) (former Com C §1201(36)(a)) (definition of "security interest"); Com C §9102(a)(72) (definition of "secured party"). Division 9 is intended to regulate sales of accounts that constitute commercial financing transactions. See Official Comment 12 to UCC §9-102. Therefore, several particular types of sales or assignments of accounts are excluded from Division 9, including (Com C §9109(d)(3)-(7)):

- Assignments of claims for wages, salary, or other compensation of an employee (see §7.29);
- Sales of accounts, chattel paper, payment intangibles, or promissory notes as part of a sale of the business out of which they arose;
- Assignments of accounts, chattel paper, payment intangibles, or promissory notes for collection purposes only;
- An assignment of a right to payment under a contract to an assignee who is also obligated to perform under the contract; and
- An assignment of a single account, payment intangible, or promissory note to an assigned in full or partial satisfaction of a preexisting debt.

In general, the exclusions are intended to carve out from Division 9 certain types of assignments of receivables that are unrelated to commercial financing. See Official Comment 12 to UCC §9-102. The sales or assignments of accounts excluded from Division 9 will be governed by the Civil Code and other applicable law.

A detailed discussion of commercial financing transactions (including sales of accounts) subject to Division 9 of the Commercial Code is beyond the scope of this title. See Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001). However, certain provisions of Division 9 that affect the ability of an account debtor to assert claims or defenses against an assignee and that render antiassignment clauses unenforceable are noted briefly in context below.

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§7.5 b. Transfers of Nonnegotiable Instruments (CC §1459)

Civil Code §1459 provides that a nonnegotiable written contract for the payment of money or other property may be transferred by endorsement, but that the assignee remains subject to any defenses that the other party to the contract had against the assignor:

> A non-negotiable written contract for the payment of money or personal property may be transferred by indorsement, in like manner with negotiable instruments. Such indorsement shall transfer all the rights of the assignor under the instrument to the assignee, subject to all equities and defenses existing in favor of the maker at the time of the indorsement.

Under CC §1459, an assignment of a right to payment transfers all of the rights and interest of the assignor to the assignee. "The assignee 'stands in the shoes' of the assignor, taking his rights and remedies, subject to *any defenses* which the *obligor* has against the assignor prior to notice of the assignment." *Royal Bank Export Fin. Co. v Bestways Distrib. Co.* (1991) 229 CA3d 764, 768, 280 CR 355. For further discussion of the rights of the nonassigning party (the account debtor) against the assignee, see §7.16.

Civil Code §1459 should be read together with CC §§955 and 955.1, discussed in §7.10, concerning when certain transfers of nonnegotiable instruments or accounts are deemed to be perfected as against third persons.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.6 3. Assignments of Choses in Action (CC §§953-954; CCP §§368, 368.5)

§7.6 3. Assignments of Choses in Action (CC §§953-954; CCP §§368, 368.5)

Civil Code §§953 and 954 address transfers of choses in action, also known as things in action. A chose in action is essentially a litigation claim or cause of action, and is a form of personal property. *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 23 CR3d 233. Civil Code §953 defines "thing in action" as "a right to recover money or other personal property by a judicial proceeding." See also *People v Kozlowski* (2002) 96 CA4th 853, 117 CR2d 504; *Bush v Superior Court* (1992) 10 CA4th 1374, 1381, 13 CR2d 382. Transfers of certain choses in action are expressly authorized by CC §954, which provides that "[a] thing in action, arising out of the violation of a right of property, or out of an obligation, may be transferred by the owner." See also CCP §368.5. Civil Code §954 thus authorizes transfers of causes of action based on breach of contractual obligations, and a cause of action for breach of contract may be validly assigned without a formal assignment of the underlying contract, although the underlying contract rights that give rise to the litigation claim would follow the assignment of the claim. See CC §1084.

NOTE: Civil Code §954 does not authorize transfers of things in action arising out of violations of personal rights, such as causes of action in tort for defamation, personal injury, or emotional distress. See *Murphy v Allstate Ins. Co.* (1976) 17 C3d 937, 942, 132 CR 424; *McLaughlin v National Union Fire Ins. Co.* (1994) 23 CA4th 1132, 1147, 29 CR2d 559. Similarly, claims for legal malpractice cannot be assigned. *Musser v Provencher* (2002) 28 C4th 274, 285, 121 CR2d 373. A claim that has been merged into a judgment, however, is assignable in accordance with CC §954.5. *Portillo v Farmers Ins. Exch.* (1965) 238 CA2d 58, 62, 47 CR 450. See also *Great W. Bank v Kong* (2001) 90 CA4th 28, 31, 108 CR2d 266.

In general, like the assignee of a contract right (see §7.16), the assignee of a thing in action stands in the shoes of the assignor, taking the assignor's rights and remedies subject to any right of offset or other claims or defenses of the other party against the assignor before the other party receives actual notice of the assignment. *Brienza v Tepper* (1995) 35 CA4th 1839, 1848, 42 CR2d 690. See also CCP §368.

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§7.7 4. Assignments of After-Acquired Rights, Future Interests (CC §1045)

Civil Code §1045 provides that "[a] mere possibility, not coupled with an interest, cannot be transferred." In spite of CC §1045, California courts will enforce assignments of contingent expectancies, provided that the assignment is "fairly made, supported by valuable consideration, and not against public policy." *Bank of Cal. v Connolly* (1973) 36 CA3d 350, 366, 111 CR 468 (agreement to share profits from future land sale was enforceable, did not involve "a *mere* naked hope" (emphasis in original)). In *Dougherty v California Kettleman Oil Royalties, Inc.* (1937) 9 C2d 58, 69 P2d 155, the court stated that CC §1045 applies to assignments of legal rights only, and not in cases where equitable principles are properly invoked. "Equity… has always recognized assignments of contingent interests and expectations." 9 C2d at 89. However, the distinction between assignments of expectancies coupled with an interest and those enforceable only in equity is now a matter of historical interest only. *Bank of California,* 36 CA3d at 367. See also §7.11 regarding equitable assignments.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/ 5. How Made/§7.8 a. Assignments of Contract Rights Generally (CC §§1040, 1052-1056, 1084)

5. How Made

§7.8 a. Assignments of Contract Rights Generally (CC §§1040, 1052-1056, 1084)

No particular form of assignment is required for a voluntary assignment of a contract right to be effective. It is essential, however, for the assignor to manifest an intention to transfer the right, either to the transferee or to a third person, without further action or manifestation of intention. *Sunburst Bank v Executive Life Ins. Co.* (1994) 24 CA4th 1156, 1164, 29 CR2d 734; *Hudson Props. Co. v Governing Bd.* (1985) 168 CA3d 63, 72, 213 CR 909; *Wheelon v Patco, Inc.* (1968) 258 CA2d 71, 74, 65 CR 533. The substance, rather than the form of the transaction, determines whether an assignment was intended. If it clearly appears from the entire transaction and the parties' conduct that the parties' intent was to pass title, an assignment will be found to have taken place. The parties' intent is of key significance. *Recorded Picture Co. (Prods.) Ltd. v Nelson Entertainment, Inc.* (1997) 53 CA4th 350, 368, 61 CR2d 742; *McCown v Spencer* (1970) 8 CA3d 216, 225, 87 CR 213.

The Civil Code provisions governing the formalities of assignments of contract rights are CC §§1040, 1052-1057, and 1059. Civil Code §1052 authorizes oral transfers, unless a writing is expressly required by statute, *e.g.,* as in the case of assignments of wages (see Lab C §300(b); §7.29). In determining whether a valid assignment has been made, the court may find an assignment based on the conduct of the parties, apart from the terms of any writing. *McCafferty v Gilbank* (1967) 249 CA2d 569, 575, 57 CR 695. The Civil Code refers to transfers in writing as "grants," whether the subject of the transfer is real property or personal property. See CC §1053. Under CC §1054, delivery is required for a grant to take effect, and CC §1055 creates a presumption that a duly executed grant has been delivered on its date. Further, CC §1056 provides that delivery is necessarily absolute; the grant takes effect on delivery. A grant cannot be delivered to the grantee conditionally, although (like a real estate deed) it may be deposited in an escrow in accordance with CC §1057 to be delivered on performance of a condition. See also CC §1059 regarding constructive delivery of a grant. Civil Code §1066 provides that assignments are to be interpreted in the same manner as contracts generally, subject to limited exceptions set forth in CC §§1067-1070.

An assignment may also occur by operation of law under CC §1084, which provides that "[t]he transfer of a thing transfers also all its incidents, unless expressly excepted; but the transfer of an incident to a thing does not transfer the thing itself." In *Champion Home Builders Co. v Sipes* (1990) 219 CA3d 1415, 1425, 269 CR 75, the court of appeal held that the defendants' personal guaranties of a debt of their recreational vehicle dealership to a finance company had been validly assigned to the plaintiff, although the guaranties had never been specifically assigned in writing. The guaranteed debt had been transferred from the finance company to the plaintiff, and that transfer included the defendants' guaranties by operation of law under CC §1084. Moreover, under CC §1052, the assignment of the guaranties was not required to be in writing. Insurance policies, however, are subject to different rules. In *General Acc. Ins. Co. v Superior Court* (1997) 55 CA4th 1444, 64 CR2d 781, the court held that a corporation that had been found to be the successor-in-interest to an asbestos distributing company for purposes of asbestos tort liability was not entitled, by operation of law, to the insurance coverage provided by the insurer-defendants to the corporation's predecessor-in-interest. The court ruled that the law can impose tort liability on a successor corporation, but cannot impose a contractual insurance relationship between an insurer and a stranger to the insurance contract. The successor corporation had never paid a premium or been subjected to an underwriting analysis.

Civil Code §1040 provides that consideration is not necessary for the validity of a voluntary transfer or assignment. Therefore, a gratuitous assignment can be effective. *First Nat'l Bank v Pomona Tile Mfg. Co.* (1947) 82 CA2d 592, 603, 186 P2d 693. See, *e.g., Enoch v Lothrop* (1964) 227 CA2d 424, 38 CR 703. Some California cases, however, recite that consideration is a requirement for a valid assignment. See, *e.g., Bank of Cal. v Connolly* (1973) 36 CA3d 350, 366, 111 CR 468; *Smith v Harris* (1954) 127 CA2d 311, 316, 273 P2d 835. In the *Bank of Cal.* case, the court stated that the consideration necessary to support an assignment of a future expectancy is the same as what is required for formation of a contract. *Bank of Cal.,* 36 CA3d at 367. At issue in that case was an assignment of future profits of a partnership.

An assignment of one party's entire interest in a contract might read as follows:

> **Assignor assigns, transfers, and conveys to Assignee all of Assignor's right, title, and interest in and to, and delegates to Assignee all of Assignor's duties and obligations under, the _ _[*title of contract*]_ _ dated _ _[*date*]_ _, between _ _[*name of nonassigning party*]_ _ and Assignor.**

As discussed in §7.13, the foregoing language would be effective to transfer the assignor's rights, but would not be effective as a delegation of the assignor's duties without the assignee's consent.

Once made, a voluntary assignment is a fully executed act, effecting an immediate change of ownership. *Office of Statewide Health Planning & Dev. v Musick* (1999) 76 CA4th 830, 833, 90 CR2d 705. As stated in CC §1040, "[a] voluntary transfer is an executed contract, subject to all rules of law concerning contracts in general." For discussion of the legal effects of an assignment of contract rights, see §§7.12-7.16.

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§7.9 b. Notice of Assignment

In the absence of an express requirement for notice in a statute or in the contract to be assigned, no notice of an assignment for value of a contract right is necessary to preserve the assignee's equitable rights, even in a contest between the assignee and a creditor of the assignor. What is essential is "the bona fide agreement between the assignor and assignee, for a sufficient consideration and without intent to defraud creditors or subsequent purchasers." If this is done, the assignment is effective, and any failure to give notice of the assignment later does not affect the validity of the assignment. *Smith v Harris* (1954) 127 CA2d 311, 316, 273 P2d 835.

A failure to give notice of the assignment to the debtor or obligor (the nonassigning party) may have important consequences, however. First, it will affect the assignee's priority as against a subsequent assignee. In California, the assignee who first gives notice of the assignment to the debtor will prevail over a subsequent assignee of the same right. *First Nat'l Bank v Pomona Tile Mfg. Co.* (1947) 82 CA2d 592, 605, 186 P2d 693. See §7.17; *Royal Bank Export Fin. Co. v Bestways Distrib. Co.* (1991) 229 CA3d 764, 767, 280 CR 355.

Second, if the assignee of a contract right does not give notice of the assignment to the obligor, and the obligor performs the obligation directly for the benefit of the assignor, the obligor's performance may be pleaded as a complete defense to the assignee's subsequent attempt to enforce the assignment. *Board of Admin. v Glover* (1983) 34 C3d 906, 916, 196 CR 330. This common law rule is also reflected in Com C §9406 for assignments of accounts, chattel paper, or payment intangibles subject to Division 9 (see §7.4), which provides that an account debtor may discharge its obligation by continuing to pay the assignor until it receives notice that the account has been assigned and that payment is to be made to the assignee. See Com C §9406(a). Commercial Code §9406 specifies the requirements for an effective notice and gives the account debtor the right to receive reasonable proof of the assignment; Com C §9406 is expressly made subject to any law establishing different rules for consumer transactions.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.10 c. Perfection of Transfers of Nonnegotiable Instruments and Certain Payment Rights (CC §§955, 955.1)

§7.10 c. Perfection of Transfers of Nonnegotiable Instruments and Certain Payment Rights (CC §§955, 955.1)

Civil Code §955 addresses perfection as against third parties of transfers of certain nonnegotiable instruments. It provides that

- A transfer (other than one intended to create a security interest under Division 9 of the Commercial Code) of an instrument that is otherwise negotiable but is not payable to order or to bearer; and
- A transfer of accounts, chattel paper, payment intangibles, or promissory notes as part of a sale of the business out of which they arose (which are excluded from Division 9 of the Commercial Code, see §7.4)

are each deemed perfected against third persons when endorsed or assigned in writing, and in the case of instruments or chattel paper, delivered to the transferee, whether or not notice of the transfer or sale was given to the account debtor. Such endorsement, assignment, or delivery, however, does not constitute notice to the obligor so as to invalidate any payments made by the account debtor to the transferor.

Civil Code §955.1(a) addresses perfection as against third parties of transfers of payment intangibles and certain transfers of accounts, chattel paper, and promissory notes. It provides that, subject to CC §955.1(b)-(c), and with specified exceptions:

- A transfer of a payment intangible (other than one intended to create a security interest under Division 9 of the Commercial Code); and
- A transfer of accounts, chattel paper, payment intangibles, or promissory notes as part of a sale of the business out of which they arose (which are excluded from Division 9 of the Commercial Code; see §7.4)

are each deemed perfected as against third persons on execution and delivery to the transferee of an assignment thereof in writing. The statutory exceptions to CC §955.1(a) are assignments of nonnegotiable instruments subject to CC §955 and assignments of judgments subject to CC §954.5. Under CC §955.1(c), the assignment alone does not constitute notice to the obligor so as to invalidate any payments made by the obligor to the assignor. Further, CC §955.1(b) provides that "[a]s between bona fide assignees of the same right for value without notice, the assignee first giving notice thereof to the obligor in writing has priority." See *Royal Bank Export Fin. Co. v Bestways Distrib. Co.* (1991) 229 CA3d 764, 767, 280 CR 355. See §7.17 for further discussion of priority issues.

It is important to note that CC §§955 and 955.1 cover *perfection* of an assignment as against third parties and do not set forth the requirements for an effective transfer of the rights subject to the assignment. *Champion Home Builders Co. v Sipes* (1990) 219 CA3d 1415, 1423, 269 CR 75. See §§7.8-7.9. The phrase "perfected against third persons" as used in CC §§955 and 955.1 means that, after the transferee has completed all the steps described in these sections, the transferee's title to the instrument has priority over any succeeding transferees. *Royal Bank Export Fin. Co.,* 229 CA3d at 280. See §7.17. Further, perfection of a transfer under CC §955 or §955.1 does not mean that the transferee thereby acquires title free and clear of any defenses that the obligor had against the transferee. The transferee remains subject to all equities and defenses existing in favor of the obligor at the time of the assignment; perfection under CC §955 or §955.1 does not confer holder in due course status on the transferee. *Royal Bank Export Fin. Co. v Bestways Distrib. Co., supra*. See CC §1459; §7.16.

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§7.11 d. Equitable Assignments

The doctrine of equitable assignment has typically been used either to enforce an attempted assignment of rights that is not in writing or is otherwise technically defective, or to create a right of subrogation. See *Recorded Picture Co. (Prods.) Ltd. v Nelson Entertainment, Inc.* (1997) 53 CA4th 350, 368, 61 CR2d 742; *Fidelity Nat'l Title Ins. Co. v Miller* (1989) 215 CA3d 1163, 1174, 264 CR 17; *First Nat'l Bank v Pomona Tile Mfg. Co.* (1947) 82 CA2d 592, 606, 186 P2d 693. The doctrine is also used to refer to an assignment of future rights, which becomes enforceable without further action by the assignor when the right assigned "ripens" into existence. *Gintel v Green* (1958) 165 CA2d 723, 332 P2d 298. See also *Schlauch v Hartford Acc. & Indem. Co.* (1983) 146 CA3d 926, 194 CR 658.

A right of subrogation is a creature of equity. It applies in all cases where one party involuntarily pays a debt for which another person is primarily liable and which in equity and good conscience should have been paid by the other person. *Recorded Picture Co. (Prods.) Ltd. v Nelson Entertainment, Inc., supra*; *Fidelity Nat'l Title Ins. Co. v Miller, supra*; *Marriage of Shore* (1977) 71 CA3d 290, 297, 139 CR 349. In effect, the party who pays the debt (the assignee in equity) steps into the shoes of the original creditor (the assignor in equity) and can exercise all of the original creditor's rights against the primary obligor. See generally *Bush v Superior Court* (1992) 10 CA4th 1374, 1381, 13 CR2d 382.

Evidence of an equitable assignment must be clear and specific, and the assignor cannot retain any control over the fund or any authority to collect it. *Iriart v Southwest Fertilizer & Chem. Co.* (1958) 51 C2d 270, 275, 332 P2d 285; *Recorded Picture Co. (Prods.) LTD v Nelson Entertainment, Inc., supra.*

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6. Effect of Assignment

§7.12 a. Generally (CC §1084)

An assignment transfers all of the rights of the assignor to the assignee. The assignee thus "stands in the shoes" of the assignor, taking the assignor's rights and remedies subject to any defenses that the obligor has or had against the assignor before receiving notice of the assignment. *Johnson v County of Fresno* (2003) 111 CA4th 1087, 1096, 4 CR3d 475; *Professional Collection Consultants v Hanada* (1997) 53 CA4th 1016, 1018, 62 CR2d 182. This common law principle is reflected in CC §1084, which provides that "[t]he transfer of a thing transfers also all its incidents, unless expressly excepted; but the transfer of an incident to a thing does not transfer the thing itself." An assignment of a contract carries with it all of the rights of the assignor under the contract. *Foreman Roofing Inc. v United Union of Roofers* (1983) 144 CA3d 99, 107, 192 CR 439 (right to terminate or renew collective bargaining agreement rested solely with corporation as successor in interest to assignor).

Once a valid assignment has been made, the assignor cannot cancel or modify the assignment by unilateral action without consent of the assignee, or defeat or impair the rights of the assignee in any other way. *Marriage of Shore* (1977) 71 CA3d 290, 296, 139 CR 349. Further, the assignee becomes the owner and has the right to sue to enforce the rights assigned. See CCP §368.5 (action or proceeding does not abate by the transfer of an interest). After the transfer has been made, the assignor lacks standing to sue on the claim. The assignor's right to demand performance is extinguished, and the assignee acquires the right to maintain an action on the rights assigned. *Johnson v County of Fresno* (2003) 111 CA4th 1087, 1096, 4 CR3d 475; *McCown v Spencer* (1970) 8 CA3d 216, 225, 87 CR 213.

NOTE: If an assignment has been made only for purposes of collection or as collateral security, the assignor retains the equitable interest in the property assigned and therefore can maintain an action for its recovery. *Stanislaus Pump, Mach. & Constr. Corp. v City of Modesto* (1988) 200 CA3d 1442, 1447, 246 CR 601.

Unless the assignee expressly assumes the assignor's obligations under the contract, however (see §7.13), the assignor remains liable to perform its contractual obligations. The general rule is "that the mere assignment of rights under an executory contract does not cast upon the assignee any of the personal liabilities imposed by the contract upon the assignor." *Melchior v New Line Prods., Inc.* (2003) 106 CA4th 779, 789, 131 CR2d 347 (citations omitted). See also *Heppler v J.M. Peters Co.* (1999) 73 CA4th 1265, 1289, 87 CR2d 497.

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§7.13 b. Assumption of Obligations (CC §1589)

How assumption occurs. In order for an assignee to be obligated on a contract, the assignee must either (1) expressly assume the assignor's duties under the contract or (2) accept the benefits of the contract, in which case an assumption of the burdens is presumed. *Wilson's Heating & Air Conditioning v Wells Fargo Bank* (1988) 202 CA3d 1326, 1334, 249 CR 553.

Express assumption. As noted in §7.12, in general, a simple assignment of rights under an executory contract does not transfer the assignor's obligations under the contract, unless the assignee assumes those obligations. "[W]hether there has been an assumption of the obligations" is to be determined by "the intent of the parties as indicated by their acts, the subject matter of the contract or their words." *Heppler v J.M. Peters Co.* (1999) 73 CA4th 1265, 1290, 87 CR2d 497; *Recorded Picture Co. (Prods.) Ltd. v Nelson Entertainment, Inc.* (1997) 53 CA4th 350, 362, 61 CR2d 742; *Enterprise Leasing Corp. v Shugart Corp.* (1991) 231 CA3d 737, 745, 282 CR 620.

Acceptance of benefits. In the absence of an express assumption by the assignee, an assumption of contractual obligations may be implied from the assignee's acceptance of the benefits under the contract. *Heppler,* 73 CA4th at 1289; *Recorded Picture Co. (Prods.) Ltd.,* 53 CA4th at 362; *Enterprise Leasing Corp.,* 231 CA3d at 745. Civil Code §1589 provides that "[a] voluntary acceptance of the benefit of a transaction is equivalent to a consent to all the obligations arising from it, so far as the facts are known, or ought to be known, to the person accepting." In effect, an acceptance of the benefits of the contract by the assignee operates as an estoppel. See *Melchior v New Line Prods., Inc.* (2003) 106 CA4th 779, 131 CR2d 347; *Citizens Suburban Co. v Rosemont Dev. Co.* (1966) 244 CA2d 666, 679, 53 CR 551. In the *Citizens* case, a limited partnership entered into a contract that was binding on "successors and assigns." The contract was later assigned in turn to several successor entities. One of the original partners was either an employee, partner, or stockholder in each succeeding entity, and each entity accepted the benefits of the contract. The court held that the corporate successor of the original limited partnership was bound to perform obligations of the original assignor as successor in interest. Similarly, in *Enterprise Leasing Corp.,* 231 CA3d at 745, the court held that when an assignee takes over a going business, the assignee's intention to assume the obligations of a contract relating to the business may be found from the assignee's acquiescence to the terms of the contract. The maxim of jurisprudence codified in CC §3521, "[h]e who takes the benefit must bear the burden," is also cited in support of the rule that an assignee's acceptance of the benefits of the contract constitutes an assumption of the contract's burden. See *Melchior v New Line Prods., Inc.*, *supra*.

NOTE: Even if an assignee expressly assumes the assignor's contractual duties, the assignor remains jointly liable under the contract for performance of those duties. *Travelers Indem. Co. v Gillespie* (1990) 50 C3d 82, 95, 266 CR 117. To release the assignor, an effective delegation of duties also requires consent of the nonassigning party, *i.e.,* the party entitled to the benefit of the assignor's performance. CC §1457. Delegation of duties is discussed in §§7.30-7.34.

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§7.14 c. Effect of "Successors and Assigns" Clause

Following is a typical contract provision intended to bind successors and assignees of the original parties to the obligations of the contract as well as the contract benefits:

> **This Agreement shall be binding on, and shall inure to the benefit of, the parties hereto and their heirs, administrators, executors, personal representatives, successors, and assigns.**

Such a clause is normally intended to eliminate the necessity for an express assumption of the contract's burdens. *Citizens Suburban Co. v Rosemont Dev. Co.* (1966) 244 CA2d 666, 675, 53 CR 551. Such a clause, however, does not render an otherwise unassignable contract assignable. *Davis v Basalt Rock Co.* (1951) 107 CA2d 436, 444, 237 P2d 338 (holding contract was personable and not assignable, notwithstanding presence of "successors and assigns" clause). See §§7.18-7.29 for discussion of restrictions on assignability. In *Davis,* the court held that the inquiry into the assignability of a contract is not foreclosed as a matter of law by a successors and assigns clause. See also *Shutes v Cheney* (1954) 123 CA2d 256, 263, 266 P2d 902.

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§7.15 d. Assignments for Security

If an assignment of a contract is made solely for purposes of collateral security, the assignment transfers only the assignor's rights and not the assignor's obligations under the assigned contract. *Black v Sullivan* (1975) 48 CA3d 557, 564, 122 CR 119. In *Black,* the court ruled that an assignee who received the contract as collateral security for money loaned did not thereby accept the benefits of the contract within CC §1589 (see §7.13) other than as pledgee, and did not become a party to the contract or obligate himself to perform the work that the assignor was required to perform under the contract. This common law principle is reflected in Com C §9402, which provides that a secured party is not liable for a debtor's acts or omissions. It states that "[t]he existence of a security interest, agricultural lien, or authority given to a debtor to dispose of or use collateral, without more, does not subject a secured party to liability in contract or tort for the debtor's acts or omissions."

NOTE: Assignments of contract rights as collateral security are common in real estate financing transactions and in some intellectual property financings. Taking an outright assignment of a borrower's contract, rather than a security interest in the contract, is intended to enable a lender to exercise all of the borrower's rights under the contract immediately on default, without need to conduct foreclosure proceedings first. Assignments of rents in real property financings, however, are subject to special rules. See California Real Estate Finance Practice: Strategies and Forms, chap 5 (Cal CEB 2000). For examples of collateral assignments in a construction financing, see Real Estate Finance §§9.47-9.48. Further discussion of collateral assignments is beyond the scope of this book.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.16 e. Assignee Subject to Obligor's Claims and Defenses Against Assignor (CC §1459; CCP §368); Waiver of Defenses

§7.16 e. Assignee Subject to Obligor's Claims and Defenses Against Assignor (CC §1459; CCP §368); Waiver of Defenses

As noted in §7.12, when contract rights are assigned, the assignee "steps into the shoes" of the assignor, taking the same, but no greater, rights than those of the assignor. The assignee's rights are subject to any claims and defenses that the obligor had against the assignor existing before the obligor receives notice of the assignment, whether acquired before or after execution of the assignment. *Johnson v County of Fresno* (2003) 111 CA4th 1087, 1096, 4 CR3d 475; *Royal Bank Export Fin. Co. v Bestways Distrib. Co.* (1991) 229 CA3d 764, 280 CR 355; *Lara v Board of Supervisors* (1976) 59 CA3d 399, 407, 130 CR 668. See also Restatement (Second) of Contracts §336(2) (1981). In *Lara,* a hospital had assigned a patient's account for collection. The court held that the patient and his relatives had available against the hospital's collection agency all of the equities and defenses they would have against the county.

This fundamental principle of the law of assignments is echoed in CC §1459, which provides that a transfer by endorsement of a nonnegotiable written contract for the payment of money or personal property "shall transfer all the rights of the assignor under the instrument to the assignee, subject to all equities and defenses existing in favor of the maker at the time of the indorsement," and in CCP §368, which provides:

> In the case of an assignment of a thing in action, the action by the assignee is without prejudice to any set-off, or other defense existing at the time of, or before, notice of the assignment; but this section does not apply to a negotiable promissory note or bill of exchange, transferred in good faith, and upon good consideration, before maturity.

A corresponding rule is found in Com C §3305(a), which is generally applicable to assignments of negotiable instruments *not* made to a holder in due course, as defined in Com C §3302. See Com C §3305(b). The rule is also found in Com C §9404(a) for those assignments of accounts subject to Division 9 (see §7.4). That section states that, with certain exceptions (Com C §9404(a)):

> Unless an account debtor has made an enforceable agreement not to assert defenses or claims,… the rights of an assignee are subject to both of the following:
>
> (1) All terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract.
>
> (2) Any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.

The requirements for an enforceable agreement between an account debtor and an assignor not to assert defenses or claims against an assignee—also referred to as a waiver of defenses—are specified in Com C §9403(b). In general, a waiver of defenses clause will be enforceable if the assignee takes the assignment for value, in good faith, and without notice of certain claims, rights, or defenses—in effect, if the assignee is equivalent to a holder in due course. See Com C §9403(b). In *Wells Fargo Bank v B.C.B.U.* (2006) 143 CA4th 493, 49 CR3d 324, the court enforced a waiver of defenses clause in an equipment lease signed by the account debtor because the requirements of Com C §9403(b) had been met, even though the account debtor never received the leased goods.

The rules in Com C §§9403 and 9404 are expressly subject to any law that establishes a different rule for account debtors who are consumers. Com C §§9403(e), 9404(c). See, *e.g.,* CC §§804.2 (retail installment sales; assignee subject to all equities and defenses of buyer against seller), 2986.10 (motor vehicle leases; assignee subject to all equities and defenses of lessee against lessor).

NOTE: If the document assigned is a negotiable instrument, as defined in Com C §3104, and the assignee is a holder in due course, as defined in Com C §3302, the rights of the assignee are *not* subject to claims and defenses of the obligor, except for defenses based on lack of capacity, duress, illegality, fraud in the inducement, or discharge in insolvency proceedings. Com C §3305(b).

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§7.17 7. Priority Among Successive Assignees

Priority of assignments of accounts subject to Division 9 of UCC. The priority among successive assignees of assignments intended to create a security interest and of assignments of accounts or other payment rights subject to Division 9 of the Commercial Code (*i.e.,* commercial financing transactions; see §7.4) is governed by Com C §9322 and the other rules set forth in Chapter 3 of Division 9. For discussion of these rules, see Secured Transactions in California Commercial Law Practice, chap 4 (2d ed Cal CEB 2001).

Priority of assignments of rights to payment subject to CC §955 or §955.1. Civil Code §§955 and 955.1 govern the priority among successive assignees of assignments (other than assignments intended to create a security interest; see above) of nonnegotiable instruments or payment intangibles (as defined in Com C §9102(a)(61)), and of accounts, chattel paper, payment intangibles, or promissory notes made as part of the sale of a business from which they arose. Civil Code §955 does not expressly address priority among successive assignees, but provides generally that an assignment of the rights described in §955 is deemed perfected as against third persons when endorsed or assigned in writing, and, in the case of instruments or chattel paper, delivered to the assignee, regardless of whether notice of the assignment is given to the obligor (although such assignment or delivery does not constitute notice to the obligor so as to invalidate any payments made by the obligor to the assignor). Civil Code §955.1(b) provides that, with respect to the rights described in CC §955.1(a), as between "bona fide assignees of the same right for value without notice, the assignee first giving notice thereof to the obligor in writing has priority." See §7.10; *Royal Bank Export Fin. Co. v Bestways Distrib. Co.* (1991) 229 CA3d 764, 767, 280 CR 355.

NOTE: There are some anomalies in the statutory language of CC §§955 and 955.1—particularly when considered together with applicable Commercial Code sections—which are beyond the scope of this discussion. For example, transfers of accounts, chattel paper, payment intangibles, or promissory notes made as part of the sale of a business from which they arose (see Com C §9109(d)(4)) are referenced in both CC §§955 and 955.1; it is therefore not clear which of the two statutes is applicable to such transfers.

Priority of assignments of other types of contract rights. Most contests between successive assignees of the same contract rights, including the dispute over receivables in the pre-UCC case of *First Nat'l Bank v Pomona Tile Mfg. Co.* (1947) 82 CA2d 592, 186 P2d 693, discussed below, involve rights to payment and are therefore now settled under the UCC and other statutes discussed above. There appears to be no recent case authority on the common law rules of priority among successive assignments of contract rights that are not subject either to the UCC or to CC §955 or §955.1. (Many earlier cases rely on statutes that were repealed with the enactment of the UCC in California, and are therefore no longer good law. See, *e.g., Continental Bank v Blethen* (1970) 7 CA3d 178, 86 CR 485.) The *First Nat'l Bank* case, however, includes a useful review of the common law rules of priority. In California, the applicable common law rule of priority between successive assignees of the same contract right is that the assignee who first gives notice to the debtor (or instead, to the holder of any fund involved) prevails. *First Nat'l Bank,* 82 CA2d at 605, citing *Graham Paper Co. v Pembroke* (1899) 124 C 117, 121, 56 P 627. The California rule differs from the so-called American Rule, reflected in the Restatement (Second) of Contracts §342 (1981), which is "first in time, first in right," *i.e.,* the first assignee in time prevails. See *First Nat'l Bank v Pomona Tile Mfg. Co., supra.*

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§7.18 C. Restrictions on Assignment

As noted in §7.3, California statutes "clearly manifest a policy in favor of the free transferability of all types of property, including rights under contracts." *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 222, 308 P2d 732; *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 396, 21 CR3d 404. See also CC §711 ("[c]onditions restraining alienation, when repugnant to the interest created, are void"), which codifies the common law rule against restraints on alienation; *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467. Assignability of contract rights is the rule; nonassignability is the exception. *Rokos v Peck* (1986) 182 CA3d 604, 617, 227 CR 480. Assignment of a contract may be restricted, however, either by the contract's express terms (see §§7.19-7.26) or by applicable law (see §§7.27-7.29). The restrictions on assignability of contract rights are expressed in the Restatement (Second) of Contracts §317 (1981) as follows:

> (2) A contractual right can be assigned unless
> (a) the substitution of a right of the assignee for the right of the assignor would materially change the duty of the obligor, or materially increase the burden or risk imposed on him by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him, or
> (b) the assignment is forbidden by statute or is otherwise inoperative on grounds of public policy, or
> (c) assignment is validly precluded by contract.

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1. Contractual Restrictions

§7.19 a. Enforcement of Anti-Assignment Clauses Generally

"In the absence of a controlling statute the parties may provide that a contract right or duty is nontransferable." *Masterson v Sine* (1968) 68 C2d 222, 230, 65 CR 545; *Kreisher v Mobil Oil Corp.* (1988) 198 CA3d 389, 400, 243 CR 662. The overall purpose and terms of a contract may demonstrate that the parties intended it to be nonassignable. *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 222, 308 P2d 732; *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 396, 21 CR3d 404.

The enforceability of anti-assignment clauses in contracts for the sale or lease of goods is discussed in §§7.43-7.46 and 7.53-7.59. Clauses in commercial real estate leases that absolutely prohibit transfer of a tenant's interest under the lease are enforceable by statute. See CC §1995.230. Outside the contexts of the UCC and commercial real estate leases, current law is less clear. Courts may construe strictly any restrictions on assignability, given the strong policy in favor of the free transferability of all kinds of property, including contract rights. See CC §711; *Benton v Hofmann Plastering Co.* (1962) 207 CA2d 61, 68, 24 CR 268. See, *e.g., Kendall v Pestana, Inc.* (1985) 40 C3d 488, 220 CR 818 (superseded by CC §§1995.010-1995.270), discussed in §7.23. In *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 363, 6 CR2d 467, however, the California Supreme Court applied a balancing test to uphold the reasonableness of a termination and rent recapture clause in a commercial real estate lease, finding that the strong public policy favoring freedom of contract outweighed any marginal restraint on alienation inherent in the clause.

Following is a sample of a clause flatly prohibiting an assignments of a contract by one party, either voluntarily or by operation of law:

> **_____ shall not assign any of its rights or delegate any of its duties under this Agreement. Any voluntary assignment or assignment by operation of law of any rights or obligations of _____ under this Agreement shall be deemed a default allowing _____ to exercise all remedies available to it under applicable law.**

For other samples, see Drafting Business Contracts: Principles, Techniques & Forms, chap 13 (Cal CEB 1994).

Clauses restricting assignment operate for the benefit of the obligor only. They do not affect the validity of an assignment made in violation of the clause as between the assignor-obligee and the assignee. The assignor's interest in the contract passes to the assignee, subject to the rights of the obligor. *Klamath Land & Cattle Co. v Roemer* (1970) 12 CA3d 613, 619, 91 CR 112; *Benton v Hofmann Plastering Co.* (1962) 207 CA2d 61, 68, 24 CR 268. See also Restatement (Second) of Contracts §322(2)(c) (1981). The obligor may waive its rights under an anti-assignment clause, however, if it proceeds to deal directly with the assignee on the contract with knowledge of the assignment. *Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 342, 182 P2d 182; *Benton v Hofmann Plastering Co.* (1962) 207 CA2d 61, 68, 24 CR 268.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.20 b. When Assignment Requires Consent of Nonassigning Party

§7.20 b. When Assignment Requires Consent of Nonassigning Party

Very often, contracts provide that the contract may be assigned only with the obligor's consent, for example:

> **Neither party to this Agreement may assign any of its rights or delegate any of its duties under this Agreement without the prior written consent of the other party to this Agreement.**

Such clauses often add that the obligor's consent "may not be unreasonably withheld or delayed," or alternatively, that the obligor's consent "may be withheld in that party's sole and absolute discretion." If the clause does not provide a standard for giving or withholding consent, the legal issue becomes whether the obligor can withhold its consent arbitrarily.

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§7.21 (1) Commercial Real Estate Leases (CC §1995.260)

For commercial real estate leases executed on or after September 23, 1983, CC §1995.260 provides that, unless a lease includes an express standard for giving or withholding consent, a clause requiring a landlord's consent to the transfer of a tenant's interest in a lease shall be construed to include an implied standard that the landlord's consent cannot be unreasonably withheld. Civil Code §1995.250 clarifies that a commercial real estate lease may contain any express standard or condition for granting or withholding consent to transfer, including without limitation a provision that the landlord's consent may not be unreasonably withheld, or a provision that the landlord's consent may be withheld subject to express standards or conditions. See generally *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467; Office Leasing: Drafting and Negotiating the Lease, chap 24 (Cal CEB 1996).

There is no comparable state statute applicable to residential real estate leases. Landlord consent clauses in residential leases are therefore subject to any applicable municipal regulations (see, *e.g., Danekas v San Francisco Residential Rent Stabilization & Arbitration Bd.* (2001) 95 CA4th 638, 115 CR2d 694) or else common law principles (see *Kendall v Pestana, Inc.* (1985) 40 C3d 488, 220 CR 818 (superseded by CC §§1995.010-1995.270), discussed in §7.23). See generally California Landlord-Tenant Practice, chap 4 (2d ed Cal CEB 1997).

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.22 (2) Franchise Agreements

§7.22 (2) Franchise Agreements

Business and Professions Code §21148 sets forth a number of limitations on the ability of a franchisor to validly withhold its consent to a franchisee's proposed sale, transfer, or assignment of a franchise, which are beyond the scope of this discussion. See generally Bus & P C §21148; *California Serv. Station & Automotive Repair Ass'n v Union Oil Co.* (1991) 232 CA3d 44, 283 CR 279. Business and Professions Code §21148 was effective January 1, 1981, and is not applicable to franchise agreements entered into before that date. *Kreisher v Mobil Oil Corp.* (1988) 198 CA3d 389, 243 CR 662.

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§7.23 (3) Other Contracts

Before the California Supreme Court's decision in *Kendall v Pestana, Inc.* (1985) 40 C3d 488, 496, 220 CR 818 (superseded by CC §§1995.010-1995.270), if a real estate lease provided that the tenant could assign or sublet only with the landlord's consent, the rule in California was that the landlord *could* withhold its consent arbitrarily and without regard to the qualifications of the proposed assignee, unless the lease stated that consent could not be withheld unreasonably or arbitrarily. The rule existed to protect the landlord's reversionary interest in the real property subject to the lease. See *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467. See also CC §1995.270(b) (landlord's consent may be unreasonably withheld if lease executed before September 23, 1983).

Kendall imported the covenant of good faith and fair dealing (see §§6.33-6.36) into the analysis, holding that if a lease provides for assignment only with the landlord's prior consent, consent may be withheld *only if* the landlord has a commercially reasonable objection to the assignment—even without an express lease provision stating that consent shall not be unreasonably withheld. 40 C3d at 496. The *Kendall* holding, however, has been superseded by statute for commercial real estate leases (see CC §1995.270), and there appear to be no California cases since *Kendall* holding that clauses requiring consent to assignment in other types of contracts are subject to an implied good faith standard. In *Roberts v Lomanto* (2003) 112 CA4th 1553, 1567, 5 CR3d 866, without analysis, the court stated that the *Kendall* holding was inapplicable to an assignment of a buyer's right to purchase real property under a contract of sale. Further, in recommending the adoption of CC §§1995.010-1995.270 for commercial leases, the California Law Review Commission expressed concern about *Kendall*'s reliance on the rule against unreasonable restraints on alienation and the implied covenant of good faith and fair dealing, stating that these doctrines should not prevent enforcement of a restriction on transfer in accordance with the express terms of the restriction in a commercial context, subject only to general contract law principles limiting freedom of contract, such as unconscionability. Recommendation Relating to Commercial Real Property Leases, 20 Cal L Rev'n Comm'n Reports (1990).

Because California law is not yet settled on the question of whether an obligor can withhold its consent arbitrarily if a contract clause requiring the obligor's consent to assignment does not provide a standard for giving or withholding consent, it is advisable to include such a standard in drafting any consent clause.

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c. When Contractual Restrictions Not Enforceable

§7.24 (1) Assignments of Money Due

In certain circumstances, express anti-assignment clauses will not be enforced. It is well established that a contractual restriction or rule of law against assignment does not preclude an assignment of money due or to become due under the contract or of money damages for breach of the contract. This principle also applies to the assignment of benefits under an insurance policy. *Henkel Corp. v Hartford Acc. & Indem. Co.* (2003) 29 C4th 934, 944, 129 CR2d 828. See also *St. Paul Fire & Marine Ins. Co. v James I. Barnes Constr. Co.* (1963) 59 C2d 691, 31 CR 52; *Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 339, 182 P2d 182.

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§7.25 (2) Assignments of Accounts; Grants of Security Interests (Com C §§9406(d), 9408(a))

For assignments of accounts subject to Division 9 of the Commercial Code (see §7.4), Com C §9406(d) generally invalidates any provision in the underlying contract or promissory note that "[p]rohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation… of a security interest in, the account, chattel paper, payment intangible, or promissory note" or provides that such an assignment or transfer or creation of a security interest gives rise to a default, termination right, or other remedy or claim. Commercial Code §9406(f) similarly invalidates any like provision of any rule of law, statute, or regulation. The policies underlying this section build on common law developments that have essentially eliminated legal restrictions on assignments of payment rights as security and other assignments of payment rights such as accounts and chattel paper. Official Comment 5 to UCC §9-406. See Com C §9406 for certain exceptions, including consumer transactions.

For sales or assignments of payment intangibles, health care insurance receivables, or promissory notes subject to Division 9 (see §7.4), Com C §9408(a) generally invalidates any term in a promissory note or underlying contract, license, or franchise that "prohibits, restricts, or requires the consent of the person obligated on the promissory note or the account debtor to, the assignment or transfer of, or the creation … of a security interest in, the promissory note, health care insurance receivable, or general intangible" to the extent that the term impairs the creation, attachment, or perfection of a security interest or provides that such an assignment or transfer or creation of a security interest gives rise to a default, termination right, or other remedy or claim. Commercial Code §9408(c) similarly invalidates any such provision of any rule of law, statute, or regulation. In effect, Com C §9408(a) renders invalid any attempt to restrict the assignment of a general intangible, health care insurance receivable, or promissory note, thus allowing the creation, attachment, and perfection of a security interest in such collateral without giving rise to a default. This enhances the ability of certain debtors to obtain credit. Official Comment 2 to UCC §9-408. Note that Com C §9408(d) protects account debtors by allowing enforcement of certain contract terms that would otherwise be unenforceable under Com C §9408(a). In *321 Henderson Receivables Origination, Inc. v Sioteco* (2009) 173 CA4th 1059, 1060, 93 CR3d 321, the court held that Com C §9408(a) applies to structured settlement payments because they are considered general intangibles under the UCC.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.26 (3) Assignments by Operation of Law

§7.26 (3) Assignments by Operation of Law

California courts have recognized the distinction between voluntary assignments of contract rights and involuntary assignments by operation of law. If the anti-assignment clause forbids only voluntary assignments, it will not prevent an involuntary assignment by operation of law. *Trubowitch v Riverbank Canning Co.* (1947) 30 C2d 335, 344, 182 P2d 182. In *Trubowitch,* the court held that if an assignment results merely from a change in the form of legal ownership of a business, the validity of the assignment depends on whether and how it affects the interests of the parties protected by the nonassignability clause in the contract. For example, in the absence of contrary language, an anti-assignment clause in a lease is not breached by changes in the firm of a partnership-lessee incident to the admission of a new partner, withdrawal of an old partner, or dissolution of the partnership and transfer of the leasehold rights along with all other partnership assets to one of the partners. 30 C2d at 344. See also *People ex rel Department of Pub. Works v McNamara Corp. Ltd.* (1972) 28 CA3d 641, 649, 104 CR 822.

If, however, an anti-assignment clause specifically prohibits assignments by operation of law, such as the sample clause in §7.19, it will be enforceable to prevent, *e.g.,* a decedent's rights under a contract to pass to his or her estate at death. *Miller v San Francisco Newspaper Agency* (1985) 164 CA3d 315, 317, 210 CR 159.

NOTE: Under 11 USC §365, clauses prohibiting or restricting assignment of a contract may or may not be enforceable against the trustee or debtor in possession in bankruptcy proceedings.

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2. Legal Restrictions

§7.27 a. Contracts Requiring Unique Personal Skill

Even in the absence of a clause expressly prohibiting assignment, the assignability of a contract may be restricted by statute or by the common law principle that contract rights cannot be assigned if the assignment would materially impair the nonassigning party's chance of obtaining the performance it expected. *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 222, 308 P2d 732; *Superbrace, v Tidwell* (2004) 124 CA4th 388, 396, 21 CR3d 404. A party's duties may be of such a personal character that performance of those duties by anyone else would effectively deprive the other party of what it bargained for. In such a situation, the duties cannot be assigned or delegated. *Farmland Irrig.,* 48 C2d at 222; *Superbrace v Tidwell, supra*; *Knipe v Barkdull* (1963) 222 CA2d 547, 551, 35 CR 283. Even when there is no express written or oral agreement that the duties under the contract are personal, the courts will imply a presumed intent to that effect if the circumstances indicate that performance by a substituted person would be different from what the parties contracted for. *Masterson v Sine* (1968) 68 C2d 222, 230, 65 CR 545. In *Masterson,* the plaintiffs sought to enforce an option to repurchase a ranch that the plaintiffs had previously conveyed to relatives. The court held that it was reversible error for the trial court to exclude extrinsic evidence offered to demonstrate that the option was personal to the grantors and intended to keep the ranch in the family.

In *Superbrace,* the court reviewed the cases that prohibited assignment of a contract right, finding that "there always exists evidence that a personal skill, promise, or performance was expected by one of the contracting parties." The court stated (124 CA4th at 404, citations omitted):

> There are contracts for personal service or other personal performance which cannot be assigned so as to transfer the concurrent obligation without the consent of the person entitled to such performance. This is illustrated by the contract of an artist to paint a portrait; or a sale of land under agreement by the purchaser to execute his own promissory note for a part of the purchase price.

On the one hand are situations where the bargained-for performance attempted to be assigned is clearly within the unique capability of the assignor, *i.e.,* is based on the assignor's unique skills, talents, or personality. If allowed, such an assignment would change the essential purpose of the contract. On the other hand, some arguably personal aspects of a contract have been found to be too de minimis to prevent an assignment. For example, in *Superbrace,* the court held that a patent license granted by the inventor to his friends and neighbors was not too personal to be assignable.

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§7.28 b. Assignments of Patent and Copyright Licenses

Both federal courts within the Ninth Circuit and California state courts recognize the general rule for licenses and other agreements relating to patents or copyrights—that state law controls issues of contractual interpretation unless state law would conflict or interfere with federal law or policy. See *Gardner v Nike, Inc.* (9th Cir 2002) 279 F3d 774, 781 n5; *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673, 677; *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 308 P2d 732; *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 21 CR3d 404. The two jurisdictions part company, however, over the narrower questions of whether assignments of patent or copyright licenses are governed by federal or state law and whether, under applicable law, patent or copyright licenses are assignable without consent of the licensor.

Gardner v Nike, Inc., supra (regarding copyright licenses), and *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.), supra* (regarding nonexclusive patent licenses), each held that assignments of the type of license at issue in the case were subject to federal common law rules rather than state contract law, and that under federal common law rules, the licenses were not assignable without consent of the licensor. Specifically, *Gardner v Nike, Inc.* held that in the absence of express contract language to the contrary, under the Copyright Act of 1976 (17 USC §§101-1332), an exclusive licensee of a copyright must obtain the licensor's consent before it may assign its rights. *Gardner,* 279 F3d at 781. Further, *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.), supra,* held that a nonexclusive licensee of a patent has only a personal and not a property interest in the patent, and that this interest is not transferable unless the owner of the patent consents to the assignment or the license itself permits assignment. *Everex,* 89 F3d at 679. *In re Hernandez* (Bankr D Ariz 2002) 285 BR 435 and *Proteotech, Inc. v. Unicity Int'l, Inc*. (WD Wash 2008) 542 F Supp 2d 1216 extended the *Everex* holding to exclusive patent licenses. The *Everex* court believed that allowing states to permit free assignability of nonexclusive patent licenses would undermine the policies of the federal patent laws. *Everex,* 89 F3d at 679.

California state courts, however, follow different rules. In *Farmland Irrig. Co. v Dopplmaier*, *supra,* the California Supreme Court held that state law, rather than federal common law, should be applied when determining whether a patent license is assignable. In *Farmland Irrig.,* the court stated that it could find no policy underlying the federal patent statutes that would require a uniform federal rule of construction of patent licenses to determine their assignability, and therefore, in the absence of congressional action, it was free to make its own determination of whether the assignment of a patent license contract requires express consent of the assignor. *Farmland Irrig.,* 48 C2d at 220. Confirming the assignability of the licenses at issue in the case, the court held that "[n]othing in the nature of patent licenses makes the rights conferred by them necessarily so personal that the parties must have intended that they be nonassignable." *Farmland Irrig.,* 48 C2d at 222. See also *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 21 CR3d 404; *Mattel, Inc. v Luce, Forward, Hamilton & Scripps* (2002) 99 CA4th 1179, 1186, 121 CR2d 794.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.29 c. Assignments of Wages (Lab C §300)

§7.29 c. Assignments of Wages (Lab C §300)

Labor Code §300 imposes a series of detailed requirements for assignments of wages or salary earned or to be earned. The restrictions are inapplicable to (1) assignments of earnings of independent contractors (see *Fitch v Pacific Fid. Life Ins. Co.* (1975) 54 CA3d 140, 126 CR 445); (2) earnings assignment orders under Chapter 8, Part 5, Division 9 of the Family Code; (3) assignments for support and maintenance of conservatees under Prob C §3088; (4) deductions requested by the employee for insurance premiums; taxes; retirement, disability, or similar plan benefits; payments for goods or services furnished by the employer to the employee or the employee's family; or charitable or similar purposes (Lab C §300(g)).

No assignment of wages or salary to be earned is valid, unless it is for "necessities of life," is given to the one furnishing such necessities directly, and is for only the amount needed to furnish them. Lab C §300(h). In addition, such assignments must comply with the requirements of Lab C §300(b).

Labor Code §300(b) provides that, to be valid, an assignment of wages or salary, either earned or to be earned, must satisfy all of the following conditions:

- The assignment must be contained in a separate written instrument, signed by the person who has earned or will earn the subject wages or salary, and specifically identifying the transaction to which the assignment relates.
- If the assignment is made by a married person, written consent of his or her spouse must be attached. If the assignor is legally separated or is living apart from his or her spouse after entry of an interlocutory judgment of dissolution of their marriage, a written statement by the assignor setting forth these facts must be attached to or included in the assignment.
- If the assignment is made by a minor, written consent of a parent or guardian must be attached.
- If the assignment is made by a person who is unmarried or who is an adult, or who is both unmarried and an adult, a written statement by the assignor setting forth these facts must be attached to or included in the assignment.
- There must be no other assignment in connection with the same transaction or series of transactions, and a written statement by the assignor to that effect must be attached to or included in the assignment.
- A copy of the assignment and of the written statements required, authenticated by a notary public, must be filed with the employer, along with an itemized statement of the amount then due to the assignee.
- At the time the assignment is filed with the employer, there must be no other assignment of wages of the employee subject to payment and no earnings withholding order against the employee's wages or salary in force.

No more than 50 percent of the assignor's wages or salary is collectible from the assignor's employer at the time of each payment of wages or salary under any such assignment. Lab C §300(c). Assignments of future wages are revocable at any time by the assignor. See Lab C §300(e). Assignments of wages earned or to be earned are not valid under any circumstances if the wages are paid under a centralized wage payment plan pursuant to Lab C §204a.

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D. Delegation of Duties

§7.30 1. Definition of Delegation

The term "delegation" was defined by the court in *Ochs v PacifiCare of Cal.* (2004) 115 CA4th 782, 790, 9 CR3d 734, as the "transfer of authority by one person to another, which may infer a general power to act for another's benefit or which may assign a debt to another." It normally refers to the transfer of the burden of a contractual obligation. See CC §1457. In *Ochs,* the court stated (115 CA4th at 790, citations omitted):

> [Delegation] does not always connote a complete relinquishment of rights or responsibilities by the delegator. But when the thing to be delegated is a legal *duty* of one party to another, the characterization of that duty as nondelegable is a shorthand way of saying that a party could not escape liability altogether by placing that duty on someone else. Conversely, to say a duty is delegable is to say that there is no residual liability.

As noted in §7.2, the term "assignment" is sometimes used to refer both to the assignment of contract rights and to the delegation of contractual obligations. See, *e.g.,* Restatement (Second) of Contracts §328(1) (1981).

NOTE: Delegation is not the only way to shift the performance of duties owed under a prime contract to a third party. A subcontract can be used to accomplish the same result. Unless a statute (see, *e.g.,* Pub Cont C §4107) or the prime contract itself addresses the issue, a subcontract can be entered into independently of the prime contract and would have no direct legal effect on the prime contract or the duties owed thereunder; it would not involve the law of assignment or delegation. However, the promisee under the prime contract may be a third party beneficiary of the subcontract and, as such, would be entitled to sue the subcontractor for breach. *Gilbert Fin. Corp. v Steelform Contracting Co.* (1978) 82 CA3d 65, 69, 145 CR 448.

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§7.31 2. Principles of Delegation (CC §1457)

Civil Code §1457 addresses the delegation of contractual obligations. It states that, except as provided in CC §1466 (regarding covenants in real estate deeds that run with the land), "[t]he burden of an obligation may be transferred with the consent of the party entitled to its benefit, but not otherwise." Note that CC §1457 does not mean that a third party assignee cannot assume the obligations under a contract (see §7.13), but only that the third party cannot relieve the assignor or primary obligor under the contract from his or her obligations without consent of the nonassigning party. *AICCO, Inc. v Insurance Co. of N. Am.* (2001) 90 CA4th 579, 588, 109 CR2d 359 (insurer could not transfer its liability under unprofitable asbestos and environmental insurance policies to another company without consent of insured; ability of assignee to perform contract was irrelevant). An assignor or delegor of contractual obligations cannot be released from its obligations without consent of the other party—in effect, without a novation. *Baer v Associated Life Ins. Co.* (1988) 202 CA3d 117, 123, 248 CR 236. See §7.32. Neither the delegor's act of delegating its performance obligation nor the delegee's assumption of the delegor's obligation to perform will release or discharge the delegor unless the party to whom the duty is owed consents. In the absence of such consent, the delegor and delegee remain jointly liable for performance. *Travelers Indem. Co. v Gillespie* (1990) 50 C3d 82, 96, 266 CR 117; *AICCO, Inc. v Insurance Co. of N. Am., supra*; *People ex rel Department of Pub. Works v McNamara Corp. Ltd.* (1972) 28 CA3d 641, 649, 104 CR 822. See also Restatement (Second) of Contracts §318(3) (1981).

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§7.32 3. Novation Compared (CC §§1530-1532)

The principles of delegation are closely related to the concept of a novation—a substitution of a new contract for an existing one, with the intent to extinguish immediately the existing contract. See CC §1530; *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 431, 38 CR2d 521. In general, when contractual duties are transferred to a third party, the delegating party is not necessarily released from all of its obligations under the contract. The delegating party can be released only by an agreement of the nondelegating party to release the delegor and to substitute the delegee on the obligation—which is essentially equivalent to a novation. See CC §1531(2); *Wells Fargo Bank v Bank of America, supra*. The two concepts often overlap in case discussions. See, *e.g., Ochs v PacifiCare of Cal.* (2004) 115 CA4th 782, 790, 9 CR3d 734, in which the court stated that "to say a duty is delegable is to say that [the delegor has] no residual liability." See also *Baer v Associated Life Ins. Co.* (1988) 202 CA3d 117, 123, 248 CR 236. Novation is discussed further in §5.88.

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§7.33 4. How Made

Under CC §1457, delegation of contractual duties can occur only with the consent of the nondelegating party—the party to whom the duties are owed. Although there appear to be no California cases on point, consent to delegation presumably may be express or else implied from the parties' conduct and the circumstances surrounding the delegation. A contracting party that wishes to have the right to delegate its performance should negotiate the point in advance with the other party and include a provision in the contract clarifying the scope of the first party's authority to delegate its duties without consent of the other. See generally Drafting Business Contracts: Principles, Techniques & Forms, chap 13 (Cal CEB 1994). The nondelegating party may give its consent in advance in the contract to the substitution of a new debtor and the discharge of the old debtor from liability. *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 432, 38 CR2d 521.

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§7.34 5. Nondelegable Duties; Personal Services Contracts

As discussed in §7.27, a party's duties may be of such a personal character that performance of those duties by anyone else would effectively deprive the other party of what it bargained for. In such a situation, the duties cannot be assigned or delegated unless the other party consents to accept performance from the delegee. *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 222, 308 P2d 732; *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 396, 21 CR3d 404; *Knipe v Barkdull* (1963) 222 CA2d 547, 551, 35 CR 283. In *AICCO, Inc. v Insurance Co. of N. Am.* (2001) 90 CA4th 579, 109 CR2d 359, the court held that the plaintiffs stated a claim for an unlawful business practice under the Unfair Competition Law (Bus & Prof C §§17200-17210) by alleging that the defendant insurance company had transferred policies to another insurer without obtaining the policyholders' consent. If the other party to the contract does not object to the substituted performance, however, a contract calling for personal services can be assigned. *Superbrace,* 124 CA4th at 404; *Knipe v Barkdull, supra*. See §7.27 for further discussion of this issue.

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§7.35 E. Revocability of Assignments; Modification of Assigned Contract

In general, unless the language of the assignment or the surrounding circumstances indicate otherwise, an assignment of contract rights is irrevocable. After making a valid assignment of contract rights, the assignor cannot modify or cancel the completed assignment by unilateral action without consent of the assignee. Further, the assignor cannot modify the underlying contract, nor defeat or impair the rights of the assignee in any other way, without the assignee's consent. *Marriage of Shore* (1977) 71 CA3d 290, 296, 139 CR 349. See §7.12.

A different rule is applicable to assignments in commercial financing transactions subject to Division 9 of the Commercial Code. See §7.4. Under Com C §9405, if a right to payment under an assigned contract has not yet been fully earned by performance, or if the right to payment has been fully earned by performance but the account debtor has not yet received notice of the assignment, any modification (or substitution) of an assigned contract is effective against an assignee if made in good faith. The assignee acquires corresponding rights under the modified (or substituted) contract. Commercial Code §9405 is subject to any law that establishes a different rule for individual consumers. Further, it does not apply to health care receivables.

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§7.36 F. Assignments for Benefit of Creditors

A general assignment for the benefit of creditors is an alternative to a federal Chapter 7 bankruptcy proceeding, used for the orderly liquidation of the assets of an insolvent business or individual. It is initiated by a written instrument under which the assignor assigns all of its assets to an entity or individual who, acting as a fiduciary, sells the assets and distributes the proceeds to the assignor's unsecured creditors pro rata. It is an out-of-court process without judicial supervision, and, unlike a federal bankruptcy proceeding, it does not enjoy the protection of the automatic stay of 11 USC §362. Moreover, unlike a personal bankruptcy, if the assignor is an individual and the liquidation proceeds are not sufficient to repay all of the assignor's creditors, the assignor is not discharged from the remaining liability for his or her debts. There are professionals in most regions of California who are familiar with the process and regularly accept such assignments.

The assignment document itself and the procedures for carrying out the liquidation of the assignor's assets are not directly regulated by statute in California, but a number of provisions addressing other aspects of general assignments for the benefit of creditors are scattered throughout the California Codes. For example, CCP §§493.010-493.060 provide that qualifying assignments operate to terminate attachment liens, thus protecting the assigned assets from levy. Code of Civil Procedure §§1204 and 1204.5 address the priority of payment of certain types of claims, including claims for wages, commissions, and contributions to employee benefit plans. Code of Civil Procedure §1800 allows recovery of preassignment preferential transfers of assets from transferee-creditors (but see *Sherwood Partners, Inc. v Lycos, Inc.* (9th Cir 2005) 394 F3d 1198, cert denied (2005) 546 US 927, and *Credit Managers Ass'n v Countrywide Home Loans, Inc.* (2006) 144 CA4th 590, 50 CR3d 259, for conflicting discussion of the federal bankruptcy preemption issue). Code of Civil Procedure §1801 establishes exemptions for certain types of property if the assignor is an individual, and CCP §1802 sets forth requirements for notice to creditors. Other relevant statutes include CC §1954.1 (conditional right to occupy assignor's leased premises); Com C §6103 (exemption from UCC bulk transfer rules); Bus & P C §§24071 and 24074 (liquor license transfers); and Fish & G C §1058, Rev & T C §6756, and Veh C §9859 (priority of payment of certain state taxes and license fees).

For further information on this topic, see Weinberg, *General Assignments for the Benefit of Creditors: An Alternative to Bankruptcy*, 19 CEB Cal Bus L Prac 64 (Spring 2004).

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§7.37 III. ASSIGNMENT AND DELEGATION OF CONTRACTS FOR THE SALE OR LEASE OF GOODS

Sections 7.38-7.60 discuss assignment and delegation of contracts for the sale or lease of goods subject to Division 2 or Division 10 of the Commercial Code. Note that this chapter does not address assignments or transfers of negotiable instruments, letters of credit, documents of title, or investment securities, nor does it provide detailed treatment of grants of security interests, or assignments of accounts or payment rights in commercial financing transactions—all of which are governed by other Divisions of the Commercial Code.

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A. Contracts for the Sale of Goods (Com C §2210)

§7.38 1. Scope of Com C §2210

Assignment and delegation of contracts for the sale of goods are addressed in Com C §2210. Section 2210 covers only selected issues in the law of assignment and delegation. In particular, it does not address the need for or effect of a notice of assignment (see §7.9); the enforceability of any claims or defenses of the nonassigning party against the assignee (see §7.16); rights of successive assignees (see §7.17); issues concerning the form of assignments (see §7.8); or assignments for the benefit of creditors (see §7.36). See Official Comment 7 to UCC §2-210. These and other issues not addressed in Com C §2210 are left to other applicable law. See Com C §1103.

NOTE: For a more detailed discussion of assignment and delegation under Division 2 of the Commercial Code, see California UCC Sales and Leases, chap 11 (Cal CEB 2002).

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.39 2. Distinction Between Assignment and Delegation

§7.39 2. Distinction Between Assignment and Delegation

Section 2210 refers to the parties to both assignments and delegations as "assignor" or "assignee." See Com C §2210(4)-(5). The distinction between assignment and delegation is important under Division 2, even though the two concepts are often conflated.

- In general, parties are free to perform their obligations under a contract for the sale of goods through a delegate—unless the contract provides otherwise or unless the other party has a substantial interest in having the original promisor perform. Delegation, however, does not relieve the original obligor of the duty to perform or of any liability for breach. Com C §2210(1).
- Likewise, in general, parties are free to assign their rights under a contract for the sale of goods—unless the contract provides otherwise or unless the assignment would materially change the nonassigning party's duty, or materially increase the nonassigning party's burden or risk under the contract, or materially impair the nonassigning party's chance of obtaining return performance. Com C §2210(2). Official Comment 1 to former UCC §2-210 (Official Comment 2 to UCC §2-210 (2003)).
- An assignment transfers rights to the assignee and away from the assignor. A delegation transfers duties to the assignee, but the assignor remain liable for performance. See Com C §2210(1)-(2).
- All delegations, but not all assignments, can be prohibited by agreement. See Com C §2210(1)-(2).
- Unless the contract language or the circumstances indicate to the contrary, an assignment of "the contract" or "all my rights under the contract" constitutes a delegation of performance, and the assignee's acceptance constitutes its agreement to perform the delegated duties. Com C §2210(5).
- A prohibition on "assignment" of a contract is a prohibition of delegation only, unless the circumstances indicate otherwise. Com C §2210(4).
- A delegation, but not an assignment that does not include a delegation, gives the nondelegating party the right to require assurances from the assignee. Com C §2210(6). Unless the nondelegating party receives assurances within a reasonable time after demand, not exceeding 30 days, that party can treat the contract as repudiated. Com C §2609(4).

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§7.40 3. Financing Assignments

A financing assignment is a transfer of only an assignor's rights under the contract, and does not involve a delegation of the assignor's duties. *Black v Sullivan* (1975) 48 CA3d 557, 564, 122 CR 119; Official Comment 5 to former UCC §2-210. Typically, a financing assignment is made to a bank or other financial institution by a seller-assignor of all (or part) of its right to payment under the contract. Financing assignments, like grants of security interests, are governed by Division 9 of the Commercial Code; they are technically classified as sales of "accounts" (rights to payment) under Division 9. See Com C §§9102(a)(2), 9109(a)(3). See also §7.4.

NOTE: For a detailed discussion of security interests (including sales of accounts) under Division 9, see Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

Division 9 applies generally to all sales or assignments of accounts, even if not made for the purpose of security. See Com C §9109(a)(3). Specific types of sales or assignments of accounts are excluded from Division 9, however. The excluded types will be subject to Com C §2210 if they involve contracts for the sale of goods, to Com C §10303 if they involve personal property leases, or else to the general law of assignments discussed in §§7.2-7.36. The exclusions are detailed in §7.4.

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§7.41 B. Assignment of Rights

Under Com C §2210, all rights of either the seller or the buyer under a contract for the sale of goods may be assigned unless, subject to Com C §9406 (see §7.25), (1) the parties have agreed otherwise, or (2) the assignment of rights would materially change the duties of the other party, materially increase the other party's burden or risk imposed by the contract, or materially impair the other party's chance of obtaining the contracted—for return performance. Com C §2210(2). In general, Com C §2210 recognizes assignment and delegation as "normal and permissible incidents" of a contract for the sale of goods. Official Comment 1 to former UCC §2-210 (Official Comment 2 to UCC §2-210 (2003)). Even if the contract prohibits assignment, rights that are no longer executory, *e.g.,* a right to damages for breach of the entire contract or a right arising from the assignor's performance of his or her entire obligations, may be assigned. Com C §2210(2); Official Comment 3 to former UCC §2-210. If the assignment purports to transfer a right that involves material personal discretion, however, the assignment is ineffective. Official Comment 4 to former UCC §2-210.

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§7.42 1. Creation of Security Interest Not Deemed Material

Commercial Code §2210(3) provides that, for purposes of Com C §2210(2), the creation, attachment, perfection, or enforcement of a security interest in the seller's interest in a contract for the sale of goods is not an assignment that "materially changes the duty of, or increases materially the burden or risk imposed on, the buyer or impairs materially the buyer's chance of obtaining return performance" unless (and only to the extent that) enforcement results in a delegation of material performance of the seller. Even so, the security interest remains effective, but the seller may be liable to the buyer for damages and a court may grant other relief.

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§7.43 2. Contractual Restrictions on Assignment

The parties to a contract for the sale of goods may restrict or prohibit altogether assignments of their respective contract rights, with certain limitations. See Com C §2210(2), (4). Commercial Code §2210(4) states that, unless the circumstances otherwise indicate, a prohibition of assignment of "the contract" is to be interpreted as barring only the delegation of the assignor's performance to the assignee.

If a contract for the sale of goods provides that an assignment can be made only with the consent of the nonassigning party, it is not clear whether that consent can be unreasonably withheld. Given the requirement of good faith and fair dealing present in every contract (Com C §1203), a court might impose a reasonableness standard in a sales contract whenever one party has the right to grant or withhold its consent to an assignment. But see *Bergquist v Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)* (8th Cir 1988) 850 F2d 1275, 1285 (reasoning that because UCC expressly authorizes parties to sales contract to prohibit assignment, parties can allow consent to assignments to be unreasonably withheld); *Carma Developers (Cal.), Inc. v Marathon Dev. Cal., Inc.* (1992) 2 C4th 342, 6 CR2d 467 (regarding consent to assignment of commercial real estate leases).

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3. When Restrictions on Assignment Are Unenforceable

§7.44 a. Fully Executed Contracts

Even if a contract for the sale of goods prohibits assignment, a party may nonetheless validly assign a right to damages for breach of the whole contract or a right arising from the assignor's due performance of his or her entire obligation, *i.e.,* the assignor's rights under the contract if it has been fully executed by the assignor. Com C §2210(2). A right arising from the assignor's performance of its entire obligation can be a right to something other than money. For example, a buyer who has paid the entire price of goods cannot be prohibited by agreement from assigning the right to receive delivery of those goods. *Benton v Hofmann Plastering Co.* (1962) 207 CA2d 61, 66, 24 CR 268. If an assignor performs all obligations before making the assignment, there are no duties to be delegated and therefore no issues regarding delegation. Official Comment 3 to former UCC §2-210.

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§7.45 b. Creation of Security Interest

Commercial Code §9406(d) (see §7.25) invalidates any prohibition on creation or enforcement of a security interest in the seller's right to payment under a contract for the sale of goods, in furtherance of the policy to permit the free alienability for security purposes of intangible assets such as accounts and general intangibles.

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§7.46 4. Material Adverse Effect on Nonassigning Party

Under Com C §2210(2), even if the parties have not expressly prohibited assignment of a contract for the sale of goods, an assignment will be unenforceable if it materially changes the nonassigning party's duties, materially increases the nonassigning party's burden or risk under the contract, or materially impairs the nonassigning party's chance of obtaining return performance. In most cases, an assignment that has these effects is one that includes a delegation of performance. The assignment may be prohibited, however, even if there is no delegation of performance. See Official Comment 4 to former UCC §2-210 (Official Comment 3 to UCC §2-210 (2003)). For example, assignment of a buyer's right to delivery of goods without delegation of the duty of payment might have an adverse effect on the seller, but ordinarily a seller's assignment of rights to payment does not materially increase the buyer's risk.

It may be difficult to prove a material negative effect of assignment on the nonassigning party because of protections offered to the parties under other sections of Division 2. For example, although rights under output, requirements, and exclusive dealing contracts may involve personal discretion, such rights may be assignable. The good faith standards imposed on such contracts by Com C §2306 and the nonassigning party's right to demand assurances from the assignee (see Com C §2210(6)) should protect the nonassigning party from a material adverse change. See Official Comment 4 to UCC §2-210.

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C. Delegation of Duties

§7.47 1. Principles of Delegation

As noted in §7.41, in general, Com C §2210 recognizes assignment and delegation as "normal and permissible incidents" of a contract for the sale of goods. Official Comment 1 to former UCC §2-210 (Official Comment 2 to UCC §2-210 (2003)). Either party to a contract for the sale of goods may delegate his or her duties under the contract unless otherwise agreed or unless the other party has "a substantial interest in having his or her original promisor perform or control the acts required by the contract." Com C §2210(1). This statute balances the policy of free alienability of contract rights against the policy of protecting the nondelegating party's right to preserve the bargain that it made. *Sally Beauty Co. v Nexxus Prods. Co.* (7th Cir 1986) 801 F2d 1001, 1006. The parties may agree to prohibit delegation, and some duties are not delegable even if the contract is silent on the issue. In general, delegation is permitted, either alone or in conjunction with an assignment of rights, if there is no substantial reason why the delegated performance will not be as satisfactory as performance by the original promisor. Official Comment 2 to former UCC §2-210 (Official Comment 3 to UCC §2-210 (2003)).

After delegation, the nondelegating party has certain rights, including (1) the right to continue to look to the delegor for performance of the contract (Com C §2210(1)); (2) the right to look to the delegee for performance of the contract (Com C §2210(5)); and (3) the right to demand adequate assurances of future performance from the delegee without prejudice to any rights the nondelegating party may have against the delegor (Com C §2210(6)). See §§7.49-7.51.

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§7.48 2. Delegation Implied by Assignment

An assignment of "the contract" or of all the assignor's "rights under the contract" or a similar assignment worded in general language includes a delegation of duties, unless the language of the assignment or the surrounding circumstances indicate that no delegation was intended. If the assignee accepts the assignment, the assignee becomes obligated to perform the assignor's duties under the contract. The assignee's obligation of performance may be enforced either by the assignor or by the nonassigning party. Com C §2210(5).

Assignments for security (financing assignments; see §7.40) do not carry with them a delegation of duties, because the surrounding circumstances indicate that the parties do not intend a delegation. See Com C §2210(5); Official Comment 5 to former UCC §2-210. See also *Black v Sullivan* (1975) 48 CA3d 557, 564, 122 CR 119. If an assignment of a contract for the sale of goods does not expressly exclude delegation or if the assignment is not clearly a financing assignment, it may be uncertain whether the parties intended to delegate performance, and a court may admit parol evidence of the surrounding circumstances to interpret the document.

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3. Effect of Delegation

§7.49 a. As Between Nondelegating Party and Assignee

Once a delegation of duties under a sales contract occurs, the nondelegating party obtains several rights against the assignee (delegee):

- The assignee's acceptance of a delegation constitutes a promise to perform, which is enforceable by the nondelegating party. Com C §2210(5). See §7.48. The nondelegating party has the same remedies against the assignee that it has against the assignor.
- The delegation gives the nondelegating party the right to demand assurances of performance from the assignee without showing any other grounds for insecurity. Compare Com C §2210(6) with Com C §2609(1). The nondelegating party's demands for, or receipt of, assurances from the assignee do not affect the nondelegating party's rights against the assignor (Com C §2210(6)); the assignor remains liable for performance or damages if the assignee is in breach (Com C §2210(1)).
- If the nondelegating party is the buyer under the contract, it need not make payments to the assignee until it receives notice of the assignment. Com C §9406(a).

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§7.50 b. As Between Nondelegating Party and Assignor

A delegation imposes liability for performance on the assignee, but it does not relieve the assignor of liability. Com C §2210(1). The assignor's liability to the nondelegating party continues to be primary liability. If the assignee fails to perform, the assignor may be liable in damages and remains subject to other remedies available to the nondelegating party, including the right to demand assurances (Com C §2609) and specific performance (Com C §2716). The assignor can be freed entirely from the burdens of the contract only if the nondelegating party agrees to a novation extinguishing the assignor's liability as a matter of non-Commercial Code law. See §§5.88, 7.32.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.51 c. As Between Assignor and Assignee

§7.51 c. As Between Assignor and Assignee

The assignee's acceptance of the delegation constitutes the assignee's promise to perform, which is enforceable by the assignor as well as the nondelegating party. Com C §2210(5).

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§7.52 4. When Delegation of Duties Prohibited

The parties may expressly prohibit delegation of duties in their contract. Com C §2210(1). Moreover, general language prohibiting assignment of "the contract" is construed to bar delegation of duties. Com C §2210(4).

Even in the absence of an agreement prohibiting delegation, a purported delegation will be unenforceable if the nondelegating party has a "substantial interest" in having the assignor perform or control performance of the contract. Com C §2210(1). This means that "no substantial reason can be shown as to why the delegated performance will not be as satisfactory as personal performance." Official Comment 2 to former UCC §2-210. In general, contracts for personal services or those requiring the exercise of personal skill or discretion fall within the scope of Com C §2210(1). For example, a buyer of custom-made goods may want them manufactured by a seller known for careful, dependable work rather than by an unknown party who may do careless work. The question of whether the nondelegating party has a "substantial interest" may arise only rarely, however, because even after delegation the assignor remains liable to perform and liable for any breach of the contract (see Com C §2210(1)), and the nondelegating party has the right to demand assurances from the assignee (see Com C §2210(6)). See Official Comment 6 to UCC §2-210 (Official Comment 5 to UCC §2-210 (2003)).

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D. Leases of Goods (Com C §10303)

§7.53 1. Scope of Com C §10303

The assignment or other transfer of a party's rights and interests under a lease of goods and delegation of performance of lease obligations, as well as the transfer of the lessor's residual interest in the leased goods, are addressed in Com C §10303, which is summarized in §§7.54-7.60. Commercial Code §10303 was based on Com C §2210 (see §§7.38-7.52), but covers involuntary as well as voluntary transfers. Official Comment 2 to UCC §2A-303. Important restrictions on the enforceability of certain terms in lease agreements are contained in Com C §9407 (see §7.58). For a more detailed discussion of transfers of interests in leases of goods, see California UCC Sales and Leases, chap 19 (Cal CEB 2002).

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§7.54 2. Assignment and Delegation

An assignment of "the lease" or of "all my rights under the lease" is both a transfer of rights and a delegation of duties, unless the language of the assignment or the circumstances indicate otherwise. Com C §10303(e); *Bescos v Bank of America* (2003) 105 CA4th 378, 394, 129 CR2d 423 (assignment of automobile lease by dealer to bank did not include delegation of duties, because any duties of automobile dealer were executed when customer and dealer entered into lease). See also *LaChapelle v Toyota Motor Credit Corp.* (2002) 102 CA4th 977, 990, 126 CR2d 32. For example, an assignment for security is a transfer of only the assignor's rights under the lease, and does not involve a delegation of the assignor's duties. In the absence of contrary language in the lease or other facts indicating that no delegation of duties was intended, the assignee's acceptance constitutes a promise to perform the assignor's duties under the lease. This promise is enforceable both by the assignor and the other party to the lease contract. Com C §10303(e). Unless otherwise agreed, however, a delegation of performance does not relieve the transferor of any duty to perform or of any liability for default. Com C §10303(f).

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§7.55 3. Subleases of Goods

The term "sublease" is defined in Division 10 as "a lease of goods the right to possession and use of which was acquired by the lessor as a lessee under an existing lease." Com C §10103(a)(23).

NOTE: A real estate sublease is commonly distinguished from an assignment of a real estate lease by the requirement that, in a sublease, the tenant-sublessor retains a reversionary interest in the leased premises. In contrast, an assignment of a real estate lease terminates the tenant's entire interest in the leasehold. See California Landlord-Tenant Practice §3.50 (2d ed Cal CEB 1997). Note that the definition of "sublease" in Com C §10103(a)(23) does not make this distinction.

The rules in Com C §10303 concerning transfer of a lessee's interest under a lease of goods are the same, whether the transfer is denoted an "assignment" or a "sublease." If a lease agreement subject to Division 10 does not contain an express prohibition on subleasing, the lessee is permitted to sublease the goods unless the sublease will materially impair the lessor's prospect of obtaining return performance, materially change the lessor's duties, or materially increase the lessor's burdens or risks. Com C §10303(d)(2). If a lease agreement does prohibit the lessee from entering into a sublease, but the lessee subleases the leased goods in violation of the agreement, the sublease is generally considered to be effective. The lessee-sublessor, however, is in breach of the lease agreement, and the lessor has the remedies set forth in the agreement and other remedies provided by Division 10, including damages, cancellation of the lease contract, or an injunction against the transfer. Com C §10303(b), (d)(1).

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§7.56 4. Restrictions on Lease Transfers

If the lease contract prohibits transfers (including assignments, subleases, creation of security interests, or transfers by judicial process) or makes a transfer an event of default, the transfer will still be effective, but the other party to the lease will have the remedies provided in the lease agreement for its breach and the other remedies provided by Division 10. Com C §10303(b), (d)(1). See also Official Comment 1 to UCC §2A-303; Com C §10501(b).

If the lease provides that an assignment can be made only with the consent of the nonassigning party, as in the case of sales contracts (see §7.43), it is not clear whether consent can be withheld unreasonably. At least one court has held that a lessor with an express right to consent to an assignment who unreasonably withholds its consent is liable to the lessee for any damages resulting from its refusal to permit the assignment. *E.D.S. Corp. v W.A. Foote Mem. Hosp., Inc.* (6th Cir 1994) 25 F3d 406 (applying California law).

In a consumer lease, language prohibiting the transfer of an interest or making a transfer an event of default must be specific, in writing, and conspicuous. Com C §10303(g).

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5. When Restrictions on Transfer Unenforceable

§7.57 a. Transfers of Right to Payment or Damages on Default

Prohibitions on transfer of a right to damages for default with respect to the entire lease contract or a right to payment arising from the transferor's performance of its entire obligation, and provisions that make such transfers an event of default, are not enforceable. Moreover, such a transfer is not deemed to be a transfer that has a material adverse effect on the other party within the scope of Com C §10303(d)(2) (see §7.59). Com C §10303(c).

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§7.58 b. Creation of Security Interest

Commercial Code §9407(a) generally invalidates any prohibition or restriction in a lease agreement (including a provision requiring consent of the other party or triggering an event of default) on creation or enforcement of a security interest in either party's interest under a lease agreement (or in the lessor's residual interest in the goods), in furtherance of the policy to permit the free alienability for security purposes of intangible assets such as accounts, chattel paper, and general intangibles. There is an exception for provisions that make creation or enforcement of a security interest an event of default if there is also either a transfer by the lessee of its right of possession or use of the goods or delegation of material performance of either party in violation of the lease. See also Com C §10303(b); Official Comments 2-4 to UCC §2A-303.

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§7.59 c. Material Adverse Effect on Other Party

Even if the parties have not expressly prohibited assignment or other transfer of a lease contract, or made it an event of default, the other party may still have a claim for damages or other relief if the transfer materially impairs the prospect of obtaining return performance, materially changes the other party's duties, or materially increases the burdens or risks on the other party under the lease contract. Com C §10303(d)(2). The transferor could be liable for damages caused by the transfer (to the extent they could not reasonably be prevented by the other party), and a court may order other relief, such as cancellation of the lease contract or an injunction against the transfer. Com C §10303(d)(2). Official Comment 5 to UCC §2A-303, however, states that relief on the grounds of material prejudice should be granted only in "extreme circumstances," given that the party asserting prejudice did not insist on a provision in the lease agreement that would protect against such a transfer. Moreover, Com C §9407(c) provides that the creation or enforcement of a security interest in the lessor's interest under the lease contract or the lessor's residual interest in the goods is not deemed to be a transfer that has a material adverse effect on the lessee in Com C §10303(d) except to the extent that enforcement actually results in a delegation of material performance of the lessor.

In the context of a typical "net" lease, in which the lessee undertakes responsibility for virtually all operating and other expenses relating to the goods and the lessor's remaining performance relates primarily to honoring the covenant of quiet enjoyment, no material performance remains for the lessor. Consequently, a prohibition on assignment by the lessor in a net lease most likely will not be enforceable. In certain types of operating leases, in which the lessor agrees to undertake responsibilities such as performing repairs or providing some related service, the lessor's remaining performance may be deemed material and the restriction on assignment is likely to be effective.

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§7.60 6. Priorities Among Conflicting Claimants

Because Division 10 gives effect to some transfers that are made in violation of a lease agreement (even though one party may have a right to receive damages or exercise remedies against the other party), conflicting claims to the goods may arise between the transferee and the nondefaulting lessor or lessee. For a detailed discussion of the rules of priority applicable in these situations, see California UCC Sales and Leases, chap 19 (Cal CEB 2002).

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/ IV. THIRD PARTY BENEFICIARIES/§7.61 A. Generally (CC §1559)

IV. THIRD PARTY BENEFICIARIES

§7.61 A. Generally (CC §1559)

Civil Code §1559 codifies the common law principle that a third party for whose benefit a contract has been made may enforce the contract if it has not been rescinded. The statute provides that "[a] contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it." When one party contracts with another to perform an act for the benefit of a third person, the third person for whose benefit the contract was made or who would enjoy the benefit of the act may maintain an action against the promisor for breach of contract. As long as the contract has not been rescinded, the relations among the parties are the same as if the promise had been made directly to the third party. Even if the third party for whose benefit the promise was made was not aware of it when made, the promise is deemed to have been made to the third party if the third party later adopts it. *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1232, 18 CR3d 178.

The third party beneficiary's rights are not founded on the existence of an actual contractual relationship between the parties but rather on the law's recognition that the actions of the contracting parties created an obligation and established privity between the promisor and the third party with respect to that obligation. *Mercury Cas. Co. v Maloney* (2003) 113 CA4th 799, 802, 6 CR3d 647. See also *Spinks v Equity Residential Briarwood Apartments* (2009) 171 CA4th 1004, 1024, 90 CR3d 453. The third party's rights are predicated on the contracting parties' intent to benefit the third party. *Hess v Ford Motor Co.* (2002) 27 C4th 516, 117 CR2d 220; *Vahle v Barwick* (2001) 93 CA4th 1323, 113 CR2d 793. A third party beneficiary need not have given any consideration in order to enforce the agreement. *Macaulay v Norlander* (1992) 12 CA4th 1, 15 CR2d 204.

NOTE: A third party beneficiary may voluntarily waive his or her rights after learning of the contract. The burden is on the party asserting the waiver "to prove it by clear and convincing evidence that does not leave the matter to speculation.… [D]oubtful cases will be decided against a waiver." *Bass v John Hancock Mut. Life Ins. Co.* (1974) 10 C3d 792, 796, 112 CR 195 (although decedent-employee had waived his rights as third party beneficiary of old group insurance plan, he had not waived his rights under new plan).

As used in CC §1559, the word "expressly" has been interpreted to mean simply "the negative of 'incidentally.'" *Prouty v Gores Technol. Group, supra*; *Gilbert Fin. Corp. v Steelform Contracting Co.* (1978) 82 CA3d 65, 70, 145 CR 448. In some cases, however, the statutory term is given a more literal meaning. See, *e.g., Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 957, 23 CR3d 233; *Sofias v Bank of America* (1985) 172 CA3d 583, 587, 218 CR 388 (term "expressly" means "in an express manner; in direct or unmistakable terms; explicitly; definitely; directly"). At a minimum, it must be clear that an intent to make the obligation inure to the benefit of the third party was manifested by the contracting parties. *Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 891, 38 CR3d 78; *Schauer v Mandarin Gems of Cal., Inc., supra*. The test for third party beneficiary status often stated by California courts is as follows (*Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 891, 38 CR3d 78 (citations omitted)):

> The test for determining whether a contract was made for the benefit of a third person is whether an intent to benefit a third person appears from the terms of the contract.… If the terms of the contract necessarily require the promisor to confer a benefit on a third person, then the contract, and hence the parties thereto, contemplate a benefit to the third person. The parties are presumed to intend the consequences of a performance of the contract.

See also *Spinks v Equity Residential Briarwood Apartments* (2009) 171 CA4th 1004, 1023, 90 CR3d 453; *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1232, 18 CR3d 178.

An incidental or remote benefit to a third party is not sufficient to confer third party beneficiary status. *Souza,* 135 CA4th at 891; *Harper v Wausau Ins. Co.* (1997) 56 CA4th 1079, 1087, 66 CR2d 64; *Bancomer, S.A. v Superior Court* (1996) 44 CA4th 1450, 1459, 52 CR2d 435. See also *Martinez v Socoma Cos.* (1974) 11 C3d 394, 400, 113 CR 585. The parties to the contract must have intended to confer a benefit on the third party. *Spinks v Equity Residential Briarwood Apartments*, *supra*; *Souza v Westlands Water Dist., supra*; *Neverkovec v Fredericks* (1999) 74 CA4th 337,

348, 87 CR2d 856. Ascertaining the parties' intent is a matter of ordinary contract interpretation. *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 957, 23 CR3d 233; *Hess v Ford Motor Co.* (2002) 27 C4th 516, 524, 117 CR2d 220. See §§7.64-7.65 for further discussion of the distinction between intended and incidental beneficiaries.

NOTE: Civil Code §1559 does not apply to beneficiaries of a trust, whose rights are governed by the Probate Code. Trust beneficiaries do not have standing as third party beneficiaries to enforce contracts between the trustee and agents of the trustee concerning the internal affairs of the trust. See *Saks v Damon Raike & Co.* (1992) 7 CA4th 419, 8 CR2d 869. Further, third party beneficiary contracts must be distinguished from contracts that have been assigned to a third party. The rights of an assignee arise only when a party to the original contract assigns those rights to a third party. The rights of a third party beneficiary, however, arise at the time when the contract is made for that party's benefit.

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§7.62 B. Scope of Third Party's Rights

Because the foundation of the third party's rights is the promisor's contract, a third party beneficiary cannot assert any rights that are greater than the rights of the promisee under the contract. A third party beneficiary must take the contract as he or she finds it. The third party cannot select only the parts that are favorable to him or her and reject the rest. *Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 38 CR3d 78; *Syufy Enters., L.P. v City of Oakland* (2002) 104 CA4th 869, 888, 128 CR2d 808. In *Syufy Enters.,* the court held that, although a subtenant might be considered a third party beneficiary of a master lease that anticipated the subtenant's continued occupation of part of the premises, the lease did not give the subtenant a greater right to remain in possession of the property than the lessee. Therefore, when the master lease terminated as a result of the lessee's default, the rights of the subtenant also terminated.

In *Whiteside v Tenet Healthcare Corp.* (2002) 101 CA4th 693, 709, 124 CR2d 580, the court held that a hospital patient was not a third party beneficiary of an attorney-fee clause in a contract between the hospital and the patient's health insurance plan, although the patient was a third party beneficiary to the extent that the contract provided for payment of hospital services by the plan on his behalf. The court ruled that a third party is not entitled to enforce covenants in the contract that were not made for his or her benefit. The court emphasized that third party beneficiaries are not parties to the contract itself; their rights to performance are predicated on the contracting parties' intent to benefit them. Therefore, they become intermeddlers with respect to any provisions of the contract not made for their benefit. See also *Loduca v Polyzos* (2007) 153 CA4th 334, 62 CR3d 780 (property owner was intended third party beneficiary of contractor-subcontractor contract and thus could rely on contract's attorney fee clause).

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§7.63 C. Creditor and Donee Beneficiaries

Traditionally, the common law classified third persons holding enforceable rights under contracts to which they were not parties as either creditor beneficiaries or donee beneficiaries. This distinction was reflected the Restatement (First) of Contracts §133 (1932) and has been followed by California courts. See, *e.g., Martinez v Socoma Cos.* (1974) 11 C3d 394, 400, 113 CR 585; *Outdoor Servs., Inc. v Pabagold, Inc.* (1986) 185 CA3d 676, 681, 230 CR 73. Note that both types derive their status as third party beneficiaries from an intent or obligation of a promisee to benefit them. Without such an intent or obligation on the part of the promisee, the third party has no enforceable claim under the contract at all. *Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 893, 38 CR3d 78.

A creditor beneficiary is a third party to whom a promisee owes a preexisting duty that the promisee intends to discharge by means of the promisor's performance. The promisee enters into the contract specifically for the purpose of discharging his or her preexisting duty to the third party beneficiary. *Martinez,* 11 C3d at 400; *Souza,* 135 CA4th at 893; *Outdoor Servs., Inc.,* 185 CA3d at 681.

A donee beneficiary is a third party to whom a promisee intends to make a gift of the promisor's performance. Unlike cases involving third party creditor beneficiaries, the promisee is under no preexisting duty to confer a benefit on the third party. *Souza,* 135 CA4th at 893; *Outdoor Servs., Inc.,* 185 CA3d at 681. If the promisee intends to make a gift, the donee beneficiary can recover if the promisee's donative intent was understood by the promisor or from the nature of the contract and the circumstances accompanying its execution. *Martinez,* 11 C3d at 400. For example, in *Gourmet Lane, Inc. v Keller* (1963) 222 CA2d 701, 35 CR 398, the court held that a restaurant association was a third party donee beneficiary of an agreement among all of its members to bear certain costs; the other members intended to benefit the association by obtaining a promise of payment from the defendant-member.

A third party creditor beneficiary may sue either the promisor or the promisee or may join them both in a lawsuit and obtain judgment against both of them. *Kraus v Willow Park Pub. Golf Course* (1977) 73 CA3d 354, 371, 140 CR 744. The creditor beneficiary's claim against the promisor is based on the contract itself, while its claim against the promisee is based on the promisee's preexisting duty that gives rise to the beneficiary's creditor status. In contrast, at least historically, a donee beneficiary could sue only the promisor in the event of the promisor's nonperformance, because the promisee has no duty to the donee beneficiary. See generally Eisenberg, *Third party Beneficiaries*, 92 Colum L Rev 1358 (Oct. 1992).

The Restatement (Second) of Contracts §302 (1981) eliminated the terms "creditor" and "donee" but has retained the same concepts in §302(1)(a)-(b). *Souza,* 135 CA4th at 893. The Restatement (Second) allows both creditor and donee beneficiaries to sue either the promisor or the promisee or both, depending on the respective duties of the promisor and promisee owed to the beneficiary, as long as the beneficiary is an *intended* beneficiary. Restatement (Second) of Contracts §310(1) (1981). California courts are following this trend, and the historical distinction between creditor and donee beneficiaries is beginning to vanish. Although the concepts are still viable, the specific terms are being abandoned by the courts to permit broader application of third party beneficiary doctrine. *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1236 n3, 18 CR3d 178.

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D. Intended and Incidental Beneficiaries

§7.64 1. Intended Beneficiaries

As discussed in §7.61, the test articulated by California courts for determining whether a third party has a right to enforce a contract as a third party beneficiary is whether an intent to benefit the third party appears from the contract terms. *Spinks v Equity Residential Briarwood Apartments* (2009) 171 CA4th 1004, 1023, 90 CR3d 453; *Souza v Westlands Water Dist.* (2006) 135 CA4th 879, 891, 38 CR3d 78. This test is consistent with the approach of Restatement (Second) of Contracts §302 (1981), which defines third party beneficiaries with enforcement rights as "intended beneficiaries," and then defines more remote or "incidental" beneficiaries (without enforcement rights) as beneficiaries who are not intended beneficiaries. Although many cases state generally that both contracting parties must intend to confer a benefit on the third party, the party whose intent is most relevant is the promisee. The promisor's intent is not generally at issue, although the promisor's knowledge of the promisee's intent may be relevant. "The point of the third party beneficiary doctrine is to allow a third party to enforce, against a promisor, rights running to the third party for which the *promisee* bargained." 135 CA4th at 893 (citations omitted). As the court of appeal explained in *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 957, 23 CR3d 233 (citations omitted):

> [A]n intent to make the obligation inure to the benefit of the third party must have been clearly manifested by the contracting parties.… Although this means persons only incidentally or remotely benefited by the contract are not entitled to enforce it, it does not mean both of the contracting parties must intend to benefit the third party: Rather, it means the promisor… must have understood that the promisee… had such intent.… No specific manifestation by the promisor of an intent to benefit the third person is required.

See also *Lucas v Hamm* (1961) 56 C2d 583, 591, 15 CR 821; *Johnson v Superior Court* (2000) 80 CA4th 1050, 1064, 95 CR2d 864.

Normally, it is a question of fact whether a particular third party is an intended beneficiary of a contract. *Souza,* 135 CA4th at 891; *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1233, 18 CR3d 178. "Whether the third party is an intended beneficiary or merely an incidental beneficiary involves construction of the intention of the parties, gathered from reading the contract as a whole in light of the circumstances under which it was entered." 121 CA4th at 1233 (citations omitted). See also *Spinks v Equity Residential Briarwood Apartments* (2009) 171 CA4th 1004, 1024, 90 CR3d 453; *Business to Bus. Mkts., Inc. v Zurich Specialties London Ltd.* (2005) 135 CA4th 165, 170, 37 CR3d 295; *Burnett v Chimney Sweep* (2004) 123 CA4th 1057, 1070, 20 CR3d 562. This is a wide-ranging inquiry that focuses on the language of the contract and relevant surrounding circumstances. In contrast, if the issue of whether a particular third person is an intended beneficiary is presented to the court on the basis of undisputed facts and only a question of the application of the law to those facts remains, the issue becomes a question of law that the courts will resolve independently. *Souza,* 135 CA4th at 891; *Prouty v Gores Technol. Group,* 121 CA4th at 1233.

Following is an example of a contract clause designed to prevent any third person from attaining third party beneficiary status:

> **This Agreement is made solely for the benefit of the parties to this Agreement and their respective successors and assignees, and, except as provided in ___, no other person or entity shall have or acquire any right by virtue of this Agreement.**

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§7.65 2. Incidental Beneficiaries

A third person who receives only an incidental or remote benefit from performance of a contract is not entitled to enforce it. The fact that the third party is named incidentally in the contract or that the contract, if performed in accordance with its terms, would inure to his or her benefit is insufficient to entitle the third party to demand performance. For a third party to have the right to enforce the contract, it must appear that the contracting parties intended to secure the benefit of the contract's provisions for the third party. *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1232, 18 CR3d 178.

Following are cases in which the courts found that the plaintiffs were incidental beneficiaries, too remote to have standing to enforce the contract.

- *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 4 CR3d 583 (emergency medical group was not intended beneficiary of contracts between hospital and insurance company).
- *Bancomer, S.A. v Superior Court* (1996) 44 CA4th 1450, 52 CR2d 435 (bank trustee under purchase agreement was incidental beneficiary; parties had entered into contract and named bank as trustee for their own, rather than its, benefit).
- *Kalmanovitz v Bitting* (1996) 43 CA4th 311, 50 CR2d 332 (beneficiaries named in will codicils were not intended beneficiaries of will agreement; neither agreement nor principal wills referred to them).
- *Ascherman v General Reinsurance Corp.* (1986) 183 CA3d 307, 228 CR 1 (contract of reinsurance was for benefit of insurance company, not its insured; insured had no enforceable claim against reinsurer).
- *Martinez v Socoma Cos.* (1974) 11 C3d 394, 113 CR 585 (disadvantaged poor had no right of action against contractor hired by government to provide 2000 jobs to them when less than 2000 jobs were actually provided).
- *Chamberlain v City of Los Angeles* (1949) 92 CA2d 330, 206 P2d 661 (third party victim is not third party beneficiary of indemnity insurance policy unless policy expressly so states).

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§7.66 E. Who Qualifies as Third Party Beneficiary

It is not necessary that the third party beneficiary be named or otherwise specifically identified in the contract. *Spinks v Equity Residential Briarwood Apartments* (2009) 171 CA4th 1004, 1024, 90 CR3d 453. A third party beneficiary may enforce the contract if he or she can show that he or she is a member of a class for whose benefit the contract was made. *Prouty v Gores Technol. Group* (2004) 121 CA4th 1225, 1232, 18 CR3d 178; *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479; *Soderberg v McKinney* (1996) 44 CA4th 1760, 1773, 52 CR2d 635. Further, the contract need not have been made exclusively for the benefit of the third party seeking to enforce it. That party does not need to be the sole or even the primary beneficiary. *Prouty v Gores Technol. Group, supra*; *Johnson v Superior Court* (2000) 80 CA4th 1050, 1064, 95 CR2d 864. There is no requirement that all intended beneficiaries join in the suit to enforce the contract. *Johnson v Superior Court, supra.* It is enough to be one of the intended third party beneficiaries of a contract. The intended beneficiary has the burden of proving that the promise he or she seeks to enforce was actually made to him or her personally or to a class of which he is a member. *Neverkovec v Fredericks* (1999) 74 CA4th 337, 348, 87 CR2d 856.

Following are cases in which the courts found that the plaintiffs were intended third party beneficiaries with standing to enforce the contracts indicated:

- *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 957, 23 CR3d 233 (ring owner, under contract between jewelry store and ring owner's ex-husband for purchase of ring to be given to ring owner).
- *Prouty v Gores Technol. Group, supra* (former employees, under purchase agreement between prior employer and acquiring company, with provisions regarding termination of employees and severance pay).
- *Diamond Woodworks, Inc. v Argonaut Ins. Co.* (2003) 109 CA4th 1020, 1040, 135 CR2d 736 (client of employee leasing company, under leasing company's workers' compensation policy).
- *Johnson v Superior Court* (2000) 80 CA4th 1050, 95 CR2d 864 (sperm donor, under contract between sperm bank and its client, with confidentiality provisions).
- *Alling v Universal Mfg. Corp.* (1992) 5 CA4th 1412, 1440, 7 CR2d 718 (licensor of technology, under asset purchase and sale agreement between licensee and acquiring company).
- *20th Century Cigarette Vendors v Shaheen* (1966) 241 CA2d 391, 50 CR 773 (lenders, under borrower's contract to transfer property to defendant, under which defendant had agreed to pay lenders).
- *Dick v Woolson* (1951) 106 CA2d 415, 419, 235 P2d 119 (creditors of selling business, under sales agreement, with provision for assumption of their claims by purchaser).

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§7.67 F. Defenses to Enforcement by Third Party Beneficiary

For a third party beneficiary to enforce a contract, there must be a valid and subsisting obligation between the promisor and the promisee. *Johnson v Superior Court* (2000) 80 CA4th 1050, 95 CR2d 864; *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479. Hence, in addition to the potential defense that the third party is not in fact an intended beneficiary of the contract (see §§7.61, 7.64), any defenses to formation of the contract, such as incapacity, fraud, undue influence, mistake, illegality, or inadequate consideration (see generally chaps 2-4), will constitute potential defenses to an enforcement action by a third party beneficiary. See Restatement (Second) of Contracts §309(1) (1981). A legally recognized excuse for nonperformance, such as force majeure, impossibility or impracticability, or the nonoccurrence or nonperformance of a condition (see generally chap 8), will also operate as a defense. See Restatement (Second) of Contracts §309(2) (1981). Further, the contract cannot have been rescinded. CC §1559; *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman*, *supra*. Enforcement by a third party beneficiary is also subject to the applicable contract statute of limitations. *Skylawn & Skyview Mem. Lawn v Superior Court* (1979) 88 CA3d 316, 319, 151 CR 793. See chap 9.

NOTE: If rescission of a third party beneficiary contract has not occurred, but the contract is terminated for some other reason (*e.g.,* because of one party's breach of contract or by operation of law), the third party beneficiary might be allowed to enforce the agreement, depending on the language of the contract and other circumstances of the case. See *Principal Mut. Life Ins. Co.,* 65 CA4th at 1486. The *Principal Mutual* case involved the foreclosure of a deed of trust that extinguished a lease with an attornment clause that was designed to take effect on foreclosure. The court held that the new owner could enforce the attornment provision as a third party beneficiary and require the tenants to execute a new lease, notwithstanding that the old lease had terminated. However, in the absence of a clause (such as the attornment clause in the *Principal Mutual* case) that remains effective on or after termination of other provisions of the contract, courts will not allow a third party beneficiary to enforce a contract provision that has terminated because of the general rule that a third party beneficiary has no greater rights than those of the promisee under the contract. *Syufy Enters., L.P. v City of Oakland* (2002) 104 CA4th 869, 888, 128 CR2d 808. See §7.62.

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§7.68 G. Rescission or Modification of Third Party Beneficiary Contracts

As discussed in §7.61, CC §1559 provides that a third party beneficiary may enforce the contract at any time before it is rescinded. The principles governing rescission of third party beneficiary contracts are the same as those applicable to the rescission of contracts generally. *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1486, 77 CR2d 479. The remedy of rescission is discussed in §§11.46-11.58. Rescission or modification may not be allowed if the third party beneficiary has acted in justifiable reliance on the promises made for his or her benefit. *Principal Mut. Life Ins. Co.,* 65 CA4th at 1490 n9; *Dick v Woolson* (1951) 106 CA2d 415, 419, 235 P2d 119. See Restatement (Second) of Contracts §311, Comment g (1981).

Life insurance policies are classic examples of third party beneficiary contracts, but are subject to a special rule. Insurance Code §10170(e) provides that life insurance policies can be rescinded or amended by the insurer and the policyholder without consent of the beneficiary unless the policy provides that the beneficiary's rights are irrevocable. See *Marriage of O'Connell* (1992) 8 CA4th 565, 576, 10 CR2d 334. Another section of the Insurance Code, Ins C §650, ostensibly prohibits an insurer from unilaterally rescinding a policy after a beneficiary of the policy has filed suit to enforce it, but the insurer is nonetheless allowed to raise the same issues (such as misrepresentation or concealment of material facts in the insurance application) by asserting rescission as an affirmative defense and counterclaim. *Resure, Inc. v Superior Court* (1996) 42 CA4th 156, 166, 49 CR2d 354. In *LA Sound USA, Inc. v St. Paul Fire & Marine Ins. Co.* (2007) 156 CA4th 1259, 67 CR3d 917, an action for breach of the duty to defend, St. Paul asserted the affirmative defense of misrepresentation, alleging material misrepresentations in the application rendered the policy "voidable, and/or subject to reformation or rescission." St. Paul also filed a cross-complaint asserting a cause of action for misrepresentation and sought "rescission or appropriate reformation or voidance of the Policy." The court, following *Resure*, held this was allowable under Ins C §650, which bars an insurer only from filing a separate suit for rescission. 156 CA4th at 1268.

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V. JOINT AND SEVERAL OBLIGATIONS

§7.69 A. Introduction (CC §1430)

Civil Code §1430 provides that "[a]n obligation imposed upon several persons, or a right created in favor of several persons, may be: 1. Joint; 2. Several; or, 3. Joint and several." Liabilities are said to be "joint" if two or more obligors promise the same performance to another, *e.g.,* if X and Y together promise to pay Z a total of $10,000. See *Chun v Chun* (1987) 190 CA3d 589, 597, 235 CR 553 (holding two or more obligors are considered jointly liable only if each is bound to render same performance to obligee). If X and Y further agree that each will be fully responsible to Z for the entire amount, the liability of X and Y is "joint and several." Joint and several liability may also be presumed in certain cases. See §7.71. If X and Y promise separate, although similar, performances, *e.g.,* if each promises to pay Z $5,000, for a total of $10,000, X and Y have several, but not joint, liability. See generally Restatement (Second) of Contracts, chap 13, Introductory Note (1981). As discussed in §7.72, the distinction made historically between "joint" and "joint and several" liability—still reflected in CC §1430—is obsolescent if not entirely obsolete now in California following amendments to the Code of Civil Procedure.

NOTE: The following discussion is limited to joint and several rights and liabilities arising from contractual obligations. It does not address issues relating to joint and several liability in tort, including comparative fault issues. See generally CC §§1431.1-1431.5; California Tort Guide (4th ed Cal CEB 2009); California Tort Damages (2d ed Cal CEB 2002).

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B. Two or More Obligors

§7.70 1. Interpreting the Contract

In the first example in §7.69 (if X and Y together promise to pay Z a total of $10,000), without anything further, it is not certain whether X and Y have made a joint or a joint and several promise. In these situations, a court will consider "the language used by the parties… in the light of the surrounding circumstances and of the practical and mutual construction placed thereon as shown by their acts and conduct before any controversy has arisen between them." *Kaneko v Okuda* (1961) 195 CA2d 217, 225, 15 CR 792; *Douglas v Bergere* (1949) 94 CA2d 267, 270, 210 P2d 727. The court will also employ the presumptions of joint and several liability in CC §§1659-1660. See §7.71. The issue may also be clarified by the conduct of a party that constitutes an estoppel. See, *e.g., Monroe v Owens* (1946) 76 CA2d 23, 27, 172 P2d 110 (plaintiff's action in bringing suit for unpaid rents against defendants jointly and obtaining joint recovery constituted acknowledgment that defendants' contractual obligations were joint; therefore, plaintiff could not deny that defendants' rights were also joint).

These cases emphasize the importance of precise contract drafting in documenting any agreement having two or more promisors or two or more promisees. In *Vons Cos., Inc. v United States Fire Ins. Co.* (2000) 78 CA4th 52, 64, 92 CR2d 597, a settlement agreement called for payment of the settlement proceeds by the defendants as a group, without specifying any allocation or severance of their respective liabilities. The court confirmed that although there were other parties obligated under the settlement, the defendant Vons was jointly and severally liable and legally obligated to pay the entire amount. In *Vincent v Grayson* (1973) 30 CA3d 899, 106 CR 733, the contracts expressly provided: "I/We hereby promise and agree to pay Vincent Signs…." The court found that this language created a joint and several obligation. 30 CA3d at 905. In *Dabney v Dabney* (1935) 9 CA2d 665, 51 P2d 108, the contract language stated "We, each for himself or herself, hereby agree to bind ourselves to pay." The court held that this evidenced the parties' intention to form a joint and several obligation. 9 CA2d at 674.

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§7.71 2. When Joint and Several Liability Presumed (CC §§1659, 1660; Corp C §16306)

Civil Code §1659 provides that "[w]here all the parties who unite in a promise receive some benefit from the consideration, whether past or present, their promise is presumed to be joint and several." Section 1659 does not require that the benefit be received equally, as long as each of the promisors received some benefit from the contract. *Olson v Foster* (1941) 42 CA2d 493, 109 P2d 388. The presumption of joint and several liability in §1659 is not conclusive; it is rebuttable, but it controls in the absence of contrary evidence. *Kaneko v Okuda* (1961) 195 CA2d 217, 227, 15 CR 792; *Douglas v Bergere* (1949) 94 CA2d 267, 210 P2d 727. See *Keppelman v Heikes* (1952) 111 CA2d 475, 245 P2d 54 (corporate and individual defendants were jointly and severally liable, regardless of whether they were partners or joint venturers); *Gelbach v Dewey* (1930) 105 CA 149, 286 P 1062 (joint and several liability of co-makers of promissory note). In *Davis v Morris* (1940) 37 CA2d 269, 99 P2d 345, the court held that members of a mining partnership named in a lawsuit as individuals were jointly and severally liable, notwithstanding that the members were not sued as a partnership.

Civil Code §1660 provides that "[a] promise, made in the singular number, but executed by several persons, is presumed to be joint and several." See *William v Reed* (1952) 113 CA2d 195, 248 P2d 147, in which the court held that when a promissory note is drafted in the singular but is signed by several co-makers, the presumption is that the promise and the obligations of the co-makers are joint and several. See also *Dabney v Dabney* (1935) 9 CA2d 665, 51 P2d 108.

The Uniform Partnership Act of 1994 (Corp C §§16100-16962) provides that, except for newly admitted partners and partners in certain limited liability partnerships, "all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law." Corp C §16306.

There is a presumption that a person who cosigns a promissory note with others is liable on the note as a comaker or co-obligor rather than as a guarantor. Under CC §2832, parol evidence is admissible by a comaker of an instrument who appears to be a principal, to show that he or she is instead a guarantor, except as against persons who have acted on the faith of his or her apparent status as principal. *Quality Wash Group V, Ltd. v Hallak* (1996) 50 CA4th 1687, 1700, 58 CR2d 592; *Beverly Hills Nat'l Bank v Glynn* (1968) 267 CA2d 859, 73 CR 808.

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§7.72 3. Joint Obligations Distinguished (CC §1431)

Civil Code §1431 states a general rule, operative before consideration of the presumptions of joint and several liability discussed in §7.71:

> An obligation imposed upon several persons, or a right created in favor of several persons, is presumed to be joint, and not several,… except in the special cases mentioned in the title on the interpretation of contracts. This presumption, in the case of a right, can be overcome only by express words to the contrary.

The rule is also reflected in older decisions as follows: "several persons contracting together with the same party for one and the same act, shall be regarded as jointly and not individually or separately liable, in the absence of any words to show that a distinct as well as entire liability was intended to fasten upon the promisors." *Farmers' Exch. Bank v Morse* (1900) 129 C 239, 243, 61 P 1088. See also *Morrison Drilling Co. v Superior Court* (1962) 208 CA2d 740, 742, 25 CR 682. The reference in CC §1431 to "special cases mentioned in the title on the interpretation of contracts" are to CC §§1659-1660. See §7.71.

Historically, the distinction between "joint" and "joint and several" liability was important primarily because a suit could not be maintained against obligors who were jointly, but not jointly and severally, liable unless all obligors were joined in the action. See former CCP §382; *Farmers' Exch. Bank,* 129 C at 243. This is no longer the rule under the Code of Civil Procedure. See CCP §§382, 410.70. The distinction was also important under the Uniform Partnership Act of 1914, which was repealed in California effective January 1, 1999. Under former Corp C §15015, the liability of general partners for partnership obligations was joint rather than joint and several. As a consequence, a judgment against less than all of the partners would extinguish the claim against all partners because the joint obligation was merged into the judgment, and because the partners did not undertake individual liability. See *Vincent v Grayson* (1973) 30 CA3d 899, 907 n3, 106 CR 733. As noted in §7.71, the current Uniform Partnership Act of 1994 (Corp C §§16100-16962) now provides that, in general, all partners are jointly and severally liable for all partnership obligations, unless otherwise agreed by the creditor or otherwise provided by law. See Corp C §16306(a).

The distinction between "joint" and "joint and several" is maintained in the Restatement (Second) of Contracts (1981), but the Restatement notes that the older common law rules set forth in the Restatement have been repudiated by statute in many jurisdictions, including California. See Restatement (Second) of Contracts, chap 13, Introductory Note (1981).

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§7.73 4. Several Obligations Distinguished

A several obligation is created when "two or more parties to a contract promise separate performances, to be rendered respectively by each of them, or where each of them makes only a separate promise that the same performance shall be rendered." *Douglas v Bergere* (1949) 94 CA2d 267, 270, 210 P2d 727; *George Herz & Co. v Solt* (1937) 23 CA2d 178, 72 P2d 251 (where members of association pledged to pay amounts listed opposite their names, obligation was several, not joint). Each promisor is bound severally for the performance that he or she promised and is not bound jointly with any of the other promisors. *Freeman v Jergins* (1954) 125 CA2d 536, 562, 271 P2d 210. Several liability is also referred to as individual and several liability or individual liability. See *Chun v Chun* (1987) 190 CA3d 589, 596 n5, 235 CR 553.

In *Freeman,* three stockholders orally agreed to pay a finder for his services in introducing them to a broker if the broker was able to effect a sale of their stock. Each stockholder owned or controlled a specific number of shares as an individual. The court of appeal reversed the trial court's joint judgment against the stockholders for the finder's fee. The court noted that each block of stock sold was owned entirely separately by each shareholder, and there was no evidence that they promised jointly to compensate the finder. Each shareholder had contributed a certain number of shares to the total amount of stock to be sold, but did not make any promises on behalf of other shareholders to pay the finder a specific sum. There was no express agreement that would create joint liability and no community of ownership that would create an inference that any shareholder would ever be expected to pay more than his proportionate share of the finder's fee. The court held that the judgment should have been against the defendants severally, in accordance with their respective interests. 125 CA2d at 562.

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§7.74 5. Suretyship Relationships Distinguished

Joint or joint and several liability is distinct from the liability of a surety or guarantor on an obligation. A suretyship relationship also arises when two persons are under an obligation to the same obligee who is entitled to only one performance, but in a suretyship only one of the obligors is primarily liable to bear the burden of the obligation. The obligor who is primarily responsible for the debt is the principal, and the other is the surety. *Mead v Sanwa Bank* (1998) 61 CA4th 561, 566, 71 CR2d 625. "A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor." CC §2787. See CC §2794 for exceptions to this definition. See generally *First Nat'l Ins. Co. v Cam Painting, Inc.* (2009) 173 CA4th 1355, 93 CR3d 808. The surety may require the obligee to proceed first against the principal. See CC §2845. Suretyship relationships are governed by CC §§2787-2856. A full discussion of suretyship relationships is beyond the scope of this title.

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6. Effect of Joint and Several Liability

§7.75 a. Performance by One Obligor (CC §1474)

If one obligor who is jointly liable with another for performance of a contractual obligation performs the entire obligation, his or her performance serves to eliminate the other's liability. As Civil Code §1474 provides, "[p]erformance of an obligation, by one of several persons who are jointly liable under it, extinguishes the liability of all." For the liability to be extinguished under CC §1474, it must be shown that the entire obligation has been performed. Performance of the whole is required to eliminate the whole liability. *BII Fin. Co. v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 127, 115 CR2d 312.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.76 b. Release of One Obligor (CC §1543; CCP §877)

§7.76 b. Release of One Obligor (CC §1543; CCP §877)

If one joint obligor pays or otherwise satisfies part of the obligation and is thereafter released by the obligee, the release does not extinguish the obligation of any other joint obligor to pay the remaining part of the debt not paid by the released obligor. In other words, the release does not extinguish the remainder of the obligation with respect to the other co-obligor(s). *Lovetro v Steers* (1965) 234 CA2d 461, 477, 44 CR 604. As stated in CC §1543:

> A release of one of two or more joint debtors does not extinguish the obligations of any of the others, unless they are mere guarantors; nor does it affect their right to contribution from him or her, except as provided in Section 877 of the Code of Civil Procedure.

For contracts made on or after January 1, 1988, co-obligors who have not expressly agreed in writing to an apportionment of liability for losses or claims among themselves are subject to the rules stated in CCP §877 concerning the effect of a release, dismissal, or covenant not to sue or enforce a judgment. It provides that:

> Where a release, dismissal with or without prejudice, or a covenant not to sue or not to enforce judgment is given in good faith before verdict or judgment… to one or more other co-obligors mutually subject to contribution rights, it shall have the following effect:
>
> (a) It shall not discharge any other such party from liability unless its terms so provide, but it shall reduce the claims against the others in the amount stipulated by the release, the dismissal or the covenant, or in the amount of the consideration paid for it whichever is the greater.
>
> (b) It shall discharge the party to whom it is given from all liability for any contribution to any other parties.

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§7.77 c. Assignment by Obligee to One Obligor

Assignment of a joint and several debt by the obligee to one of the co-obligors extinguishes that debt. Such an assignment is the equivalent of payment. As a result, the evidence of the debt, *e.g.,* a note or judgment, becomes of no further effect, and no action can be maintained on the original debt. However, the party who satisfies the obligation has a right of contribution against the other co-obligors under CC §1432. See §7.78. Note that the rule concerning assignment applies only if the co-obligors share primary liability. If a guarantor or surety with secondary liability pays the debt, the obligation is not automatically extinguished. Instead, the guarantor or surety can maintain an action on the original obligation against the party primarily liable for its payment. *Great W. Bank v Kong* (2001) 90 CA4th 28, 32, 108 CR2d 266; *Quality Wash Group V, Ltd. v Hallak* (1996) 50 CA4th 1687, 58 CR2d 592.

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§7.78 d. Rights of Contribution (CC §1432)

If one party who is jointly or jointly and severally liable on a claim with others satisfies more than its share of the claim, that party has a right of contribution to recover proportionately from the others. As stated in CC §1432:

> Except as provided in Section 877 of the Code of Civil Procedure, a party to a joint, or joint and several obligation, who satisfies more than his share of the claim against all, may require a proportionate contribution from all the parties joined with him.

In *Murchison v Murchison* (1963) 219 CA2d 600, 604, 33 CR 285, the court noted that, although in some cases an agreement for contribution can be implied, the common law principle reflected in CC §1432 developed in the courts of equity and is founded on natural justice rather than an agreement of the parties. "The underlying idea is that it is just and equitable for the person benefited to pay his proportionate share." Civil Code §1432 is "consistent with the equitable origin of the doctrine in that its application is not limited to cases where consent, express or implied, can be found." 219 CA2d at 604.

In *Jans v Nelson* (2000) 83 CA4th 848, 100 CR2d 106, the court considered the "proportionate contribution" concept set forth in CC §1432. The court confirmed that, in the absence of an express agreement, an allocation of contribution rests on principles of equity and natural justice. If business associates are primarily liable as co-obligors on a business debt, their shares of contribution among themselves are presumed to be proportionate to their ownership interest in the business, in the absence of an agreement to the contrary. 83 CA4th at 857. In *Jans,* all of the limited partners had guaranteed the partnership's note, including both partners who were active in daily management of the business and partners whose participation was only financial. Further, their respective interests in partnership profits varied greatly. The court found that the inference was inescapable that the guarantors were required to sign the guaranties solely because of their partnership interests. The court concluded that "in a circumstance in which all limited partners execute guaranties of a partnership debt and there is no other express agreement concerning rights of contribution, equity requires the proportionate obligation for contribution to be based upon the ownership interest of the various guarantors." 83 CA4th at 858.

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Source: Business Law/California Law of Contracts/7 Assignment and Delegation, Third Party Beneficiaries, and Joint and Several Obligations/§7.79 e. Joinder of Joint Obligors in Action on Contract

§7.79 e. Joinder of Joint Obligors in Action on Contract

As discussed in §7.72, it is no longer the rule under the Code of Civil Procedure that all parties who are jointly liable on a obligation must be joined in a suit to enforce the obligation. Code of Civil Procedure §410.70 now provides:

> In an action against two or more persons, who are jointly, jointly and severally, or severally liable on a contract, the court in which the action is pending has jurisdiction to proceed against such of the defendants as are served as if they were the only defendants.

If a judgment is entered against one or more joint obligors by proceeding under CCP §410.70, a so-called "joint debtor summons" may be issued against the joint obligors who were not originally served and did not appear in the action, to show cause why they should not be bound by the judgment as if they had been served originally. CCP §989. See also CCP §§990-994. Section 989 only applies if the alleged joint obligor was named or joined as a party in the original suit and the complaint stated a joint liability cause of action against the joint obligor, but it was not served with summons. *Meller & Snyder v R & T Props., Inc.* (1998) 62 CA4th 1303, 1310, 73 CR2d 740

For further discussion of issues relating to permissive and compulsory joinder of parties in state court litigation, see California Civil Procedure Before Trial (4th ed Cal CEB 2004).

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§7.80 C. Two or More Obligees (CC §§1431, 1475)

Civil Code §1431 (see §7.72) applies to jointly held contract rights in addition to joint liabilities. It provides in part that "a right created in favor of several persons, is presumed to be joint, and not several.… This presumption, in the case of a right, can be overcome only by express words to the contrary." Ordinarily, parties are not joint obligees unless they have entered into a contract together that operates to give them a joint right of action or unless they have suffered injury to a property interest owned by them in some form of joint ownership. *Leeper v Beltrami* (1959) 53 C2d 195, 209, 1 CR 12. In *Cober v Connolly* (1942) 20 C2d 741, 744, 128 P2d 519, the promissory note at issue contained an unqualified general promise to pay to "Keith C. Eversole, W. D. L. Held and P. Connolly, or order" a stated amount. The court found that in this form, the note created a joint right in favor of the three payees, the legal consequences of which were as follows (20 C2d at 745, citations omitted):

> [W]hen one of two or more joint creditors accepts payment of the obligation, he holds the proceeds as a trustee or agent for them and is directly accountable to them as such. But so far as the debtor is concerned, the co-obligee is more than a mere agent; he is the owner of the obligation. Since each of several joint obligees is interested in the entire claim, he has the power to discharge the entire claim either by release or by accord and satisfaction, and so a payment or other performance of the whole obligation to one obligee discharges it; and a tender to one is legally a tender to all.

Civil Code §1475 provides that "[a]n obligation in favor of several persons is extinguished by performance rendered to any one of them" (with an exception that is likely no longer of any effect). In *Cober,* the debtor provided goods and services to one joint creditor. The court held that this effectually discharged that creditor's individual right against the debtor, and, under the general rule, also discharged the debt as to all of the other creditors. 20 C2d at 745.

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8

Performance or Breach of Contract

I. INTRODUCTION §8.1

II. PERFORMANCE OF CONTRACTS UNDER THE CIVIL CODE
- A. Full and Part Performance
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§8.1 I. INTRODUCTION

Once a contract has been formed and its terms interpreted so as to specify the duties of each party, any conditions to those duties, and the time for performance, contract law analysis shifts to issues of how contractual duties can be discharged. (The Civil Code uses the word "extinguish" in place of "discharge.") In this chapter, discharge by performance or a tender of performance is discussed in §§8.2-8.27 (non-Commercial Code contracts) and 8.48-8.61 (Commercial Code contracts), and discharge by legally recognized excuses for nonperformance is discussed in §§8.28-8.41 (non-Commercial Code contracts) and 8.62-8.64 (Commercial Code contracts). The other means of discharge or extinction of contractual obligations are accord and satisfaction (discussed in §§8.42-8.45), novation (discussed in §8.46), and release (discussed in §8.47).

Breach of contract is discussed in §§8.66-8.77. Remedies for breach of contract are addressed in chaps 10-12.

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II. PERFORMANCE OF CONTRACTS UNDER THE CIVIL CODE

A. Full and Part Performance

§8.2 1. Full Performance Discharges Obligation; Substantial Performance (CC §§1473-1475)

Civil Code §1473 provides that full performance of an obligation, by the party whose duty it is to perform it, or by any other person on his or her behalf, and with his or her assent, extinguishes the obligation if accepted by the creditor. Similarly, CC §1474 provides that performance of an obligation by one of several persons who are jointly liable for performance of it, extinguishes the liability of all. To extinguish an obligation, performance of it must be of the entire obligation; partial performance is insufficient. *BII Fin. Co. v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 127, 115 CR2d 312. Further, the performance or tender of performance must be timely and in proper form. For example, if a creditor directs a debtor to mail a payment, the payment is deemed made when it is deposited in the mail. Otherwise, the payment is not effective until the creditor receives it. *Nguyen v Calhoun* (2003) 105 CA4th 428, 439, 129 CR2d 436 (payment in full of sums due secured by deed of trust that arrived at lender's office 3 days after foreclosure sale did not satisfy obligation, and foreclosure sale would not be set aside).

Civil Code §1475 provides that an obligation in favor of several persons is extinguished by performance rendered to any one of them (with an exception that is likely no longer of any effect). In *Hurley v Southern Cal. Edison Co.* (9th Cir 1950) 183 F2d 125, the court commented that this section should apply only as long as the obligor can rightly assume that the obligee to whom performance is rendered will account to the other obligees. If the obligor has reason to know that the obligee will not account to the other obligees, the obligation should not be discharged.

The doctrine of "substantial performance" as distinct from strict performance of an obligation often finds application in California in the context of building contracts. It holds that substantial performance is sufficient and will justify an action on the contract, but the other party will be entitled to a reduction in the amount owed to compensate for the deficiency in performance. *Denver D. Darling, Inc. v Controlled Env't's Constr., Inc.* (2001) 89 CA4th 1221, 1238 n8, 108 CR2d 213. See also *Posner v Grunwald-Marx, Inc.* (1961) 56 C2d 169, 186, 14 CR 297; *Votaw Precision Tool Co., Inc. v Air Canada* (1976) 60 CA3d 52, 55, 131 CR 335 (under doctrine of substantial performance, obligor is entitled to contract price less any damages caused by its failure to perform). Substantial performance is a corollary of the doctrine of immaterial breach. See §8.70; *Superior Motels, Inc. v Rinn Motor Hotels, Inc.* (1987) 195 CA3d 1032, 1051, 241 CR 487. In *Lowy v United Pac. Ins. Co.* (1967) 67 C2d 87, 92, 60 CR 225, the California Supreme Court described the proper application of the doctrine as follows:

> [I]n the case of a building contract where the owner has taken possession of the building and is enjoying the fruits of the contractor's work in the performance of the contract, if there has been a substantial performance thereof by the contractor in good faith, if the failure to make full performance can be compensated in damages to be deducted from the price or allowed as a counterclaim, and if the omissions and deviations were not wilful or fraudulent and do not substantially affect the usefulness of the building or the purpose for which it was intended, the contractor may, in an action upon the contract, recover the amount of the contract price remaining unpaid, less the amount allowed as damages for the failure of strict performance.

Under this approach, there is substantial performance if there is no willful departure from the terms of the contract and the defective performance is capable of being easily remedied or compensated for, so that the obligee receives the practical benefit of the contract. *Denver D. Darling, Inc. v Controlled Env't's Constr., Inc.*, *supra*. What constitutes substantial performance is a question of fact. *Denver D. Darling, Inc. v Controlled Env't's Constr., Inc., supra*.

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§8.3 2. Performance in Manner Directed by Creditors (CC §1476)

Civil Code §1476 provides that if a creditor (or any one of two or more joint creditors) directs the debtor to perform its obligation in a particular manner, the obligation is extinguished by performance in that manner, even if the creditor does not receive the benefit of the performance. This statute has been construed narrowly. For example, in *Cornwell v Bank of America* (1990) 224 CA3d 995, 998, 274 CR 322, the borrower mailed a loan payment, which the lender never received. The borrower argued that the lender had directed him to mail payments by providing envelopes and payment coupons that stated "Detach and mail with payment" and "Mail this coupon with check payable to Bank of America." But the court rejected this argument, observing that nothing prevented the debtor from making payments in person at a local branch of the bank. The court ruled that, as a matter of law, payment had not been made. In the absence of a specific direction by the lender to mail the payment, depositing a check in the mail does not constitute payment, and merely supplying a mailing address does not constitute a direction to mail the payment. See also *Nguyen v Calhoun* (2003) 105 CA4th 428, 439, 129 CR2d 436.

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§8.4 3. Effect of Partial Performance (CC §1477); Indivisible and Divisible Contracts

Civil Code §1477 provides:

> A partial performance of an indivisible obligation extinguishes a corresponding portion thereof, if the benefit of such performance is voluntarily retained by the creditor, but not otherwise. If such partial performance is of such a nature that the creditor cannot avoid retaining it without injuring his own property, his retention thereof is not presumed to be voluntary.

This rule was applied in *McCall v Four Star Music Co.* (1996) 51 CA4th 1394, 59 CR2d 829, in which the court held that full payment by one tortfeasor discharges all others who may be liable for the same injury; but a partial payment only discharges the judgment pro tanto, that is, to the extent paid, and does not discharge the remaining tortfeasors of their obligation under the judgment.

Civil Code §1477 by its terms applies only to indivisible contracts. A divisible contract is one in which the entire performance is subdivided into sets of partial performances, each part being the agreed exchange for a corresponding part of the set of part performances to be rendered by the other party. "It is one in which two or more separate partial performances on each side are agreed to be exchanged for partial performances on the other side. The failure to perform one part does not bar recovery for performance of another." *Filet Menu, Inc. v C.C.L.&G. Inc.* (2000) 79 CA4th 852, 859, 94 CR2d 438. Divisibility is similar to, but not identical with, the concept of severability. See *World Sav. & Loan Ass'n v Kurtz Co.* (1960) 183 CA2d 319, 327, 6 CR 665. Severability is discussed in §§5.70-5.71. Note that a contract that calls for payment of a certain sum for performance by the other party is not divisible or severable merely because the payments are divided into installments. *Jozovich v Central Cal. Berry Growers Ass'n* (1960) 183 CA2d 216, 224, 6 CR 617.

There are various consequences once a contract is determined to be divisible. As the Restatement (Second) of Contracts (1981) §240 explains:

> If the performances to be exchanged under an exchange of promises can be apportioned into corresponding pairs of part performances so that the parts of each pair are properly regarded as agreed equivalents, a party's performance of his part of such a pair has the same effect on the other's duties to render performance of the agreed equivalent as it would have if only that pair of performances had been promised.

This serves to reduce the potential for a forfeiture. See Restatement (Second) of Contracts (1981) §240, Comment a. If a party has breached one part of a divisible contract, that party may yet obtain the consideration that was allocated to that portion of the contract that that party did perform. *Filet Menu, Inc. v C.C.L.&G. Inc.* (2000) 79 CA4th 852, 859, 94 CR2d 438. A divisible contract is still only one contract, however. Each part is not a separate contract. "If there is an uncured material failure by either party, he can claim compensation for any parts that he has already performed, but he cannot enforce the contract with respect to any other pair of corresponding parts, including the part or parts that he has failed to perform." Restatement (Second) of Contracts (1981) §240, Comment b. See *Filet Menu, Inc. v C.C.L. & G. Inc., supra.*

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.5 4. Payment Defined (CC §1478)

§8.5 4. Payment Defined (CC §1478)

Civil Code §1478 defines "payment" as the "[p]erformance of an obligation for the delivery of money only." This definition is not exclusive, however. *Bacon v Kessel* (1939) 31 CA2d 245, 87 P2d 857. The term has also been defined as "that which the parties to the contract agree shall be accepted as such" (*Strain v Security Title Ins. Co.* (1954) 124 CA2d 195, 200, 268 P2d 167), *i.e.,* as the agreed consideration. See *Rabinowitz v Kandel* (1969) 1 CA3d 961, 81 CR 897 (fact that creditor kept collateral security for debt was not proof that creditor agreed to accept collateral as full payment of debt).

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.6 5. Payment by Check or Promissory Note (Com C §3310)

§8.6 5. Payment by Check or Promissory Note (Com C §3310)

The rules for when payment by check or promissory note constitutes full performance and discharge of an obligation in the absence of a contrary agreement by the parties are set forth in Com C §3310. Note that these rules apply to payment obligations arising under any type of contract, not merely contracts governed by other divisions of the California Commercial Code. There are two different results, depending on whether the method of payment is a certified or cashier's check (Com C §3310(a)) or an uncertified check or note (Com C §3310(b)).

Commercial Code §3310(a) treats certified or cashier's checks the same as cash. It provides:

> Unless otherwise agreed, if a certified check, cashier's check, or teller's check is taken for an obligation, the obligation is discharged to the same extent discharge would result if an amount of money equal to the amount of the instrument were taken in payment of the obligation. Discharge of the obligation does not affect any liability that the obligor may have as an indorser of the instrument.

This rule also applies to any other instrument on which a bank is liable as maker or acceptor. Com C §3310(c)

If the method of payment is an uncertified check or a promissory note, however, Com C §3310(b) provides that the obligation is not discharged, but rather suspended until the check or note is either dishonored or paid. It states in part:

> Unless otherwise agreed and except as provided in subdivision (a), if a note or an uncertified check is taken for an obligation, the obligation is suspended to the same extent the obligation would be discharged if an amount of money equal to the amount of the instrument were taken, and the following rules apply:
> (1) In the case of an uncertified check, suspension of the obligation continues until dishonor of the check or until it is paid or certified. Payment or certification of the check results in discharge of the obligation to the extent of the amount of the check.
> (2) In the case of a note, suspension of the obligation continues until dishonor of the note or until it is paid. Payment of the note results in discharge of the obligation to the extent of the payment.

If the creditor accepts a check or note which is dishonored, Com C §3310(b) further provides that the creditor may elect to sue either on the instrument or on the underlying obligation:

> (3) Except as provided in paragraph (4), if the check or note is dishonored and the obligee of the obligation for which the instrument was taken is the person entitled to enforce the instrument, the obligee may enforce either the instrument or the obligation. In the case of an instrument of a third person which is negotiated to the obligee by the obligor, discharge of the obligor on the instrument also discharges the obligation.
> (4) If the person entitled to enforce the instrument taken for an obligation is a person other than the obligee, the obligee may not enforce the obligation to the extent the obligation is suspended. If the obligee is the person entitled to enforce the instrument but no longer has possession of it because it was lost, stolen, or destroyed, the obligation may not be enforced to the extent of the amount payable on the instrument, and to that extent the obligee's rights against the obligor are limited to enforcement of the instrument.

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§8.7 6. Application of Performance to Two or More Obligations (CC §1479)

Civil Code §1479 sets forth a series of allocation rules that apply when a debtor who owes several obligations performs an act, such as payment, that is equally applicable to two or more obligations. The rules in CC §1479 apply only if the contract of the parties does not otherwise specify how the performance should be allocated. *Sunlight Elect. Supply Co. v Grossmont Shopping Ctr. Co.* (1964) 226 CA2d 110, 37 CR 802. Under CC §1479, the debtor's performance is required to be applied as follows:

- First, as the debtor may direct at the time of performance.
- Second (in the absence of direction from the debtor, and unless similar obligations were due to the creditor both individually and as a trustee), the creditor may apply it within a reasonable time after the performance toward the extinction of any obligation, performance of which was due from the debtor at the time of the performance. Once the creditor has made such an application, it cannot be rescinded without the debtor's consent.
- Third, if neither party makes a timely application of the performance, the performance is required to be applied to the obligations in the following order (or if there is more than one obligation in a particular class, to all of the obligations in that class, ratably):
- First, interest due at the time of the performance;
- Second, principal due at the time of performance;
- Third, the obligation with the earliest maturity date;
- Fourth, to unsecured obligations; and
- Fifth, to secured obligations.

If these rules are not applicable to a particular situation, common law principles of justice and equity will govern application of the performance. *Jessup Farms v Baldwin* (1983) 33 C3d 639, 650, 190 CR 355; *Pike v Tuttle* (1971) 18 CA3d 746, 96 CR 403. In *Jessup Farms,* the California Supreme Court examined §1479, holding that the term "class" in the third subdivision of §1479 referred to the five categories following the third subdivision. *Jessup Farms,* 33 C3d at 653. The court also held that when the obligations at issue have different maturity dates, §1479 requires that a payment be applied to the obligations with the earlier maturity date, in order, regardless of whether the obligations are secured or unsecured. If, however, two or more obligations have the same maturity date and are all either secured or unsecured, §1479 mandates a ratable allocation of the payment among them. The fourth and fifth categories are relevant only if there is more than one obligation with an identical maturity date and at least one of the obligations is secured and one is unsecured. As a practical matter then, the fourth and fifth categories apply only if there are secured and unsecured obligations with the same maturity date and not enough money to pay them all. In such a case, payments are allocated first to the unsecured debt. 33 C3d at 654.

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7. Time for Performance

§8.8 a. Time of Performance of Contract (CC §1657)

Civil Code §1657 provides:

> If no time is specified for the performance of an act required to be performed, a reasonable time is allowed. If the act is in its nature capable of being done instantly—as, for example, if it consists in the payment of money only—it must be performed immediately upon the thing to be done being exactly ascertained.

Thus, contractual obligations must be performed either at a time the contract specifies or, if no time is specified, within a reasonable time. *Edwards v Symbolic Int'l, Inc.* (SD Cal, Apr. 30, 2009, No. 07-CV-1826-JMA) 2009 US Dist Lexis 37523 (quoting this treatise). What constitutes a reasonable time is a question of fact, dependent on the circumstances of the case. *Patel v Liebermensch* (2008) 45 C4th 344, 349, 86 CR3d 366 (where option contract for purchase of real estate did not specify length of escrow period, reasonable time was implied under §1657); *Kotler v Pacificare of Cal.* (2005) 126 CA4th 950, 24 CR3d 447; *Consolidated World Invs., Inc. v Lido Preferred Ltd.* (1992) 9 CA4th 373, 11 CR2d 524.

If no time is specified for performance, a person with the ability to perform who has promised to do an act in the future does not breach the agreement unless and until a demand for performance is made and performance is refused —except when the evidence shows that the delay has operated to the promisee's detriment to such an extent that the delayed performance has been rendered valueless and the promisor is chargeable with knowledge of the special circumstances. *Leonard v Rose* (1967) 65 C2d 589, 592, 55 CR 916. See also *People v Southern Pac. Co.* (1983) 139 CA3d 627, 188 CR 913.

In *Eidsmore v RBB, Inc.* (1994) 25 CA4th 189, 198, 30 CR2d 357, the court held that a 6-month period between the time of contracting for one of the first Ferrari F-4 automobiles and the time of delivery was reasonable, given the unique and exotic nature of the automobile and its manufacturer's nature and reputation as a small boutique company accustomed to operating by its own rules and practices. If, however, the market in question is volatile and delay could subject the parties to fluctuations in value, courts may imply a shorter period of time as reasonable or imply a "time is of the essence" requirement if such a clause is absent. In *Eidsmore,* the court found that the time for delivery was uncertain at best and was based largely on a third party's performance. 25 CA4th at 198. Therefore, the court held that the potential for market fluctuations did not justify implying a shorter "reasonable" period of time in the contract.

In *Henry v Sharma* (1984) 154 CA3d 665, 672, 201 CR 478, the court found that a buyer's performance of a real estate purchase contract 63 days after contract signing was not an unreasonable time when the contract did not contain a "time is of the essence" clause (see §8.10) and called for performance within 30 days of escrow, and the buyer's broker was authorized to extend time periods by 30 days if needed.

In *House of Prayer: Renewal & Healing Ctr. v Evangelical Ass'n for India* (2003) 113 CA4th 48, 7 CR3d 24, the court held that the time for performance was not an essential term of a real property sales contract that must be contained in a written contract or memorandum in order to satisfy the statue of frauds. See §4.46.

NOTE: California has a set of prompt payment statutes applicable to payments by general (or sub-) contractors to sub- (or sub-sub-) contractors, triggered by the general contractor's receipt of a progress payment from an owner or other party. See, *e.g.,* Bus & P C §7108.5 and Pub Cont C §7107 (10- and 7-day prompt payment periods specified by statute; penalties may apply for late payments). See *Tesco Controls, Inc. v Monterey Mechanical Co.* (2004) 124 CA4th 780, 21 CR3d 751 (prompt payment statute applied in context of joint check agreement). See also *Murray's Iron Works, Inc. v Boyce* (2008) 158 CA4th 1279, 71 CR3d 317 (discussing progress payments).

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§8.9 b. Contracts of Indefinite Duration

Supply or distribution contracts, employment agreements, and other agreements that contemplate a course of performance by the parties over an extended period of time normally include an outside date for termination of the contract, sometimes with a renewal option. In *Zee Med. Distrib. Ass'n v Zee Med., Inc.* (2000) 80 CA4th 1, 94 CR2d 829, the parties' distribution agreements did not specify a termination date, but did specify certain events that would entitle a party to terminate the contract. The plaintiffs contended that the agreements were terminable at will because they did not have express terms of duration, but the court rejected the argument. The court held that a contract may, by its express terms, provide for a term of indefinite length, without any specific limitation other than the conduct of the contracting parties. Such a failure to specifically limit the term of the contract did not render the contract invalid and did not create a right to terminate the contract at will without liability for damages. 80 CA4th at 7.

If the agreement contemplates a continuing performance or forbearance, but does specify a termination date, the court will first determine whether the parties' intention regarding the contract's duration can be implied from the nature of the contract and the surrounding circumstances. In some cases, such as *Zee Med.,* the court will conclude that the duration of the parties' performance obligations was impliedly conditioned on the occurrence or nonoccurrence of an event or events. In other cases, however, the court may find that the parties intended the contract to continue as long as the parties faithfully performed their obligations. In the latter case, the contract will be construed as terminable at will. *Consolidated Theatres, Inc. v Theatrical State Employees Union, Local 16* (1968) 69 C2d 713, 73 CR 213; *Zee Med. Distrib. Ass'n v Zee Med., Inc.* (2000) 80 CA4th 1, 94 CR2d 829.

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§8.10 c. When "Time Is of the Essence"

The general rule is that time is not of the essence unless the contract expressly so provides or the conclusion can be implied from the nature of the contract. Contracts for the purchase and sale of real estate often state that "time is of the essence." In *Pittman v Canham* (1992) 2 CA4th 556, 3 CR2d 340, the court of appeal affirmed dismissal of a suit by a real estate purchaser against the seller for breach of a real estate contract. Because the contract contained a "time of the essence" clause, the court held that the failure of both parties to tender performance by the closing date discharged both of them from performing; neither could hold the other in default, and no cause of action to enforce the contract arose. In *Consolidated World Invs., Inc. v Lido Preferred Ltd.* (1992) 9 CA4th 373, 381, 11 CR2d 524, the contract specified a time period of 60 days to close escrow for a real property purchase, but not the time to open escrow. Based on the time of the essence clause and a provision for an extension to satisfy the financing contingency, the court concluded that the time to open escrow was immediately. See also *Baypoint Mortgage Corp. v Crest Premium Real Estate Invs. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531.

Time is normally considered to be of the essence in option contracts to purchase real estate. The court will imply a reasonable time within which the option must be accepted, even if the contract does not specify a deadline for acceptance. *Murfee v Porter* (1950) 96 CA2d 9, 214 P2d 543; *Fowler v Case* (1948) 89 CA2d 140, 200 P2d 130.

A time of the essence clause may be found unenforceable on the basis of CC §3275 if enforcement would operate as a forfeiture or unfair penalty. In *Galdjie v Darwish* (2003) 113 CA4th 1331, 7 CR3d 178, the court found that a real estate seller had waived the time provisions of the purchase contract, when the seller continued to deal with the buyer after the dates specified in the contract. The buyer failed to obtain a loan because the seller had failed to deposit a termite report into escrow, and the seller could not reestablish a time provision by giving the buyer notice that the transaction must close by a certain date. The court noted that "California courts generally *do* strictly enforce time deadlines in real estate sales contracts, permitting the seller to cancel after the time specified where time is specifically made of the essence *unless* there has been a waiver or potential forfeiture." 113 CA4th at 1341. See also *Valley View Home of Beaumont, Inc. v Department of Health Servs.* (1983) 146 CA3d 161, 168, 194 CR 56 (superseded on other grounds).

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.11 d. When Time for Performance Falls on a Holiday (CCP §13)

§8.11 d. When Time for Performance Falls on a Holiday (CCP §13)

Code of Civil Procedure §13 provides:

> Whenever any act of a secular nature, other than a work of necessity or mercy, is appointed by law or contract to be performed upon a particular day, which days falls upon a holiday, such act may be performed upon the next business day with the same effect as if it had been performed upon the day appointed.

In general, CCP §13 extends the time within which an act may be done by 1 day if the last day falls on a Sunday or holiday. If, however, the time for performance is stated to be "not less than" or "not later than" a specified number of days, and the last day is a Sunday or holiday, the statute does not extend the time for performance. *Steele v Bartlett* (1941) 18 C2d 573, 16 P2d 780. For purposes of the Code of Civil Procedure, the term "holiday" is defined in CCP §10 as "every Sunday and any other days that are specified or provided for as judicial holidays" in CCP §135.

In *Stolengberg v Harveston* (1934) 1 C2d 264, 34 P2d 472, the California Supreme Court construed a real estate lease providing for rent that became due and payable on May 1, a Sunday. The lease also stated that no default could be declared for failure to pay rent on the due date until 5 days after the due date, and granted the lessees permission pay the rent due at any time within the 5-day period. The lessees did not pay the rent on May 1 or at any time thereafter; the landlord served a default notice on the lessees on May 7th, which gave the defendants 3 days to pay the rent or deliver possession of the premises. Relying on CCP §13, the lessees argued that the notice of default was given prematurely, contending that because May 1 was a Sunday, the 5-day grace period did not begin to run until May 2 and did not end until May 7th. The court held that CCP §13 was not applicable, because the lessees were not *required* to pay the rent or to perform any other act on May 1. The first day that the lessees were under an absolute obligation to pay rent was May 6th, which was not a holiday. 1 C2d at 268.

NOTE: There are similar provisions for computation of time in CCP §§12-12b and 13a-13b, but these statutes do not operate to extend the time for performance of obligations under private contracts. They apply only to acts or duties provided by statute. *Gans v Smull* (2003) 111 CA4th 985, 4 CR3d 353 (CCP §12a does not extend time to give notice of election to extend lease term; it only applies to duties whose time for performance is set by statute); *Lynch v Harrell* (1941) 44 CA2d 863, 113 P2d 261.

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§8.12 8. Performance of Conditions (CC §1439)

Under CC §1439, a party cannot require performance from the other party to a contract unless and until the first party has fulfilled all conditions precedent and all concurrent conditions to that counter-performance. Civil Code §1439 embodies the general rule that a party asserting a breach of contract cannot recover therefor unless that party has fulfilled its own obligations. Breach of an important condition by the first party may excuse the other party from performance. *Wiz Technol., Inc. v Coopers & Lybrand LLP* (2003) 106 CA4th 1, 12, 130 CR2d 263. See also *Fogarty v Saathoff* (1982) 128 CA3d 780, 180 CR 484; *Kadner v Shields* (1971) 20 CA3d 251, 97 CR 742. The courts will require substantial, if not strict, compliance with the condition precedent. *Cline v Yamaga* (1979) 97 CA3d 239, 247, 158 CR 598; *Pacific Allied v Century Steel Prods., Inc.* (1958) 162 CA2d 70, 327 P2d 547.

If, however, the other party's conduct operates as a waiver of the first party's performance, or constitutes an abandonment of the contract or a refusal to perform in any event, the first party need not tender its performance. *United Cal. Bank v Maltzman* (1974) 44 CA3d 41, 118 CR 299. In *Pittman v Canham* (1992) 2 CA4th 556, 3 CR2d 340, both the buyer and seller under a real estate purchase and sale contract failed to make the required deposits into escrow. The court held that the failure of both parties to perform concurrent conditions did not leave the contract open for an indefinite period so that either party could tender performance at his or her leisure, but rather resulted in a discharge of both parties' obligations to perform.

For further discussion of conditions, see §§6.40-6.49.

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B. Offer or Tender of Performance

§8.13 1. Obligation Extinguished by Offer of Full Performance (CC §1485)

Civil Code §§1485-1505 contain a series of rules (discussed in §§8.13-8.27) concerning when an offer or tender of performance—as distinct from actual performance—operates to extinguish a contractual obligation.

Civil Code §1485 states that "[a]n obligation is extinguished by an offer of performance, made in conformance to the rules herein prescribed, and with intent to extinguish the obligation." To be valid and effective, an offer or tender of performance must be one of full performance and must be unconditional. *Arnolds Mgmt. Corp. v Eischen* (1984) 158 CA3d 575, 580, 205 CR 15; *Still v Plaza Marina Commercial Corp.* (1971) 21 CA3d 378, 385, 98 CR 414. In *Arnolds Mgmt.,* the court held that before a junior lienor could set aside a nonjudicial foreclosure of real property due to irregularities in the sale, it was required to tender the full amount owing on the senior obligation. Merely giving a promissory note would not constitute payment unless the parties agreed it would. See also CC §1494, discussed in §8.21. Further, "a mere indication of a willingness to perform in the future is not the equivalent of a valid, subsisting tender." *Waller v Brooks* (1968) 267 CA2d 389, 394, 72 CR 228. And an offer of performance is not effective if the person making the offer is unable to perform. *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 118, 92 CR 851. See CC §1495, discussed in §8.19. If the tender is properly made, however, it has the effect of putting the other party in default if the other party refuses to accept it. *Still v Plaza Marina Commercial Corp.* (1971) 21 CA3d 378, 98 CR 414. In *Hutton v Gliksberg* (1982) 128 CA3d 240, 247, 180 CR 141, the court affirmed an award of specific performance in favor of the buyers under a real estate purchase contract, ruling that actual funding of the buyer's loan was not required to constitute a tender of the purchase price. The evidence showed that the buyers timely performed all acts required on their part and the buyers' lender was prepared to deliver loan funds to escrow immediately on request. The lender's loan commitment therefore constituted the equivalent of cash for purposes of measuring the buyer's performance.

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§8.14 2. Effect of Offer of Partial Performance (CC §1486)

An offer or tender of partial performance is of no effect. CC §1486. In *Nguyen v Calhoun* (2003) 105 CA4th 428, 439, 129 CR2d 436, the court explained that the rules governing tenders of performance are strict and are strictly applied: "The tenderer must do and offer everything that is necessary on his part to complete the transaction, and must fairly make known his purpose without ambiguity, and the act of tender must be such that it needs only acceptance by the one to whom it is made to complete the transaction." 105 CA4th at 439, quoting *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 1165, 246 CR 421. In *Gaffney,* the borrowers tendered full payment of the arrearage under a deed of trust by mailing two checks in separate envelopes, but did not inform the lender of the unusual method of payment. The checks were returned with notices of payment error, and the lender proceeded with foreclosure. The court of appeal reversed the trial court's judgment in favor of the borrowers, holding that it was their responsibility to make an unambiguous tender of the entire amount due, or suffer the consequence that the tender would not be effective to cure the default. 200 CA3d at 1165.

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§8.15 3. Offer of Performance by or on Behalf of Debtor to Creditor (CC §§1487-1488)

Civil Code §1487 provides that "[a]n offer of performance must be made by the debtor, or by some person on his behalf and with his assent." Civil Code §1488, the corollary to CC §1487, provides:

> An offer of performance must be made to the creditor, or to any one of two or more joint creditors, or to a person authorized by one or more of them to receive or collect what is due under the obligation, if such creditor or authorized person is present at the place where the offer may be made; and if not, wherever the creditor may be found.

In *Britschgi v McCall* (1953) 41 C2d 138, 142, 257 P2d 977, the court held that defendants' attorneys did not have authority to accept the plaintiff's tender of a check in payment of the purchase price under a real estate contract plus an amount the defendants considered sufficient to satisfy an option holder's interest in the property. The court noted that the authority of attorneys to act on behalf of their clients is constrained by statute (see CCP §283) and that, under this general statutory authority, an attorney has no right to pass the client's rights or title to land. The tender was therefore insufficient under CC §1488.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.16 4. Place of Offer of Performance (CC §1489)

§8.16 4. Place of Offer of Performance (CC §1489)

Civil Code §1489 provides:

> In the absence of an express provision to the contrary, an offer of performance may be made, at the option of the debtor:
> 1. At any place appointed by the creditor; or,
> 2. Wherever the person to whom the offer ought to be made can be found; or,
> 3. If such person cannot, with reasonable diligence, be found within this state, and within a reasonable distance from his residence or place of business, or if he evades the debtor, then at his residence or place of business, if the same can, with reasonable diligence, be found within the state; or,
> 4. If this cannot be done, then at any place within this state.

A tender of performance must not only be an offer of full performance, but it must also be made at the proper place and time. *Waller v Brooks* (1968) 267 CA2d 389, 394, 72 CR 228. If a contract does not specify a place of performance, it should be performable at the place where circumstances indicate that the parties intended or expected it to be performed. Where a contract is to be performed is a question of fact. *Hale v Bohannon* (1952) 38 C2d 458, 466, 241 P2d 4. In the absence of a contrary agreement, the place of performance of an obligation to pay a debt is the place where the creditor resides or has its place of business. *Davis v Cook Bros. Truck & Equip. Co.* (1959) 175 CA2d 667, 346 P2d 890. Ordinarily, it is the debtor's obligation to seek out the creditor for purposes of making payment, unless the parties have agreed otherwise. *Pacific Bal Indus. v Northern Timber, Inc.* (1953) 118 CA2d 815, 259 P2d 465.

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§8.17 5. Time of Offer of Performance (CC §§1490-1491, 1806.3)

Civil Code §1490 provides that "[w]here an obligation fixes a time for its performance, an offer of performance must be made at that time, within reasonable hours, and not before nor afterwards." As a general rule, a premature offer of performance is not a valid tender. *Waller v Brooks* (1968) 267 CA2d 389, 394, 72 CR 228; *James Talcott, Inc. v Gee* (1968) 266 CA2d 384, 388, 72 CR 168. If a purchase agreement provides that payment is to be made at a specified time, the seller is not obliged to accept it before that time any more than the purchaser is obliged to pay it in advance, and the seller cannot be declared in default for refusing to accept the premature payment. *Warshauer v Bauer Constr. Co.* (1960) 179 CA2d 44, 50, 3 CR 570. *Waller v Brooks, supra,* involved the parties to a real estate exchange transaction. The defendant sent a letter to the plaintiff, before payment from the plaintiff was due, indicating that she was ready, willing, and able to perform, but later proceeded to withdraw the necessary deeds from escrow before the payment due date. The court found that the defendant's letter was not a valid tender sufficient to charge the plaintiff with an immediate breach of contract.

Retail installment sales are subject to a special rule in the Unruh Act (CC §§1801-1812.20), which constitutes an exception to CC §1490. Under CC §1490, if a business or commercial installment contract does not include a prepayment right, the buyer cannot put the seller in default by tendering the unpaid balance, because the seller is not required to accept payment prematurely. *James Talcott, Inc.,* 266 CA2d at 388. The Unruh Act generally applies to consumer installment sales contracts. Civil Code §1806.3 gives a retail installment buyer the right to prepay the contract in full, at any time before maturity, regardless of any contrary provision in the contract, and includes specific rules for calculating the finance charges due in the event of prepayment in full.

Civil Code §1491 provides that "[w]here an obligation does not fix the time for its performance, an offer of performance may be made at any time before the debtor, upon a reasonable demand, has refused to perform." If no time is specified for the performance of an act (other than the payment of money), a demand for performance is necessary to place the obligor in default. *Johnson v Alexander* (1976) 63 CA3d 806, 813, 134 CR 101; *World Sav. & Loan Ass'n v Kurtz Co.* (1960) 183 CA2d 319, 6 CR 665. A demand for performance may be implied from the circumstances, however. For example, in *Porter v Arthur Murray, Inc.* (1967) 249 CA2d 410, 57 CR 554, the plaintiff had contracted for a series of dance lessons. After receiving a number of lessons, he went to the dance studio to take a scheduled lesson but found the studio closed. The court found that the plaintiff was not required to make a formal demand for performance before he could claim a breach of the contract.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.18 6. Delay in Performance (CC §1492)

§8.18 6. Delay in Performance (CC §1492)

Civil Code §1492 provides:

> Where delay in performance is capable of exact and entire compensation, and time has not been expressly declared to be of the essence of the obligation, an offer of performance, accompanied with an offer of such compensation, may be made at any time after it is due, but without prejudice to any rights acquired by the creditor, or by any other person, in the meantime.

Provided time is not stated to be of essence to an agreement, and subject to any creditor's rights that have vested, this statute may enable a debtor to cure a default and avoid a forfeiture if the debtor makes an offer of performance accompanied by an offer of full compensation for the delay. See *Henck v Lake Hemet Water Co.* (1937) 9 C2d 136, 69 P2d 849. If time is not of the essence, a court may grant a period of time for a defaulting party to make a payment. *Conforti v Dunmeyer* (1962) 209 CA2d 41, 43, 25 CR 504. "*Delay* in performance is a material failure only *if time is of the essence, i.e.,* if prompt performance is, by the express language of the contract or by its very nature, a vital matter." *Johnson v Alexander* (1976) 63 CA3d 806, 813, 134 CR 101 (emphasis in original).

PRACTICE TIP: This statute points up the importance of including a "time is of the essence" clause in a contract if the parties intend that their performances occur at a certain time and that nonperformance at the time stated will constitute a material breach of the agreement.

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§8.19 7. Good Faith; Ability and Willingness to Perform (CC §§1493, 1495)

Civil Code §1493 provides that "[a]n offer of performance must be made in good faith, and in such manner as is most likely, under the circumstances, to benefit the creditor." See *K & M, Inc. v LeCuyer* (1951) 107 CA2d 710, 238 P2d 28, in which the court held that the defendant-buyers' tender of the entire unpaid purchase price for a restaurant and bar, which was made conditional on the removal of a chattel mortgage on the property, was not a proper tender because it was not made in good faith as required by CC §1493. The defendants knew of the chattel mortgage, and the agreement provided that the plaintiff-seller was selling all of the assets free and clear except as otherwise stated.

Civil Code §1495 states that "[a]n offer of performance is of no effect if the person making it is not able and willing to perform according to the offer." *Karlsen v American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 92 CR 851 was an action to set aside a trustee's sale of property conducted after the plaintiff's default. The plaintiff alleged that he had tendered payment of the amount due, but the court found that the only tender made by the plaintiff was merely a hope that he could sell part of the property and apply the proceeds to the debt. Citing CC §1495, the court ruled that if an offeror lacks the money to make the offer good and knows it, the tender is ineffective. 15 CA3d at 118. In *Canal-Randolph Anaheim, Inc. v Wilkoski* (1978) 78 CA3d 477, 144 CR 474, the court held that a creditor's failure to object to a tender or offer of performance on the grounds of the offeror's inability to perform does not waive the requirements of CC §1495.

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§8.20 8. Production of Thing to Be Delivered (CC §§1496-1497; CCP §2074)

Civil Code §1496 provides that "[t]he thing to be delivered, if any, need not in any case be actually produced, upon an offer of performance, unless the offer is accepted." There is a related evidentiary rule in the Code of Civil Procedure, as follows: "An offer in writing to pay a particular sum of money, or to deliver a written instrument or specific personal property, is, if not accepted, equivalent to the actual production and tender of the money, instrument, or property." CCP §2074. In *Symcox v Zuk* (1963) 221 CA2d 383, 390, 34 CR 462, a perfume distributor made several offers to the defendants to return unsold vials of perfume, as permitted by the distributorship contract, but the defendants never indicated a place for delivery nor tendered the refund due from them. Under these circumstances, the court found that the distributor's tender of return was valid, and affirmed judgment for the distributor.

Civil Code §1497 admonishes that personal property to be tendered must be kept and offered up separately: "A thing, when offered by way of performance, must not be mixed with other things from which it cannot be separated immediately and without difficulty."

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§8.21 9. Conditional Offers of Performance (CC §§1494, 1498)

Civil Code §1494 provides that "[a]n offer of performance must be free from any conditions which the creditor is not bound, on his part, to perform." *Arnolds Mgmt. Corp. v Eischen* (1984) 158 CA3d 575, 205 CR 15 (before junior lienor could set aside a nonjudicial foreclosure of real property due to irregularities in sale, it was required to tender full amount owing on senior obligation, not merely a note); *Lewis v James* (1955) 134 CA2d 15, 285 P2d 86 (offer to perform on terms and conditions not designated in contract is tantamount to refusal to perform and is not binding on offeree unless accepted or not objected to). Put another way, CC §1494 "requires that the offer of performance be free from unwarranted conditions" and a tender that is conditional will not be effective, among other things, to stop the running of interest under CC §1504. *Mission Ins. Group, Inc. v Merco Constr. Eng'rs, Inc.* (1983) 147 CA3d 1059, 195 CR 781. See also *Wiener v Van Winkle* (1969) 273 CA2d 774, 78 CR 761. In *Wiener,* the makers of a note tendered payment on condition that the lenders reduce or eliminate their claim for attorney fees. The court held that the tender was ineffective, however, because both the note and the related guaranty gave the lenders a contractual right to attorney fees.

Civil Code §1498 states the converse of CC §1494, as follows: "When a debtor is entitled to the performance of a condition precedent to, or concurrent with, performance on his part, he may make his offer to depend upon the due performance of such condition." In effect, a debtor's offer of performance may be conditional if the debtor is entitled to receive performance of a condition precedent or concurrent from the other party.

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§8.22 10. Debtor's Right to Written Receipt (CC §1499; CCP §2075)

Civil Code §1499 provides that "[a] debtor has a right to require from his creditor a written receipt for any property delivered in performance of his obligation." There is a similar rule in the Code of Civil Procedure, as follows: "Whoever pays money, or delivers an instrument or property, is entitled to a receipt therefor from the person to whom the payment or delivery is made, and may demand a proper signature to such receipt as a condition of the payment or delivery." CCP §2075. It follows that a tender can made conditional on a receipt without being an invalid conditional tender. *Walsh v Walsh* (1940) 42 CA2d 287, 108 P2d 765.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.23 11. Extinction of Pecuniary Obligation by Deposit (CC §1500)

§8.23 11. Extinction of Pecuniary Obligation by Deposit (CC §1500)

If a debtor cannot tender payment directly to a creditor, CC §1500 provides an alternative, namely, making a deposit in the creditor's name with a bank or savings and loan and so notifying the creditor. Civil Code §1500 states:

> An obligation for the payment of money is extinguished by a due offer of payment, if the amount is immediately deposited in the name of the creditor, with some bank or savings and loan association within this state, of good repute, and notice thereof is given to the creditor.

Note that this mechanism by its terms is available only for payment of money, not for any other form of consideration. Like other forms of tender, a deposit under CC §1500 must have no conditions attached (except those permitted by CC §§1498 and 1499). The amount must be deposited in the name of the creditor and the deposit must be unconditional, so that the deposit at once becomes the creditor's property. *Verdier v Verdier* (1955) 133 CA2d 325, 284 P2d 94. In *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 1161, 246 CR 421, an attorney's attempt to use the CC §1500 procedure failed because the attorney set up the deposit account so that the creditor did not have unconditional access to it, but rather so that the debtors' signatures were required to release any funds to the creditor.

Notice to the creditor of the deposit is required. CC §1500. Following is a sample form of notice to be sent along with the deposit account documents:

NOTICE OF PAYMENT OF MONEY BY MAKING OF DEPOSIT

_ _[*Name and address*]_ _

> **Please take notice that the check for the _ _[*specify pecuniary obligation sought to be satisfied*]_ _ was deposited in your name, Account No. _ _[*number*]_ _, in the _ _[*name of bank or savings and loan association*]_ _, located at _ _[*address*]_ _ in the City of _ _[*city*]_ _, County of _ _[*county*]_ _, State of California. The account documents evidencing the deposit are enclosed.**

_ _[*Date*]_ _ __[*Signature*]__

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§8.24 12. Waiver of Objections to Tender of Performance (CC §1501; CCP §2076)

Civil Code §1501 provides that: "[a]ll objections to the mode of an offer of performance, which the creditor has an opportunity to state at the time to the person making the offer, and which could be then obviated by him, are waived by the creditor, if not then stated." If a creditor has had the chance to object, but does not raise any objections to the form of tender at the time it is made, which the debtor could cure at that time, the creditor waives any objections. Code of Civil Procedure §2076 states essentially the same rule, and should be read together with CC §1501. *Sanguansak v Myers* (1986) 178 CA3d 110, 115, 223 CR 490. Section 2076 provides:

> The person to whom a tender is made must, at the time, specify any objection he may have to the money, instrument, or property, or he must be deemed to have waived it; and if the objection be to the amount of money, the terms of the instrument, or the amount or kind of property, he must specify the amount, terms, or kind which he requires, or be precluded from objecting afterwards.

For example, in *Collins v Marvel Land Co.* (1970) 13 CA3d 34, 91 CR 291, the court found that the defendants, by opening escrow and causing escrow instructions to be prepared for conveyance of the property after receipt of the plaintiffs' oral notice of exercise of an option, had waived any objection to the written notice requirement in the option agreement. Based on CC §1501, the court ruled that acceptance of the exercise of an option without objection to form waives objections to the form of the exercise.

The purpose of CC §1501 and CCP §2076 is to allow a debtor who is willing and able to pay the amount owed to know what the creditor demands, so that the debtor may, if desired, make a conforming tender. *Gaffney v Downey Sav. & Loan Ass'n* (1988) 200 CA3d 1154, 1166, 246 CR 421; *Sanguansak v Myers, supra*. As the *Sanguansak* court observed, most of the decisions under these two statutes are based on the doctrine of equitable estoppel, and address situations where a creditor has accepted a tender without informing the debtor that the tender is nonconforming or has refused a tender without making clear the reasons for refusal. *Sanguansak,* 178 CA3d at 115. If the creditor realizes that, by mistake, it has accepted less than full payment and then promptly and in good faith takes reasonable steps to correct the error, such as by sending the debtor notice of the underpayment, the factual predicates for an estoppel do not exist, and CC §1501 and CCP §2076 will not prevent recovery of the balance due. See *Sanguansak,* 178 CA3d at 117. Reasonable compliance by the creditor is all that is required. *Gaffney v Downey Sav. & Loan Ass'n, supra*. Further, CC §1501 and CCP §2076 do not apply when the amount of the creditor's demand is known to the debtor and the amount of the tender is wholly insufficient. *Gaffney v Downey Sav. & Loan Ass'n, supra*.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.25 13. Title to, and Custody of, Thing Offered (CC §§1502, 1503)

§8.25 13. Title to, and Custody of, Thing Offered (CC §§1502, 1503)

Civil Code §1502 provides that: "[t]he title to a thing duly offered in performance of an obligation passes to the creditor, if the debtor at the time signifies his intention to that effect." Note that this statute probably has little effect in view of the other Civil Code provisions concerning passage of title to real estate (see CC §§1054, 1091) and Commercial Code and other statutory provisions concerning passage of title to personal property (see Com C §§2401, 3203, 7502-7504, 8301-8302; Veh C §§5600, 9900).

Civil Code §1503 states:

> The person offering a thing, other than money, by way of performance, must, if he means to treat it as belonging to the creditor, retain it as a depositary for hire, until the creditor accepts it, or until he has given reasonable notice to the creditor that he will retain it no longer, and, if with reasonable diligence he can find a suitable depositary therefor, until he has deposited it with such person.

This statute essentially creates a bailment or trust relationship between the debtor and the creditor with respect to the property offered. See generally *Greenberg Bros. v Ernest W. Hahn, Inc.* (1966) 246 CA2d 529, 54 CR 770.

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§8.26 14. Effect of Offer of Performance on Interest and Other Incidents (CC §1504)

Civil Code §1504 provides that "[a]n offer of payment or other performance, duly made, though the title to the thing offered be not transferred to the creditor, stops the running of interest on the obligation, and has the same effect upon all its incidents as a performance thereof." The court in *General Ins. Co. v Mammoth Vista Owners' Ass'n* (1985) 174 CA3d 810, 220 CR 291, relied on CC §1504 in holding that a losing party's tender of the entire amount of a summary judgment award to the prevailing party stopped the interest running on the award, despite the prevailing party's refusal to accept the tender. The prevailing party was therefore not entitled to the interest that accrued on the award while the funds were on deposit with the court. See also *Covington v Clark* (1959) 175 CA2d 449, 346 P2d 229 (deposit with title company of certified check for real estate purchase price was a valid tender and stopped running of interest); *Holland v Paddock* (1956) 142 CA2d 534, 298 P2d 587 (valid tender stopped attorney fees and costs as well as interest). Relying on CC §1504, the Ninth Circuit in *Murphy v T. Rowe Price Prime Reserve Fund, Inc.* (9th Cir 1993) 8 F3d 1420 held that a mutual fund account holder who failed for 3 years to cash the fund's check closing the account was not entitled to interest.

To stop the running of interest and other incidents, however, the tender must be of the full amount due. A tender of less than the full amount will not stop the running of interest because a valid and effective tender must include everything to which the creditor is entitled. *Lovetro v Steers* (1965) 234 CA2d 461, 479, 44 CR 604. Tenders that are incomplete or conditional are not within the scope of CC §1504. *Mission Ins. Group, Inc. v Merco Constr. Eng'rs, Inc.* (1983) 147 CA3d 1059, 195 CR 781.

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§8.27 15. Creditor's Retention of Thing Without Acceptance (CC §1505)

Civil Code §1505 provides that: "[i]f anything is given to a creditor by way of performance, which he refuses to accept as such, he is not bound to return it without demand; but if he retains it, he is a gratuitous depositary thereof." In *Besco Enters., Inc. v Carole, Inc.* (1969) 274 CA2d 42, 78 CR 645, the court held that an accord and satisfaction was not implied from the creditor's retention of the debtor's check accompanied by a letter stating that the check was in full payment, when the creditor gave prompt notice that it was rejecting the check as payment in full and did not cash the check. Further, the creditor did not have a duty to return the check until the debtor made a demand for it.

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C. Excuse of Performance

§8.28 1. Generally

In limited circumstances, a party's duty to perform a contractual obligation may be extinguished or discharged by a legally recognized excuse. The circumstances in which a party's nonperformance may be excused, and certain consequences of excuse, are discussed in §§8.29-8.41.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.29 a. Prevention of Performance by Act of Creditor or Operation of Law (CC §1511(1))

§8.29 a. Prevention of Performance by Act of Creditor or Operation of Law (CC §1511(1))

Civil Code §1511 enumerates three circumstances in which the failure to perform an obligation (or to make an offer of performance) or any delay in performance (or an offer of performance) is excused. The first such circumstance is when the debtor's performance is prevented or delayed, either by an action of the creditor (see §8.30) or by operation of law (see §8.31). Civil Code §1511(1) provides that the following is cause for excusing performance:

> When such performance or offer is prevented or delayed by the act of the creditor, or by the operation of law, even though there may have been a stipulation that this shall not be an excuse; however, the parties may expressly require in a contract that the party relying on the provisions of this paragraph give written notice to the other party or parties, within a reasonable time after the occurrence of the event excusing performance, of an intention to claim an extension of time or of an intention to bring suit or of any other similar or related intent, provided the requirement of such notice is reasonable and just.

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§8.30 (1) Act of Creditor

In *Ninety Nine Invs., Ltd. v Overseas Courier Serv. (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 6 CR3d 891, the court found that a real estate seller's failure to comply with its escrow obligations prevented the lender from funding the loan, and therefore excused the buyer from tendering payment for the property before the closing date. Similarly, in *Erich v Granoff* (1980) 109 CA3d 920, 167 CR 538, the court affirmed an order of specific performance in favor of real estate buyers and further awarded rents to the buyers because they had given sufficient notice under the option agreement to create a binding bilateral contract of sale, but the seller had failed to convey the property. The court noted that "hindrance of the other party's performance operates to excuse that party's nonperformance" and that when a party who is willing and able to perform the contract is prevented from doing so by the other party, damages may consist of profits that the first party would have derived from the other party's performance. 109 CA3d at 930. See also *Parsons v Bristol Development Co.* (1965) 62 C2d 861, 868, 44 CR 767, in which the court held that a party who prevents the other party from fulfilling a condition of the first party's own obligations cannot rely on that condition to defeat liability to the other party.

If the creditor's act amounts to an anticipatory repudiation of the contract (see §8.74), the other party's performance obligation under the contract will be excused. See *County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 1275 n6, 90 CR2d 41 (anticipatory breach by agency excused performance by county; agency's payoff of school district bonds rendered it unable to perform its contract with county); *Stark v Shaw* (1957) 155 CA2d 171, 317 P2d 182 (defendant's failure to begin construction within time required constituted breach of contract, excusing other party from performance). See also *Wiz Technol., Inc. v Coopers & Lybrand LLP* (2003) 106 CA4th 1, 130 CR2d 263 (breach of important condition excused other party's performance). It is not necessary that the nonbreaching party suffer financial detriment for its performance to be excused by the other party's breach. *Wilson v Corrugated Kraft Containers* (1953) 117 CA2d 691, 697, 256 P2d 1012.

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§8.31 (2) Operation of Law

Baird v Wendt Enters., Inc. (1967) 248 CA2d 52, 56 CR 118, illustrates excuse of performance by operation of law. In that case, the parties agreed to several postponements of a contract to purchase a long-term leasehold together with plans for a high-rise apartment building. An effective building permit was a condition to closing, but the permit lapsed and could not be renewed because the city building codes changed in the interim. Performance of the contract on its original terms was therefore impossible, and the seller's inability to perform the contract was excused. Relying on CC §1511(1), the court ruled that there is no liability for breach of a contract whose performance has been made impossible by operation of law.

The "operation of law" excuse is limited. Laws or other governmental measures that simply make performance more difficult or expensive, or unprofitable, will not excuse performance of a contractual obligation. *Cutter Labs., Inc. v Twining* (1963) 221 CA2d 302, 34 CR 317; *Standard Iron Works v Glove Jewelry & Loan, Inc.* (1958) 164 CA2d 108, 330 P2d 271. For example, in *G.W. Andersen Constr. Co. v Mars Sales* (1985) 164 CA3d 326, 210 CR 409, the court held that the defendant contractors, who had repudiated a contract for construction of a building, were not discharged from their contractual duties as a result of the adoption of several city ordinances that imposed a construction moratorium and set forth development standards for new construction. At most, the ordinances would have delayed construction, and the contract provided for that contingency. Even if an ordinance had prevented construction altogether, the defendants would have had a duty to cooperate and seek a variance in accordance with the moratorium ordinance. Because the defendants failed to utilize the procedures for relief from the ordinance restrictions, they could not complain that the ordinances made performance permanently impossible and were not discharged from their obligations.

NOTE: The illegality of a contract at the time it is made will prevent its formation. See §§3.36-3.41 for discussion of illegality as a defense to formation of the contract.

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§8.32 b. Force Majeure (CC §1511(2))

The second circumstance in which a debtor's failure to perform an obligation (or to make an offer of performance) or any delay in performance (or an offer of performance) is excused is when the debtor's performance is prevented or delayed by a supervening cause or an act of war (commonly referred to as a force majeure). Civil Code §1511(2) provides that the following is cause for excusing performance:

> When it is prevented or delayed by an irresistible, superhuman cause, or by the act of public enemies of this state or of the United States, unless the parties have expressly agreed to the contrary.

Some contracts may include an express force majeure clause, providing for suspension of a party's performance obligations during a period of force majeure. Following is an example of a force majeure clause in an oil and gas lease, which was at issue in *San Mateo Community College Dist. v Half Moon Bay Ltd. Partnership* (1998) 65 CA4th 401, 406, 76 CR2d 287:

> **The obligations of Lessee hereunder shall be suspended while Lessee is prevented from complying therewith, in whole or in part, by strikes, lockouts, action of the elements, laws, rules and regulations of any federal, state, municipal or other governmental agency, acts or requests of any governmental officer or agent purporting to act under authority, exhaustion or unavailability or delays in deliver[y] of necessary materials and equipment, or other matters or conditions beyond the control of Lessee, whether or not similar to the matters or conditions herein specifically enumerated.**

Citing *Pacific Vegetable Oil Corp. v C.S.T., Ltd.* (1946) 29 C2d 228, 238, 174 P2d 441, the court of appeal in *Horsemen's Benevolent & Protective Ass'n v Valley Racing Ass'n* (1992) 4 CA4th 1538, 6 CR2d 698, held that the term "force majeure" is not necessarily limited to acts of God. The test is "whether under the particular circumstances there was such an insuperable interference occurring without the parties' intervention as could not have been prevented by prudence, diligence and care." 4 CA4th at 1564.

Either under CC §1511(2) or a contractual force majeure clause, circumstances that may make performance of the contract more difficult or costly than the parties contemplated when the agreement was signed will not excuse performance. *Butler v Nepple* (1960) 54 C2d 589, 599, 6 CR 767; *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 154, 135 CR 802. The doctrine of force majeure is not intended to shield a party from the normal business risks expressly assumed by both parties in entering into a contractual relationship. *Horsemen's Benevolent & Protective Ass'n,* 4 CA4th at 1564 (force majeure clause did not excuse buyer from consequences of normal risk of fixed-price contract, *i.e.,* that market prices will rise or fall). Moreover, the last clause of CC §1511(2) allows the contracting parties to expressly agree that force majeure will *not* constitute an excuse of performance. See, *e.g., Autry v Republic Prods., Inc.* (1947) 30 C2d 144, 180 P2d 888.

NOTE: Force majeure as an excuse for nonperformance is closely related to the doctrines of impossibility, impracticability, and frustration of purpose, discussed in §§8.35-8.38.

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§8.33 c. Creditor Induces Debtor's Nonperformance (CC §1511(3))

The third circumstance in which a debtor's failure to perform an obligation (or to make an offer of performance) or any delay in performance (or an offer of performance) is excused is when the debtor is induced not to perform by an act of the creditor. Civil Code §1511(3) provides that the following is cause for excusing performance:

> When the debtor is induced not to make it, by any act of the creditor intended or naturally tending to have that effect, done at or before the time at which such performance or offer may be made, and not rescinded before that time.

Note that CC §1511(3) differs from CC §1511(1) (see §§8.29-8.31) in that under subsection (3), the creditor need not actually prevent the debtor's performance, but rather need only take some action that naturally tends to induce the debtor not to perform. For example, *Wade v Markwell & Co.* (1953) 118 CA2d 410, 430, 258 P2d 497, was a suit for conversion of a mink coat that had served as collateral for a loan but which the pledgee sold without notice to the pledgor. The court held that the pledgor was excused from the necessity of tendering payment of the loan, because "the law does not require the doing of an idle act." See also *Beverage v Canton Placer Mining Co.* (1955) 43 C2d 769, 777, 278 P2d 694; *County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 1275 n6, 90 CR2d 41.

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§8.34 d. Nonoccurrence or Nonperformance of Condition

In some circumstances, the nonoccurrence or nonperformance of a condition may be excused and thereby render a party's obligation to perform unconditional and fully enforceable. See CC §1440; §6.49. Alternatively, the nonoccurrence or nonperformance of a condition may operate as an excuse of a party's performance obligation—particularly when the cause of the nonoccurrence or nonperformance of the condition is one of the circumstances listed in CC §1511. See §§8.29-8.33. See also *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1335, 96 CR3d 813. Restatement (Second) of Contracts §237 (1981) states generally that "it is a condition of each party's remaining duties to render performances… that there be no uncured material failure by the other party to render any such performance due at an earlier time." Excuse of conditions is discussed further in §6.49.

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e. Impossibility or Impracticability

§8.35 (1) Generally (CC §1598)

Impossibility or impracticability as an excuse for performance is related to force majeure, discussed in §8.32. Impossibility has been defined as encompassing not only strict impossibility, but also impracticability as a result of "extreme and unreasonable difficulty, expense, injury, or loss involved." *Oosten v Hay Haulers Dairy Employees & Helpers Union* (1955) 45 C2d 784, 788, 291 P2d 17. See *Kennedy v Reece* (1964) 225 CA2d 717, 37 CR 708 (performance may be so difficult and expensive that it is described as "impracticable," thus excusing performance as form of impossibility). "A thing is impossible in legal contemplation when it is not practicable; and a thing is impracticable when it can only be done at an excessive and unreasonable cost." *City of Vernon v City of Los Angeles* (1955) 45 C2d 710, 720, 290 P2d 841; *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1336, 96 CR3d 813. Civil Code §1598 provides that if a contract has only one object, and that object is "wholly impossible of performance," the entire contract is void. See also CC §§1441, 3531. Facts that make performance simply more difficult or more expensive than originally contemplated do not constitute impossibility. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802. Performance may be impracticable, however, if it would require excessive and unreasonable expense. *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga, supra*.

Destruction or cessation of the existence of the subject matter of the contract generally provide grounds to excuse performance on the basis of impossibility. If it is evident from the nature of the contract that the parties assumed the continued existence of a person, thing, or condition to which the contract relates, the subsequent perishing of such person or thing, or the cessation of existence of the condition, will excuse performance, based on an implied condition to that effect, even if the parties' express agreement was unqualified. *20th Century Lites, Inc. v Goodman* (1944) 64 CA2d Supp 938, 149 P2d 88. "'Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.' (Rest.2d Contracts, §261.)" *Maudlin v Pacific Decision Sciences Corp.* (2006) 137 CA4th 1001, 1017, 40 CR3d 724. If money is to be paid from a specific fund but not otherwise, the failure of that fund will excuse performance and defeat the creditor's right of recovery. *Parsons v Bristol Development Co.* (1965) 62 C2d 861, 44 CR 767. In *Autry v Republic Prods., Inc.* (1947) 30 C2d 144, 180 P2d 888, the court found that Gene Autry was excused from performance of his motion picture contract on account of his military service, which constituted grounds for impossibility of performance.

Good faith by the party seeking to avoid performance is an important component of the defense of impossibility. "No contractor is excused… unless he shows affirmatively that… in spite of skill, diligence and good faith on his part, performance became impossible or unreasonably expensive." *Oosten,* 45 C2d at 789. See also *G.W. Andersen Constr. Co. v Mars Sales* (1985) 164 CA3d 326, 334, 210 CR 409. A party cannot avoid liability for nonperformance by placing performance beyond its control by its own voluntary action. *Johnson v Hapke* (1960) 183 CA2d 255, 6 CR 603.

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§8.36 (2) Temporary Impossibility or Impracticability

The effect of impossibility or impracticability may be temporary, in which case the condition will not be excused, but a suspension or delay in performance will be allowed. See *Maudlin v Pacific Decision Sciences Corp.* (2006) 137 CA4th 1001, 1017, 40 CR3d 724; *G.W. Andersen Constr. Co. v Mars Sales* (1985) 164 CA3d 326, 334, 210 CR 409. See also Restatement (Second) of Contracts §269 (1981) (temporary impracticability). If, however, performance after the impossibility has ended would impose a substantially greater burden on the promisor, the temporary impossibility may operate as a permanent discharge. Otherwise, the promisor's duty is merely suspended while the impossibility exists. *Oosten v Hay Haulers Dairy Employees & Helpers Union* (1955) 45 C2d 784, 788, 291 P2d 17; *Maudlin v Pacific Decision Sciences Corp.* (2006) 137 CA4th 1001, 1017, 40 CR3d 724. In *Maudlin,* the court of appeal held that a corporation's obligation to make installment payments under a stock redemption agreement would be temporarily suspended if the corporation did not have sufficient retained earnings under Corp C §500 on the date that an installment payment was due. The court remanded the case to the trial court to determine whether any deficiency in retained earnings was only temporary or whether the deficiency was sufficiently permanent to excuse further payments.

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§8.37 (3) Death or Incapacity

The death or incapacity of an individual party may or may not excuse performance of a contract, depending on the nature of the contract, its terms, and the surrounding circumstances. If "distinctly personal considerations" are the basis for a contract, the parties' relationship is dissolved at the death of the individual whose personal qualities were the inducement to formation of the contract. The issue depends on the parties' intent. If performance of the contract rests on the continued existence of a certain person, death of that person will render his or her performance impossible and will excuse performance. *Farnon v Cole* (1968) 259 CA2d 855, 858, 66 CR 673.

In *Cazares v Saenz* (1989) 208 CA3d 279, 256 CR 209, one member of a two-person law firm became incapable of performing a contract of association with another lawyer. Relying on the Restatement (Second) of Contracts §§261-262 (1981), the court ruled that the parties' obligations were discharged. In general, the death or incapacity of an individual party to a personal services contract will excuse performance, because such contracts are founded on a basic assumption that the individual will not die or become incapacitated. 208 CA3d at 285.

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§8.38 f. Frustration of Purpose

Closely related to impossibility and impracticability (see §§8.35-8.37) is the doctrine of frustration of purpose, which may also operate to excuse performance. The doctrine applies when performance is literally possible but a supervening, fortuitous event has substantially destroyed the value of the consideration to be rendered. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 155, 135 CR 802. See also *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1336, 96 CR3d 813. The doctrine is limited to cases of extreme hardship when the subsequent unanticipated event almost entirely destroys the value of the consideration to be rendered. *Guthrie v Times-Mirror Co.* (1975) 51 CA3d 879, 888, 124 CR 577. Mere increased expense or difficulty does not rise to the level of frustration of purpose. *Ellison v City of San Buenaventura* (1975) 48 CA3d 952, 122 CR 167 (unconditional contractual duty to maintain channel in navigable condition not subject to excuse that expense of dredging equipment was too great). To establish frustration of purpose, a party must show that, although performance of contract remains possible, the fundamental reason that both parties entered into the contract has been frustrated by unanticipated supervening circumstances that destroy the value of the performance to the party attempting to enforce the contract. *Cutter Labs., Inc. v Twining* (1963) 221 CA2d 302, 34 CR 317. See also *Marriage of Benjamins* (1994) 26 CA4th 423, 432, 31 CR2d 313.

Although the doctrines are related, frustration of purpose is not a form of impossibility of performance. It focuses on the consideration for performance. Under the doctrine of frustration, performance remains possible, but is excused when a fortuitous event intervenes to cause a failure of consideration or nearly total destruction of the expected value of the performance to both parties. To excuse nonperformance of a contract on the ground of commercial frustration (*Autry v Republic Prods., Inc.* (1947) 30 C2d 144, 148, 180 P2d 888):

- The basic purpose of the contract, which has been destroyed by the supervening event, must be recognized by both parties to the contract;
- The event must be of a nature not reasonably to have been foreseen;
- The frustration must be so severe that it is not fairly to be regarded as within the risks that were assumed under the contract; and
- The value of counterperformance to the promisor seeking to be excused must be substantially or totally destroyed.

See also Restatement (Second) of Contracts §261 (1981).

Frustration is not a defense if it was reasonably foreseeable. If the parties have contracted with reference to the purportedly frustrating event or have contemplated or allocated the risks arising from the event in their contract, they may not invoke the doctrine of frustration of purpose to escape their contractual obligations. *Glenn R. Sewell Sheet Metal, Inc. v Loverde* (1969) 70 C2d 666, 75 CR 889 (problems with septic system at trailer park would not support termination of operator's sublease and return of deposit; contract had allocated risk to operator). As stated by the court (70 C2d at 678 n13):

> [T]he question whether a risk was foreseeable is quite distinct from the question whether it was contemplated by the parties. It is possible for the parties to contemplate and make express provision for, a risk that would not otherwise be considered foreseeable. Conversely, some risks may be so wholly foreseeable that it would strain credulity to believe that they were not contemplated by the parties.… Finally, the parties may have contemplated and expressly provided for a type of risk that in fact occurs, but the magnitude or duration of which is so great that it cannot fairly be said to have been either contemplated or foreseeable.… When a risk has been contemplated and voluntarily assumed, however, and the manner of its occurrence is not so extraordinary as to justify the invocation of the last stated rule, foreseeability is not an issue and the parties will be held to the bargain they made.

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§8.39 2. Debtor's Entitlement to Contract Benefits (CC §1512)

Civil Code §1512 provides that "[i]f the performance of an obligation be prevented by the creditor, the debtor is entitled to all the benefits which he would have obtained if it had been performed by both parties." This section in effect provides a measure of damages for a contract debtor if the debtor's performance is prevented by the creditor. The debtor is entitled to recover its loss, which may include the debtor's reasonable expenses incurred towards performance of the contract, together with lost profits that the debtor would have derived from full performance of the contract by both parties. See *Navarro v Jeffries* (1960) 181 CA2d 454, 5 CR 435. In *Navarro,* the court also held that the debtor was also entitled to recover depreciation on equipment that had been purchased specially for the contract and had been held in readiness for the performance prevented by the other party. As the California Supreme Court stated in *Nelson v Reisner* (1958) 51 C2d 161, 171, 331 P2d 17, "[a] party to a contract cannot take advantage of his own act or omission to escape liability thereon. Where a party to a contract prevents the fulfillment of a condition or its performance by the adverse party, he cannot rely on such condition to defeat his liability."

Erich v Granoff (1980) 109 CA3d 920, 930, 167 CR 538 was an action by the holder of an option to purchase real property against the property owner, who refused to sell after the option was exercised. The court held that the plaintiff was entitled not only to specific performance of the option contract, but also to a judgment for the net rents that the plaintiff would have received if the conveyance had been made in accordance with the contract. Similarly, in *Bruntz v Alfaro* (1989) 212 CA3d 411, 260 CR 488, the court found that the creditor's refusal to accept the debtors' tender of payment of the amounts due under a deed of trust, on grounds that the amount of attorney fees tendered was insufficient, was wrongful. The debtors were therefore not only entitled to a dismissal of the foreclosure action but further were not required to pay the excess attorney fees demanded by the creditor.

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§8.40 3. Ratable Recovery of Consideration (CC §1514)

Civil Code §1514 provides:

> If performance of an obligation is prevented by any cause excusing performance, other than the act of the creditor, the debtor is entitled to a ratable proportion of the consideration to which he would have been entitled upon full performance, according to the benefits which the creditor receives from the actual performance.

If a party has partially performed a contract and conferred a benefit on the other party but is then excused from completing performance, the first party may recover a ratable portion of the consideration otherwise due under the contract. See *Akins v Riverbank Canning Co.* (1947) 80 CA2d 868, 183 P2d 86. The Commercial Code analogue of CC §1514 is Com C §2615(b), discussed in §8.62, and will control in contracts for the sale of goods. See *Terry v Atlantic Richfield Co.* (1977) 72 CA3d 962, 140 CR 510.

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§8.41 4. Refusal to Accept Performance (CC §1515)

Civil Code §1515 provides that "[a] refusal by a creditor to accept performance, made before an offer thereof, is equivalent to an offer and refusal, unless before performance is actually due, he gives notice to the debtor of his willingness to accept it." In other words, a creditor's pre-tender refusal to accept performance operates as if the tender had been made and refused, thus excusing the debtor from its obligation to tender performance, unless the creditor withdraws the refusal before the debtor's tender of performance is due. The rule in CC §1515 is similar, although not identical, to the doctrine of anticipatory repudiation codified in CC §1440 (see §8.71). Courts tend to cite the two statutes together. See, *e.g., Never v King* (1969) 276 CA2d 461, 81 CR 161; *Hohener v Gauss* (1963) 221 CA2d 797, 800, 34 CR 656. In most cases, a creditor's refusal to accept performance will amount to a repudiation of the entire contract, not only excusing the debtor's performance but also entitling the debtor to sue immediately for breach. See, *e.g., County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 90 CR2d 41.

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D. Accord and Satisfaction

§8.42 1. Generally (CC §§1521, 1523)

Civil Code §1521 defines "accord" as "an agreement to accept, in extinction of an obligation, something different from or less than that to which the person agreeing to accept is entitled." Civil Code §1523 provides that "[a]cceptance, by the creditor, of the consideration of an accord extinguishes the obligation, and is called satisfaction." In general, an accord and satisfaction is the substitution of a new agreement in place and in satisfaction of an existing agreement between the same parties. Its purpose is usually to settle a claim or obligation at a discounted amount. *Marriage of Thompson* (1996) 41 CA4th 1049, 1058, 48 CR2d 882.

Accord and satisfaction is a defense to enforcement of a contract. To establish it, a defendant must show (*BII Fin. Co. v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 126, 115 CR2d 312; *Thompson v Williams* (1989) 211 CA3d 566, 571, 259 CR 518):

- The existence of a bona fide dispute between the parties;
- That the defendant tendered a certain sum or other performance on the express condition that the creditor's acceptance of it would constitute full payment or satisfaction of the creditor's unliquidated claim; and
- That the creditor clearly understood when accepting what was tendered that the defendant intended it to constitute payment in full of the claim at issue.

See also Com C §3311, discussed in §8.45.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.43 2. Intent of Parties (CC §§1524-1525)

§8.43 2. Intent of Parties (CC §§1524-1525)

Whether a transaction amounts to an accord and satisfaction depends on the intent of the parties and is normally a question of fact determined from the surrounding circumstances. It may be express or implied. *Thompson v U-States Forwarding Servs. Corp.* (2002) 95 CA4th 111, 126, 115 CR2d 312; *Marriage of Thompson* (1996) 41 CA4th 1049, 1058, 48 CR2d 882; *Thompson v Williams* (1989) 211 CA3d 566, 571, 259 CR 518. "[T]here must be a consent or meeting of the minds of the contracting parties; it must be shown that the parties intend the sum paid to be accepted in extinction of the amount due." *Zuckerman v Pacific Sav. Bank* (1986) 187 CA3d 1394, 1405, 232 CR 458.

If accepted by the creditor, part performance of the original obligation may constitute an accord and satisfaction. Civil Code §1524 provides:

> Part performance of an obligation, either before or after a breach thereof, where expressly accepted by the creditor in writing, in satisfaction, or rendered in pursuance of an agreement in writing for that purpose, though without any new consideration, extinguishes the obligation.

On the other hand, in situations in which a creditor is unwilling to accept what is offered by the debtor as full satisfaction of the obligation, the debtor remains free to pay any amount that is not in dispute and the creditor may accept the reduced amount without limiting its remedies with respect to the unpaid amount. Civil Code §1525 provides:

> It is the public policy of this State, in the best interests of the taxpayer and of the litigant, to encourage fair dealing and to promote justice by reducing litigated matters to the lowest level of jurisdiction.
>
> In case of a dispute over total money due on a contract and it is conceded by the parties that part of the money is due, the debtor may pay, without condition, the amount conceded to be due, leaving to the other party all remedies to which he might otherwise be entitled as to any balance claimed.
>
> If any conditions are attached to the payment, this section shall not be deemed to have limited the remedies available to the other party under other provisions of law on the original amount claimed.

Thompson v Williams, supra, was a dispute over attorney fees. The parties arrived at a settlement figure of $114,000 "by dickering back and forth." When Williams made his last offer, he said, "That's all you are going to get, Buddy… the top is $114. If you don't like it, sue me." Thompson asked if this was Williams' "final say," and when Williams said yes, Thompson said, "Fine, I'd like to pick up my money now." Thompson then accepted and cashed the check that Williams offered. The court held that the transaction was an accord and satisfaction. *Thompson,* 211 CA3d at 574. On the other hand, in *BII Fin. Co. v U-States Forwarding Servs. Corp.*, *supra,* the evidence showed that BII Finance accepted less than the total agreed price for a shipment of allegedly defective goods simply to mitigate its damages. The court of appeal affirmed the trial court's determination that there was no accord and satisfaction. *BII Fin. Co.,* 95 CA4th at 127.

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§8.44 3. Distinguished From Novation (CC §1522)

Civil Code §1522 provides that "[t]hough the parties to an accord are bound to execute it, yet it does not extinguish the obligation until it is fully executed." This means that, until the obligor performs the accord and delivers the substitute consideration, the accord is executory, and the previous obligation has not been extinguished. *Gardiner v Gaither* (1958) 162 CA2d 607, 620, 329 P2d 22. Once the consideration has been delivered and accepted by the creditor, there is satisfaction of the accord and extinction of the prior obligation. See CC §1523; *Moving Pictures Mach. Operators Union Local No. 162 v Glasgow Theaters, Inc.* (1970) 6 CA3d 395, 402, 86 CR 33.

In contrast, a novation is the substitution of a new contract for a preexisting one, which extinguishes the previous contract as soon as the parties enter into the new agreement, even if the new one is executory. See CC §1530; *Paykar Construction, Inc. v Spilat Construction Corp.* (2001) 92 CA4th 488, 494, 111 CR2d 863; *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 432, 38 CR2d 521. Novations are discussed further in §5.84.

To distinguish between an executory accord and a novation, the determining factor is the intent of the parties. *Gardiner,* 162 CA2d at 619.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.45 4. Accord and Satisfaction by Use of Instrument (Com C §3311; CC §1526)

§8.45 4. Accord and Satisfaction by Use of Instrument (Com C §3311; CC §1526)

Conflicting statutes. Two California statutes address an accord and satisfaction through use of a negotiable instrument, such as a check: Com C §3311, enacted in 1992, and CC §1526, enacted in 1987. The statutes conflict, and although the California Supreme Court has not yet ruled on the question, *Woolridge v J.F.L. Elec., Inc.* (2002) 96 CA4th Supp 52, 117 CR2d 771, held that Com C §3311 supersedes CC §1526, inasmuch as Com C §3311 was enacted more recently. See also *Jones v Baltimore Life Ins. Co.* (ED Cal, June 11, 2007, No. CIV S-06-1505 LKK/KJM) 2007 US Dist Lexis 44825; *Directors Guild v Harmony Pictures, Inc.* (CD Cal 1998) 32 F Supp 2d 1184; Hull & Sharma, *Satisfaction Not Guaranteed: California's Conflicting Law on the Use of Accord and Satisfaction*, 33 Loy LA L Rev 1 (Nov. 1999).

Effect of "payment in full" notation on check. The classic area of difficulty in the law of accord and satisfaction has been the case presented by a debtor's partial payment of amounts due by a check tendered with a notation that it is given as "payment in full" of the outstanding obligation. The issue then becomes whether (and if so, how) the creditor can cash the check but still reserve its rights with respect to the unpaid balance. At common law, the creditor could not reserve its rights and also cash the check if the check bore conspicuous "payment in full" language. See, *e.g., Potter v Pacific Coast Lumber Co.* (1951) 37 C2d 592, 234 P2d 16. Civil Code §1526 changed the common law rule. Under CC §1526(a), a creditor could accept a check for a partial payment that the debtor offered in full settlement without triggering an accord and satisfaction if the creditor struck out or otherwise deleted the "payment in full" notation on the check or if the creditor's acceptance of the check was inadvertent or without knowledge of the notation. See generally *Woolridge,* 96 CA4th Supp at 57.

General UCC rule. Commercial Code §3311, adopted in 1992, reinstates the common law rule that a creditor's acceptance of a check bearing "payment in full" or a similar notation will extinguish the claim. The drafters believed "that the common law rule produces a fair result and that informal dispute resolution by full satisfaction checks should be encouraged." Official Comment 3 to UCC §3-311. See also *Jones v Baltimore Life Ins. Co., supra.* However, Com C §3311 also provides a limited safe harbor for creditors. See Com C §3311(c).

Under Com C §3311(a) and (b), unless the safe harbor of Com C §3311(c) applies, a creditor's claim will be discharged: (1) if the debtor tendered the instrument in good faith in full satisfaction of the claim; (2) the claim was unliquidated or subject to a bona fide dispute; (3) the instrument or an accompanying written communication contained a "conspicuous statement" that the instrument was tendered in full satisfaction of the claim; and (4) the creditor obtained payment of the instrument. Commercial Code §3311(a) and (b) state the rule as follows:

> (a) If a person against whom a claim is asserted proves that (1) that person in good faith tendered an instrument to the claimant as full satisfaction of the claim, (2) the amount of the claim was unliquidated or subject to a bona fide dispute, and (3) the claimant obtained payment of the instrument, the following subdivisions apply.
>
> (b) Unless subdivision (c) applies, the claim is discharged if the person against whom the claim is asserted proves that the instrument or an accompanying written communication contained a conspicuous statement to the effect that the instrument was tendered as full satisfaction of the claim.

A statement is "conspicuous" if it is written so that a reasonable person ought to have noticed it. Com C §1201(10). If the creditor can reasonably be expected to examine the check, almost any statement on it should have been noticed, particularly a statement that appears above the space provided for endorsement. See Official Comment 4 to UCC §3-311.

Creditor safe harbor. The safe harbor of Com C §3311(c) generally allows a creditor to avoid an accord and satisfaction if either (1) the creditor (if an organization) sent the debtor a "conspicuous statement" that all communications regarding disputed debts were to be sent to a particular person or office but the debtor's instrument or accompanying communication was not received there, or (2) the creditor (whether or not an organization) returned the amount paid to the debtor within 90 days after payment of the original instrument. The second alternative is designed to prevent an inadvertent accord and satisfaction. Official Comment 6 to UCC §3-311. A creditor that is an organization

cannot utilize the second alternative, however, if it previously sent a qualifying statement to the debtor that all communications regarding disputed debts were to be sent to a designated person or office. Commercial Code §3311(c) reads as follows:

> (c) Subject to subdivision (d), a claim is not discharged under subdivision (b) if either of the following applies:
> (1) The claimant, if an organization, proves that (A) within a reasonable time before the tender, the claimant sent a conspicuous statement to the person against whom the claim is asserted that communications concerning disputed debts, including an instrument tendered as full satisfaction of a debt, are to be sent to a designated person, office, or place, and (B) the instrument or accompanying communication was not received by that designated person, office, or place.
> (2) The claimant, whether or not an organization, proves that within 90 days after payment of the instrument, the claimant tendered repayment of the amount of the instrument to the person against whom the claim is asserted. This paragraph does not apply if the claimant is an organization that sent a statement complying with subparagraph (A) of paragraph (1).

Knowledge limitation on safe harbor. The safe harbor of Com C §3311(c) is limited by Com C §3311(d), which provides that, even if §3311(c) applies, there will be an accord and satisfaction if the debtor can prove that the creditor (or a responsible agent) knew that the instrument was tendered in full satisfaction of the creditor's claim. Commercial Code §3311(d) provides:

> (d) A claim is discharged if the person against whom the claim is asserted proves that within a reasonable time before collection of the instrument was initiated, the claimant, or an agent of the claimant having direct responsibility with respect to the disputed obligation, knew that the instrument was tendered in full satisfaction of the claim.

A creditor "knows" that an instrument was tendered in full satisfaction of a claim if the creditor "has actual knowledge" of the fact. Com C §1201(25). If a full satisfaction check is sent to an office that merely processes checks for the creditor, it is not relevant whether the clerk processing the check saw the debtor's statement. The clerk's knowledge will not be imputed to the creditor's organization if the clerk has no responsibility with respect to accord and satisfaction. Official Comment 7 to UCC §3-311. If Com C §3311(d) applies, an accord and satisfaction will occur even if the debtor did not send the check to the person or office designated by the creditor and even if the creditor tendered repayment of the amount of the check to the debtor in accordance with Com C §3311(c)(2). Official Comment 7 to UCC §3-311.

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§8.46 E. Novation (CC §§1530-1532)

A novation is the substitution of a new contractual obligation for an existing one. CC §1530. It completely extinguishes the existing contract, and substitutes either a new obligor, a new obligee, a new obligation, or a combination of these in place of what the original contract provided. CC §1531; *Wells Fargo Bank v Bank of America* (1995) 32 CA4th 424, 38 CR2d 521; *Howard v County of Amador* (1990) 220 CA3d 962, 269 CR 807. Unlike simple assignments, novations operate as a complete release with regard to the party or the obligation being substituted out. See *Wells Fargo Bank,* 32 CA4th at 432. Novations are subject to all the rules governing contracts generally. CC §1532. For further discussion of novations, see §5.84.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.47 F. Release (CC §§1541-1543)

§8.47 F. Release (CC §§1541-1543)

A release by a creditor of a debtor's obligation is enforceable and extinguishes the debtor's obligation if the release is supported by consideration. No consideration is necessary if the release is given in writing. CC §1541. Like other contracts, a release is not enforceable if obtained by fraud, deception, misrepresentation, duress, or undue influence. *Tarpy v County of San Diego* (2003) 110 CA4th 267, 1 CR3d 607; *Skrbina v Fleming Cos.* (1996) 45 CA4th 1353, 1366, 53 CR2d 481. A release is an "abandonment, relinquishment or giving up of a right or claim to the person against whom it might have been demanded or enforced… and its effect is to extinguish the cause of action; hence it may be pleaded as a defense to the action." *Pellett v Sonotone Corp.* (1945) 26 C2d 705, 711, 160 P2d 783. For further discussion of releases, see §§5.86-5.91.

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III. PERFORMANCE OF COMMERCIAL CODE CONTRACTS

A. Performance Standards

§8.48 1. General Obligations of Parties (Com C §§2301, 10301)

Commercial Code §2301 provides that "[t]he obligation of the seller is to transfer and deliver and that of the buyer is to accept and pay in accordance with the contract." This is a fundamental principle of Division 2. California UCC Sales and Leases §9.2 (Cal CEB 2002). Although the statute uses the term "transfer and deliver" for the seller's obligations, a tender in accordance with the provisions is usually all that is required. See, *e.g.,* Com C §§2319(1)(b), 2503, 2507(1), 2511(1).

The corresponding provision in Division 10 has a similar practical effect. Commercial Code §10301 states that "[e]xcept as otherwise provided in this division, a lease contract is effective and enforceable according to it between the parties, against purchases of the goals, and against creditors of the parties."

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§8.49 2. Manner of Seller's Tender of Delivery (Com C §2503)

A valid tender of delivery has two requirements: (a) The seller must put and hold conforming goods at the buyer's disposition, and (b) the seller must give the buyer notice so that the buyer may take delivery. Com C §2503(1). The time, place, and manner of tender are provided by the contract of the parties and the applicable provisions of the Commercial Code. The seller's tender must occur at a reasonable hour, and the goods must be kept available for a reasonable period to enable the buyer to taken possession. Com C §2503(1)(a). What is reasonable depends on trade usage and the circumstances. Official Comment 3 to UCC §2-503. Unless otherwise agreed, the buyer must furnish facilities reasonably suited to the receipt of the goods. Com C §2503(1)(b).

If the seller is not required to deliver the goods to a particular destination (see §8.50), a valid tender requires that the seller comply with §2504. Com C §2503(2). If the seller is required to deliver the goods to a particular destination, tender also requires that the seller tender appropriate documents under Com C §§2503(4) (goods to be delivered without being moved) and 2503(5) (delivery of documents). Com C §2503(3). If the goods are in the possession of a third party bailee and are to be delivered without being moved, tender requires the seller either (1) to tender a negotiable document of title such as a bill of lading or (2) to obtain the bailee's acknowledgment of the buyer's right to possession of the goods (tendering a nonnegotiable document of title or a written direction to the bailee to deliver will be sufficient unless the buyer timely objects). The bailee's receipt of notice of the buyer's rights fixes those rights as against the bailee and all third persons. Com C §2503(4). In these circumstances, the risk of loss and any failure by the bailee to honor the nonnegotiable document of title or to obey the direction remains on the seller until the buyer has had a reasonable time to present the document or direction. A refusal by the bailee to honor the document or to obey the direction defeats the tender. Com C §2503(4).

If the contract requires the seller to deliver documents, all of the documents must be tendered in correct form (except as provided in Com C §2323 regarding sets of bills of lading), and tender through customary banking channels is sufficient. Com C §2503(5)(a). If normal banking channels are used, dishonor of a draft accompanying the documents constitutes nonacceptance or rejection. Com C §2503(5)(a).

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.50 3. Seller's Performance by Shipment (Com C §2504)

§8.50 3. Seller's Performance by Shipment (Com C §2504)

If the seller is authorized or required to send the goods to the buyer and the contract does not require the seller to deliver them at a particular destination, the seller must (unless otherwise agreed) (Com C §2504):

- Put the goods in the possession of a carrier and make a contract for their transportation in a manner that is reasonable considering the nature of the goods and other circumstances of the case;
- Obtain and promptly deliver or tender in due form any document necessary to enable the buyer to obtain possession of the goods or otherwise required by the agreement or by usage of trade; and
- Promptly notify the buyer of the shipment.

In other words, a seller's delivery obligations are found in the contract of sale but, if the contract is silent, are governed by Com C §2504, which grants the seller reasonable discretion to make a proper contract of carriage, provide the buyer with any documents needed to take delivery of the goods, and notify the buyer of the shipment. Failure to notify the buyer or to make a proper contract for carriage is grounds for the seller's rejection only if material delay or loss results from the failure. Com C §2504.

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§8.51 4. Seller's Shipment Under Reservation (Com C §2505)

"Shipment under reservation" allows the seller to retain control of the goods in transit without entering into a destination contract, and while doing so, prepaying freight and assuming the risk of loss and damage in shipment. By shipping under reservation, the seller retains a security interest in the goods, can prevent the buyer from taking the goods without first paying for them, and can make alternative arrangements for disposition of the goods should the buyer not pay. California UCC Sales and Leases §9.10 (Cal CEB 2002). Commercial Code §2505 details the process of shipping under reservation.

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§8.52 5. Perfect Tender Rule (Com C §2601)

Under non-Commercial Code law, a breach of contract by one party is generally not grounds to excuse the other party's performance unless the breach is material. See §8.70. For sales of goods under the Commercial Code, the rule is at least nominally different: The "perfect tender" rule applies: If the goods themselves, or the time, manner, and place of their tender, do not conform to the terms of the contract in any respect, the buyer may reject the goods or the tender, accept the goods or the tender, or accept any commercial units and reject the rest. Com C §2601. "Commercial unit" is defined in Com C §2105(6) as

> such a unit of goods as by commercial usage is a single whole for purposes of sale and division of which materially impairs its character or value on the market or in use. A commercial unit may be a single article (as a machine) or a set of articles (as a suite of furniture or an assortment of sizes) or a quantity (as a bale, gross, or carload) or any other unit treated in use or in the relevant market as a single whole.

The perfect tender rule is not as harsh as it might appear. It includes exceptions for installment contracts and contracts in which the parties have limited their remedies. Com C §2601. For installment contracts, substantial compliance is all that is required. Com C §2612. Additional exceptions to the perfect tender rule include rejections that are not in good faith (Com C §1203), purported rejections made after acceptance (Com C §2607(2), and cases where the goods are covered by the federal Perishable Agricultural Commodities Act (7 USC §§499a-499s). See California UCC Sales and Leases §§9.64-9.77 (Cal CEB 2002).

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§8.53 6. Seller's Cure of Improper Tender or Delivery (Com C §§2508, 2614, 10406)

Under Com C §2508, if the buyer rejects a tender or delivery as nonconforming and the seller's time for performance has not yet elapsed, the seller may cure the tender or delivery. The buyer's rejection notice must list all defects ascertainable on reasonable inspection and curable by the seller. Com C §2602(1). Any defect not included in the notice of rejection is waived, even incurable defects. Com C §2605(1). If the seller wishes to cure, it must seasonably notify the buyer that it intends to cure within the contract period for performance and may proceed to do so, even without the buyer's consent. Com C §2508(1).

The seller may also attempt to cure after the time for performance if the buyer rejects a nonconforming tender that the seller reasonably expected would be acceptable with or without a monetary allowance. If so, the seller must also seasonably notify the buyer that it intends to substitute a conforming tender. Com C §2508(2). This late cure right usually arises in two situations: (1) when the seller knows that the goods do not conform but reasonably believes that they will be acceptable, perhaps based on course of dealing or industry custom; or (2) when the seller does not know of the defects at all. See California UCC Sales and Leases §9.64 (Cal CEB 2002).

A buyer's rejection may be based on nonconformities in the method of delivery even if the goods are conforming. Com C §2601. The potentially harsh result of this right is ameliorated by the provisions governing substitute delivery methods. The buyer must accept a commercially reasonable substitute delivery method if, through no fault of the parties, the agreed shipment facility or carrier becomes unavailable or the agreed delivery method becomes commercially impracticable but a commercially reasonable substitute is available. Com C §2614.

The corollary of these rules for leases of goods is in Com C §10406. Under that section, if a lessee is notified of a delay in delivery or a need for allocation under Com C §10405, the lessee may terminate the lease contract or accept an allocated share in substitution with due allowance for the reduction in goods but without further recourse against the lessor. Com C §10406. These rights are available under an installment lease only if the delay or shortfall substantially impairs the value of the contract. See Com C §10406(a).

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§8.54 7. Tender of Payment by Buyer (Com C §2511)

Tender of payment is a condition of the seller's duty to tender and complete delivery unless the parties have agreed otherwise. Com C §2511. Tender by check is reasonable and effective unless the seller objects when tender is made and allows a reasonable time for the buyer to obtain legal tender (money). Com C §2511(2). A seller might object and seek cash if facing the buyer's insolvency. If not objected to, payment by check is conditional on the check being honored on presentment. If dishonored, the check is said to be "defeated" or ineffective. Com C §2511(3).

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.55 8. Payment by Buyer Before Inspection (Com C §2512)

§8.55 8. Payment by Buyer Before Inspection (Com C §2512)

If the contract requires payment before inspection, nonconformity of the goods does not excuse the buyer from making payment unless (a) the nonconformity appears without inspection or (b) despite tender of the required documents in a letter of credit transaction, the circumstances would justify an injunction against honor of the letter of credit on grounds of fraud or forgery under Com C §5109(b). Com C §2512. Payment prior to inspection under §2512(1) does not constitute an acceptance of goods or impair the buyer's right to inspect or any other remedy of the buyer.

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§8.56 9. Buyer's Right to Inspection of Goods (Com C §2513)

A buyer may inspect goods at any reasonable place, time, and manner. Com C §2513. Generally, this occurs either at the time of identification of the goods to the contract, tender, or delivery. But inspection may also occur later, *e.g.,* after delivery (Official Comment 2 to UCC §2-513), or when the buyer has a reasonable opportunity to inspect the goods (Com C §§2513, 2606(1)). Further, the parties may specify the time for inspection as long as it is not manifestly unreasonable. Com C §1204(1), 2513(1). The seller must bear the buyer's costs of inspection if the goods do not conform to the contract and are rejected. Com C §2513(2). If the contract provides for cash or collect on delivery terms (COD), or for payment against documents of title such as bills of lading, the buyer may not inspect the goods before payment unless the parties have agreed otherwise. Com C §2513(3). In these circumstances, the buyer is entitled to inspect after payment and receipt of the goods and, if they are nonconforming, may reject. Com C §2512(2).

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.57 10. Preserving Evidence (Com C §2515)

§8.57 10. Preserving Evidence (Com C §2515)

Should inspection, acceptance, rejection, or revocation of acceptance lead to disputes between the parties regarding the conformity of the goods to the contract or the time, place, or manner of their tender, the Commercial Code provides that the parties must act reasonably with regard to preserving evidence to support or defend against their claims. Commercial Code §2515 provides that "[e]ither party on reasonable notification to the other and for the purpose of ascertaining the facts and preserving evidence has the right to inspect, test and sample the goods," including any goods in possession or control of the other party, and further that the "parties may agree to a third party inspection or survey to determine the conformity or condition of the goods and may agree that the findings shall be binding upon them in any subsequent litigation or adjustment."

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§8.58 11. Right to Adequate Assurance of Performance (Com C §2609)

Contracts for the sale of goods under the Commercial Code create an obligation on each party to preserve the other party's expectations of receiving performance under the contract. Com C §2609(1). A party has a right to demand assurance from the other party that the other party will perform its obligations if the circumstances give the first party reasonable grounds for doubting that performance is forthcoming. Com C §2609(1).

The reasonableness of grounds for insecurity are judged under a good faith, objective reasonableness standard and, between merchants, are judged according to commercial standards. See Com C §§1203 (good faith), 2104 (definition of "merchant"), 2609(2). Whether a buyer has reasonable grounds for insecurity is a question of fact. The insecurity need not arise under the contract at issue; it may come from some extra-contractual source, such as an impending bankruptcy or the fact that the other party may not be meeting its other obligations as they come due. *Puget Sound Energy, Inc. v PG&E (In re PG&E)* (2002) 271 BR 626, 641. Examples of reasonable grounds for insecurity include a buyer falling behind in scheduled payments, discovery that a seller is defaulting on other sales contracts, a manufacturer breaching a dealer's exclusive dealing clause, a buyer's sudden broad use of credit, and a buyer that stops taking advantage of early payment discounts. Official Comments 3-4 to UCC §2-609. See generally California UCC Sales and Leases §§16.2-16.11 (Cal CEB 2002). The parties may contract to provide for specific grounds for insecurity as long as those grounds are not manifestly unreasonable or allow a party to exercise unfettered discretion; in other words, they must reasonably relate to some objective standards or criteria. See Com C §1102(3).

The request for assurance must be in writing and, once made, the requesting party may suspend performance if it is commercially reasonable to do so until adequate assurance of continued future performance is received. Com C §2609(1). The response to the request need not be in writing but can be in any reasonable form that provides the requested assurance and, between merchants, the adequacy of the assurance received is to be judged according to commercial standards. Com C §2609(2). See generally UCC Sales & Leases §§16.12-16.20.

A party's acceptance of an improper delivery or payment does not prejudice that party's right to demand adequate assurance of future performance. Com C §2609(3). A party's failure to provide adequate assurance of future performance within a reasonable time (not to exceed 30 days after receipt of a justified demand for assurance) constitutes a repudiation of the contract. Com C §2609(4). What constitutes adequate assurance is a fact-based inquiry that requires the party receiving the assurances to exercise good faith and commercial reasonableness. 271 BR at 642.

Similar provisions apply to leases of goods. See Com C §10401.

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12. Acceptance of Performance

§8.59 a. Sales of Goods (Com C §§2301, 2606-2607)

Under Division 2 of the Commercial Code, buyers are obligated to accept conforming goods on proper tender by the seller and to pay for them under the terms of the contract. Com C §§2301, 2507(1). If the goods or the tender are nonconforming, the buyer may reject the whole, accept the whole, or accept commercial units and reject others. Com C §2601. Hence, partial acceptance in good faith is allowed and the buyer's remedies under the contract and Division 2 with regard to nonconforming goods or tender remain available.

Acceptance occurs when the buyer (Com C §2606(1)):

- After reasonable opportunity to inspect the goods, signifies to the seller that the goods are conforming or that the buyer will take or retain them in spite of their nonconformity;
- Fails to make an effective rejection under Com C §2602(1), but such acceptance does not occur until the buyer has had a reasonable opportunity to inspect them; or
- Does any act inconsistent with the seller's ownership; but if such act is wrongful as against the seller it is an acceptance only if ratified by him.

Payment for the goods after tender is highly persuasive but not conclusive evidence of acceptance under §2606(1)(a); the test is based on the totality of the circumstances. Official Comment 1 to UCC §2-606. Acceptance of a part of a commercial unit constitutes acceptance of the entire unit. Com C §2606(2).

The buyer must pay at the contract rate for any goods accepted. Com C 2607(1). In cases of partial acceptance, the price of the part accepted is to be paid based on a reasonable apportionment of the overall contract rate and the standards used in quantum valebat restitution cases. Official Comment 1 to UCC §2-607. Acceptance of goods by the buyer precludes rejection of those goods, and, if made with knowledge of a nonconformity, cannot be revoked because of the nonconformity unless the acceptance was made on the reasonable assumption that the nonconformity would be seasonably cured. Acceptance of the goods by itself does not impair any other remedy provided in Division 2 for nonconformity. Com C §2607(2); Official Comment 3 to UCC §2-607. This last principle is intended to cover the buyer's rights with respect to future installments despite acceptance of any earlier nonconforming installment. Official Comment 3 to UCC §2-607.

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§8.60 b. Revocation of Acceptance (Com C §2608)

Commercial Code §2608(1) permits a buyer who has accepted the goods to revoke acceptance of any commercial unit in two situations, if the nonconformity substantially impairs its value to the buyer: (1) if the buyer reasonably assumed that the nonconformity would be cured but the seller has not seasonably cured the nonconformity, or (2) if the buyer has not discovered the nonconformity but the buyer's acceptance was reasonably induced either by the difficulty of discovery before acceptance or by assurances of the seller. The buyer must revoke acceptance within a reasonable time after the buyer discovers or should have discovered the grounds for revocation and before any substantial change occurs in the condition of the goods that is not caused by their own defects. A revocation is not effective until the buyer notifies the seller of it. Com C §2608(2). A buyer who complies with §2608(1)-(2) in revoking acceptance has the same rights and duties with regard to the goods involved as if he or she had rejected them. Com C §2608(3).

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§8.61 c. Acceptance of Leased Goods (Com C §10515)

Acceptance of leased goods occurs when the lessee has had a reasonable opportunity to inspect the goods and the lessee signifies or acts with respect to the goods in a manner that signifies to the lessor or the supplier that the goods are conforming or that the lessee will take or retain them in spite of their nonconformity; or the lessee fails to make an effective rejection of the goods under Com C §10509(b). Com C §10515(a). Acceptance of a part of any commercial unit is acceptance of the entire unit. Com C §10515(b).

A lessee must pay rent for any goods accepted in accordance with the lease contract, with due allowance for goods rightfully rejected or not delivered. Com C §10516(a). A lessee's acceptance of goods precludes rejection of the goods accepted. In the case of a finance lease (other than a consumer lease in which the supplier assisted in the preparation of the lease contract or participated in negotiating the terms of the lease contract with the lessor), an acceptance made with knowledge of a nonconformity cannot be revoked because of it. Com C §10516(b). In any other case, an acceptance made with knowledge of a nonconformity cannot be revoked because of it unless the acceptance was made on the reasonable assumption that the nonconformity would be seasonably cured. Acceptance by itself does not impair any other remedy for nonconformity provided by Division 10 or the lease agreement. Com C §10516(b).

In the case of a finance lease that is not a consumer lease, on acceptance of the goods, the lessee's promises, including the promise to pay, become irrevocable and independent of the lessee's acceptance, *i.e.,* a failure of the lessor to perform other obligations does not excuse payment or other lessee obligations under a finance lease. Com C §10407(a). See also Com C §10407(b)-(c).

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B. Excuse of Performance

§8.62 1. Excuse by Failure of Presupposed Conditions; Commercial Impracticability (Com C §§2615, 10404)

Commercial Code §2615 codifies the doctrine of excuse of performance on grounds of total or partial impracticality for contracts for the sale of goods. There are two general types of impracticability: one arising when a condition or occurrence that was a basic underlying assumption of the parties does not occur, and the second arising when a law, regulation, or governmental order prevents performance. Com C §2615(a); Official Comment 10 to UCC §2-615. If either of these events causes a delay in delivery or nondelivery of the goods, and the seller complies with the terms of Com C §2615(b)-(c), there is no breach of the contract and the seller's duty to perform is otherwise excused. If the impracticability affects only a portion of the seller's duty to perform, then the seller must allocate production and delivery among customers—both customers under contract and regular customers not under a formal contract—and may reserve some goods for use in further production if needed. Com C §2615(b). The allocation need not be pro rata but may be done by any method that is fair and reasonable under the circumstances. The seller is also obligated to give seasonable notice to buyers that will be affected by the impracticability and, if allocation is required under the circumstances, of the estimated amount and timing of goods that will be delivered. Com C §2615(c).

Commercial impracticability is to be broadly and flexibly interpreted based on the facts of each case. Official Comment 2 to UCC §2-615. As Official Comment 4 to UCC §2-615 states:

> Increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance. Neither is a rise or a collapse in the market in itself a justification, for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover. But a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section.

In keeping with the general approach of the Commercial Code, the parties are free to contract around impracticability and provide for assumption of greater or more inescapable liability by agreement, and such an agreement may be found either expressly in the contract, in the circumstances surrounding the contract, or in trade usage, course of dealing, or course of performance. Official Comment 8 to UCC §2-615.

With regard to leases of goods under Division 10, the standard regarding commercial impracticability is substantially identical. See Com C §10404.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.63 2. Buyer's Rights on Seller's Notice of Inability or Delay in Performance (Com C §§2616, 10405)

§8.63 2. Buyer's Rights on Seller's Notice of Inability or Delay in Performance (Com C §§2616, 10405)

Commercial Code §2616 establishes the means for providing certainty regarding when a supervening and excusing contingency either excuses the delay, discharges the contract, or results in a waiver of the delay by the buyer. Official Comment 1 to UCC §2-616. When a seller notifies the buyer of an impending inability or delay in performance or allocation of goods under Com C §2615, the buyer has three options. First, the buyer may terminate the contract. Com C §2616(1)(a). Second, the buyer may modify the contract by agreeing to accept the available allocation of goods in substitution for the original amount contracted for. Com C §2616(1)(b). Third, the buyer may simply do nothing, in which case the contract will terminate by operation of law with regard to any affected deliveries within a reasonable time not exceeding 30 days. Com C §2616(2). The parties may not contract around §2616 except by increasing the seller's obligations under Com C §2615.

A substantially similar statute applies to leases of goods under Division 10. See Com C §10405.

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§8.64 3. Casualty to Identified Goods (Com C §§2613, 10221)

If a contract requires goods that are identified to the contract when the contract is made, and the goods are subject to a casualty loss without fault of either party before the risk of loss (see Com C §§2509-2510) passes to the buyer, then (Com C §2613):

- If the loss is total, the contract is avoided;
- If the loss is partial or the goods have so deteriorated that they no longer to conform to the contract, the buyer may nevertheless demand inspection and at the buyer's option either treat the contract as avoided or else accept the goods with due allowance from the contract price for the deterioration or any deficiency in quantity, but without further remedy against the seller.

The same rule applies if the goods suffer casualty loss under a "no arrival, no sale" term. Com C §2613. See Com C §2324.

A substantially identical provision applies to a casualty to leased goods without the fault of the lessee. See Com C §10221.

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§8.65 C. Installment Contracts (Com C §2612)

An installment contract is one that either requires or authorizes the delivery of goods in separate lots to be separately accepted, even if the contract includes a clause stating that "each delivery is a separate contract" or its equivalent. Com C §2612(1). A buyer may reject a nonconforming installment received from the seller if the nonconformity substantially impairs the value of that installment and the seller cannot cure the nonconformity or if the nonconformity is a defect in required documents. If, however, the nonconformity or default in one or more installments does not substantially impair the value of the whole contract and the seller gives adequate assurance of its cure, the buyer must accept that installment. Com C §2612(2).

If the nonconformity of one or more installments substantially impairs the value of the whole contract, the buyer may treat the whole contract as having been breached. Com C §2612(3); Official Comment 6 to UCC §2-612. The contract may be reinstated by the buyer, however, if the buyer (1) accepts a nonconforming installment without seasonable notice having been given regarding cancellation of the contract, (2) brings an action only with respect to past installments, or (3) demands performance as to future installments. Com C §2612(3).

If one installment is rejected and the seller has reasonable doubts about the buyer's intentions regarding the balance of the installments, the seller may, in writing, demand adequate assurances of performance under Com C §2609. The buyer's failure to deliver these assurances may permit the seller to repudiate the contract. Com C §2609(4).

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IV. BREACH OF CONTRACT

A. Contracts Not Subject to Commercial Code

§8.66 1. Generally

"Any nonperformance of a duty under a contract when performance is due is a breach. This includes defective performance as well as an absence of performance; defective performance can be inadvertent as well as intentional." *Linden Partners v Wilshire Linden Assocs.* (1998) 62 CA4th 508, 531, 73 CR2d 708. See also Restatement (Second) of Contracts §235(2) (1981). Breach of contract has been defined as the "failure, without legal excuse, to perform any promise which forms the whole or part of a contract." *Gherman v Colburn* (1977) 72 CA3d 544, 564, 140 CR 330. Any breach of contract, whether total or partial, that results in measurable injury gives the nondefaulting party the right to recover damages as compensation for the breach. *Borgonovo v Henderson* (1960) 182 CA2d 220, 231, 6 CR 236. A breach of contract is not actionable, however, unless there are damages. *Bramalea Cal., Inc. v Reliable Interiors, Inc.* (2004) 119 CA4th 468, 14 CR3d 302. See also *Emerald Bay Community Ass'n v Golden Eagle Ins. Corp.* (2005) 130 CA4th 1078, 31 CR3d 43; *Patent Scaffolding Co. v William Simpson Constr. Co.* (1967) 256 CA2d 506, 511, 64 CR 187.

There can be no actual breach of contract until the time specified for performance has arrived. *Romano v Rockwell Int'l, Inc.* (1996) 14 C4th 479, 488, 59 CR2d 20. Threats of nonperformance before the time when performance is due are addressed under the doctrine of anticipatory repudiation. See §8.71.

A breach of contract may be a strategic course of action for a promisor to take, depending on the circumstances. If the value to the promisor of not performing the contract is greater than the amount of damages that the promisor will owe to the promisee on breach, at least in theory it would be more efficient for the promisor to breach the contract and pay the damages. See *Huynh v Vu* (2003) 111 CA4th 1183, 1200, 4 CR3d 595 (discussing concept of efficient breach in context of tort of intentional interference with contract); McChesney, *Tortious Interference with Contract versus "Efficient" Breach: Theory and Empirical Evidence*, 28 Univ of Chicago J Legal Studies 131 (Jan. 1999). The promisee does not have a right to specific performance unless damages would fail to compensate the promisee adequately for the harm actually resulting from the breach. See §11.8. Moreover, as stated by the California Supreme Court in *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 516, 28 CR2d 475, "the law generally does not distinguish between good and bad motives for breaching a contract." Even for breach of the implied covenant of good faith and fair dealing (see §§6.33-6.36), the nonbreaching party's remedies are limited to contract damages; the breaching party's motive is not relevant to the scope of the damages that the nonbreaching party may recover. 7 C4th at 516.

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§8.67 2. Elements of Cause of Action for Breach

The elements of a cause of action for breach of contract are (*CDF Firefighters v Maldonado* (2008) 158 CA4th 1226, 1239, 70 CR3d 667):

- Existence of a contract;
- The plaintiff's performance of its duties under the contract or excuse for nonperformance;
- The defendant's breach; and
- Resulting damages to the plaintiff.

See also *Reichert v General Ins. Co.* (1968) 68 C2d 822, 830, 69 CR 321; *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1332, 96 CR3d 813; *Wall Street Network, Ltd. v New York Times Co.* (2008) 164 CA4th 1171, 1178, 80 CR3d 6.

In addition, when liability under the contract depends on the satisfaction or performance of one or more conditions precedent, an allegation that such conditions have been satisfied or performed is an essential part of the cause of action. If the condition is an event, as distinguished from an act to be performed by the plaintiff, the plaintiff must allege specifically that the event has occurred. Further, a general allegation that all conditions have been duly performed or satisfied will not be sufficient if specific facts alleged by the plaintiff are inconsistent with this general allegation. *Careau & Co.,* 222 CA3d at 1390.

The plaintiff may plead the legal effect of a contract rather than its precise language. It then becomes a matter of proof whether such allegations are true, *i.e.,* whether the plaintiff's interpretation of the applicable contractual language is correct. *Construction Protective Servs. v TIG* (2002) 29 C4th 189, 199, 126 CR2d 908 (allegations that insurance policy obligated defendant to defend and indemnify plaintiff against suits seeking damages and that setoff claim against plaintiff was within scope of that obligation under policy were sufficient). See also *Ochs v PacifiCare of Cal.* (2004) 115 CA4th 782, 9 CR3d 734 (third party beneficiary status is matter of contract interpretation, so it may be pleaded based on legal effect rather than precise language).

Case law is in conflict over whether a breach of the covenant of good faith and fair dealing (see §§6.33-6.36) can be pleaded and adjudicated as a separate cause of action. Compare *State Farm Mut. Auto. Ins. Co. v Superior Court* (2003) 114 CA4th 434, 453, 8 CR3d 56 (distinct cause of action), with *Smith v International Bhd. of Elec. Workers* (2003) 109 CA4th 1637, 1 CR3d 374 (no separate cause of action).

If the plaintiff's claim is based on promissory estoppel (see §3.50) instead of a formal contract, a plaintiff still has the burden of proving that the defendant's breach caused the plaintiff's damages. This is especially true when a third party, rather than the defendant, is alleged to have caused the plaintiff's damages and it would be inequitable to require a defendant to bear responsibility for damages that it did not cause. *US Ecology, Inc. v State* (2005) 129 CA4th 887, 908, 28 CR3d 894.

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§8.68 3. Need for Demand for Performance

Unless a contract includes an unconditional promise to perform at a specific time, a demand for performance is normally required to give the promisor an opportunity to perform and may be a condition precedent to the promisor's obligation to perform. *Drake v Martin* (1994) 30 CA4th 984, 998, 36 CR2d 704 (demand for performance was implied condition precedent to defendants' obligation to release parcel; parcel therefore remained subject to lien). See also *Johnson v Alexander* (1976) 63 CA3d 806, 134 CR 101; *World Sav. & Loan Ass'n v Kurtz Co.* (1960) 183 CA2d 319, 6 CR 665. If there is no time stated for performance, a promisor with the ability to perform the obligation in question does not breach the contract unless and until a demand for performance has been made and performance has been refused, except in cases when the delay has operated to the detriment of the promisee to such an extent that the delayed performance is valueless and the promisor is chargeable with knowledge of the special circumstances. *Leonard v Rose* (1967) 65 C2d 589, 592, 55 CR 916. See also CC §1491, which provides that "[w]here an obligation does not fix the time for its performance, an offer of performance may be made at any time before the debtor, upon a reasonable demand, has refused to perform." If the contract is divisible or severable (see §§5.70, 9.3), a demand regarding one performance and breach will not necessarily constitute a demand for another divisible performance. *Armstrong Petroleum Corp. v Tri-Valley Oil & Gas Co.* (2004) 116 CA4th 1375, 11 CR3d 412.

NOTE: If a demand for performance would be futile or is impossible, no demand is necessary. *Porter v Arthur Murray, Inc.* (1967) 249 CA2d 410, 57 CR 554 (defendant dance studio with which plaintiff had contract for dancing lessons was closed down; demand therefore unnecessary).

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§8.69 4. Total or Partial Breach

A breach of contract may be total or partial, and each is actionable if there are measurable damages resulting from the breach. *Borgonovo v Henderson* (1960) 182 CA2d 220, 231, 6 CR 236. The concepts of total or partial breach and material or immaterial breach (see §8.70), and their legal effect, tend to be conflated. In general, a total breach results from a complete failure to perform all of a party's obligations under a contract; a partial breach results from a failure to perform something less than all of a party's duties. See, *e.g., Linden Partners v Wilshire Linden Assocs.* (1998) 62 CA4th 508, 531, 73 CR2d 708 (incorrect estoppel certificate deposited in commercial real estate escrow). See also Restatement (Second) of Contracts §236 (1981). Cases may refer to a partial but material breach as a "total" breach, however, because a material breach by one party will excuse or discharge the other party from its own obligations to complete performance under the contract. See Restatement (Second) of Contracts §237 (1981). For example, in *Sackett v Spindler* (1967) 248 CA2d 220, 229, 56 CR 435, the court found that a purchaser of stock had committed a total breach of contract when he failed to make the final installment payment due to the seller. The seller's attorney had written the purchaser's attorney a letter cancelling the sale after the purchaser's failure to make the payment, but the court found that the letter did not constitute a repudiation because the purchaser's breach was "material" and "total." The court allowed the seller to keep the stock and recover damages from the purchaser equal to the difference between the contract price and the market price. The court stated that whether a breach of contract is total or partial depends on its materiality, and recited the factors to be considered in determining materiality. 248 CA2d at 229. See §8.70.

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§8.70 5. Material and Immaterial Breach

If a breach by a promisor is found to be "material," it excuses the return performance otherwise due from the other party to a bilateral executory contract and constitutes grounds for rescission. See *Ninety Nine Invs., Ltd. v Overseas Courier Serv. (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 6 CR3d 891 (seller's failure to timely comply with escrow obligations excused buyer's obligation to perform by closing date); *Wyler v Feuer* (1978) 85 CA3d 392, 403, 149 CR 626 (insufficient evidence of material breach to justify rescission); CC §1689(b)(4) (grounds for rescission, discussed in §§11.49-11.52); Restatement (Second) of Contracts §237 (1981). An immaterial breach does not excuse the other party's performance under an executory bilateral contract, but merely gives rise to a claim for damages.

A total breach—a complete failure to perform the contract—is per se a material breach that will justify rescission. See *Integrated, Inc. v Alec Fergusson Elec. Contractors* (1967) 250 CA2d 287, 295, 58 CR 503. Not all partial breaches are material, however. "If the covenant be of minor importance, not going to the root of the matter, and one that can be readily compensated in damages, the party injured cannot rescind, but must perform his part of the contract and seek compensation in damages." 250 CA2d at 296 (citations omitted). In *Sackett v Spindler* (1967) 248 CA2d 220, 229, 56 CR 435, the court stated that the following factors should be considered in determining the materiality of a party's partial failure to perform a contractual promise:

- The extent to which the injured party will obtain the substantial benefit that he or she could have reasonably anticipated;
- The extent to which the injured party may be adequately compensated in damages for lack of complete performance;
- The extent to which the party failing to perform has already partly performed or made preparations for performance;
- The greater or lesser hardship on the party failing to perform in terminating the contract;
- The willful, negligent, or innocent behavior of the party failing to perform; and
- The greater or lesser uncertainty that the party failing to perform will perform the remainder of the contract.

See also Restatement (Second) of Contracts §241 (1981). The basic question is the extent of the breaching party's nonperformance. As stated in *Crofoot Lumber, Inc. v Thompson* (1958) 163 CA2d 324, 332, 329 P2d 302 (citations omitted):

> The defendant's breach may be nothing but a failure to perform some minor part of his contractual duty. Such a minor non-performance is a breach of contract and an action for damages can be maintained. The injured party, however, cannot maintain an action for restitution of what he has given the defendant unless the defendant's non-performance is so material that it is held to go to the "essence"; it must be such a breach as would discharge the injured party from any further contractual duty on his own part.

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Source: Business Law/California Law of Contracts/8 Performance or Breach of Contract/§8.71 6. Anticipatory Repudiation (CC §1440)

§8.71 6. Anticipatory Repudiation (CC §1440)

Definition, effect. As noted in §8.66, an actual breach of contract cannot occur until the time specified for performance has arrived. If, however, a party repudiates the contract, either expressly or by implication, before the time when its performance is due, that party's conduct is said to constitute an anticipatory breach or anticipatory repudiation. *Romano v Rockwell Int'l, Inc.* (1996) 14 C4th 479, 488, 59 CR2d 20. An anticipatory repudiation by one party allows the other party to bring an action for damages immediately for a total breach of contract, without first performing or offering to perform its own obligations under the contract. *County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 90 CR2d 41. The doctrine of anticipatory repudiation is codified in CC §1440 as follows:

> If a party to an obligation gives notice to another, before the latter is in default, that he will not perform the same upon his part, and does not retract such notice before the time at which performance upon his part is due, such other party is entitled to enforce the obligation without previously performing or offering to perform any conditions upon his part in favor of the former party.

The rationale for the doctrine is that the promisor has agreed not only to perform its obligations under the contract, but also not to repudiate that promise. 14 C4th at 488.

Express or implied repudiation. A repudiation may be express or implied. An express repudiation is "a clear, positive, unequivocal refusal to perform." *Taylor v Johnston* (1975) 15 C3d 130, 137, 123 CR 641; *Martinez v Scott Specialty Gases, Inc.* (2000) 83 CA4th 1236, 100 CR2d 403. It means a "rejection, disclaimer, or renunciation" of the contractual duty to be performed. *Gherman v Colburn* (1977) 72 CA3d 544, 140 CR 330. The party alleged to have repudiated the contract must have done so in clear terms, by a positive act or statement that he or she cannot or will not substantially perform the essential terms of the contract. *Machado v Machado* (1961) 188 CA2d 141, 10 CR 347; *Hertz Driv-Ur-Self Stations, Inc. v Schenley Distilleries Corp.* (1953) 119 CA2d 754, 260 P2d 93. A mere threat or declaration of intent not to perform does not constitute a repudiation. *Thornton v Victor Meat Co.* (1968) 260 CA2d 452, 67 CR 887; *Salot v Wershow* (1958) 157 CA2d 352, 320 P2d 926.

An implied repudiation "results from conduct where the promisor puts it out of his power to perform so as to make substantial performance of his promise impossible." *Taylor,* 15 C3d at 137; *Martinez v Scott Specialty Gases, Inc.*, *supra*. See, *e.g., County of Solano v Vallejo Redev. Agency, supra* (redevelopment agency breached contract with county when it paid off school district bonds and exhausted its funding limit, rendering performance under its contract with county impossible).

Injured party's options. The injured party has several options in the event of an anticipatory repudiation. It may treat the repudiation as an anticipatory breach of contract and immediately seek damages for breach, thereby terminating the contractual relationship between the parties. Alternatively, the injured party may treat the repudiation as an empty threat, wait until the time when performance is due, and exercise his or her remedies for an actual breach of contract if a breach in fact occurs at that time. *Romano v Rockwell Int'l, Inc.* (1996) 14 C4th 479, 488, 59 CR2d 20; *Taylor v Johnston* (1975) 15 C3d 130, 137, 123 CR 641. If the injured party elects the second alternative, the statute of limitations does not begin to run until the time set by the contract for performance. *Romano,* 14 C4th at 488. See also §9.3. Another option is for the injured party to attempt to resolve the issues surrounding the repudiation. If those efforts do not result in the nullification of the repudiation or a modification of the contract, the injured party may pursue a claim for anticipatory breach. In other words, the injured party may, but is not required to, bring suit for damages immediately upon becoming aware of the alleged repudiation, or the injured party may treat the repudiation as an anticipatory breach until it is nullified or until performance is due. *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 506, 75 CR3d 771. A repudiation is nullified when (1) the injured party disregards the repudiation, (2) the injured party treats the contract as if it is still in force, and (3) the repudiation is retracted prior to performance. 162 CA4th at 517.

Retraction. An anticipatory repudiation may be retracted and the parties' agreement restored by a clear and unequivocal retraction made before the other party has changed its position in reliance. *Pichignau v City of Paris* (1968) 264 CA2d 138, 70 CR 147. If a plaintiff elects to disregard the repudiation and waits to bring an action until the time when performance is due under the contract, the repudiating party has a chance to retract its repudiation. Hence, the

possibility of a retraction should be considered by the plaintiff in making the election discussed above.

Proof of ability to perform required. A plaintiff seeking damages for anticipatory repudiation of the contract by the other party must be able to prove that, but for the defendant's repudiation, the plaintiff would have been able to perform its own obligations. *County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 90 CR2d 41; *Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 2 CR2d 288. See also Restatement (Second) of Contracts §254(1).

Inapplicable to unilateral contracts. The doctrine of anticipatory repudiation does not apply to contracts that are unilateral from their inception or have become unilateral by complete performance by one party. The theory underlying this rule is that because the nonrepudiating party has no further obligations to perform, he or she is not prejudiced by having to wait for the time when the defendant's performance would otherwise be due in order to sue for breach. *Diamond v University of S. Cal.* (1970) 11 CA3d 49, 53, 89 CR 302. See also *Cobb v Pacific Mut. Life Ins. Co.* (1935) 4 C2d 565, 573, 51 P2d 84. In *Diamond,* the defendant USC had offered to give all season ticket purchasers an option to purchase Rose Bowl tickets if its team was selected to play. About a month before the game, USC notified first-time season ticket holders that it would be unable to furnish Rose Bowl tickets to them. According to the university's representative, when it received the game tickets, there was an insufficient number of tickets to be offered to all of the season ticket holders, so that, initially, the first-time season ticket holders were excluded from the offering. Later, however, it became possible to offer the tickets to the first-time season ticket holders, and this was done in a timely manner before the game. The court held that USC's contracts with season ticket purchasers became unilateral when the purchasers paid the price of the season tickets; thus, their lawsuit was premature.

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§8.72 7. Waiver of Breach

Performance or breach of a contract term may be waived by the party for whose benefit the provision is made. *Galdjie v Darwish* (2003) 113 CA4th 1331, 1339, 7 CR3d 178 (noting that waiver of timeliness provisions is often found when a buyer is late making one or more payments); *Spellman v Dixon* (1967) 256 CA2d 1, 63 CR 668. A waiver by one party of the other party's performance of one or more contract terms or conditions may be made verbally or by conduct. Further, a party may be estopped by words or conduct to deny that he or she has waived the other party's performance. *Bettelheim v Hagstrom Food Stores, Inc.* (1952) 113 CA2d 873, 249 P2d 301. See also *Waller v Truck Ins. Exch., Inc.* (1995) 11 C4th 1, 44 CR2d 370; *Whitney Inv. Co. v Westview Dev. Co.* (1969) 273 CA2d 594, 78 CR 302. "To be valid a waiver must be a clear expression made with full knowledge of the facts and an intent to waive the right.… Doubtful cases will be decided against the one who claims a waiver." *Spellman,* 256 CA2d at 5.

If the performance required by the contract is continuous, a waiver of one breach will not prevent the nonbreaching party from invoking his or her full contract rights on a subsequent breach. For example, if time is of the essence under the contract, the promisee may waive strict compliance but then reinstate the requirement later by a definite notice or equivalent conduct. *Call v Alcan Pac. Co.* (1967) 251 CA2d 442, 447, 59 CR 763. See also *Morton Thiokol, Inc. v Metal Bldg. Alteration Co.* (1987) 193 CA3d 1025, 1030 n1, 238 CR 722.

The concept of waiver is discussed further in §5.83.

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§8.73 8. Abandonment of Construction Contracts

Abandonment is a doctrine applied in the context of construction contracts, in most cases when the parties make numerous changes over a period of time without following the specified change order procedures in the contract, with the result that the final project is changed in such a major way that the parties are considered to have abandoned all of the provisions of the original contract. *Amelco Elec. v City of Thousand Oaks* (2002) 27 C4th 228, 239, 115 CR2d 900. In *Sehulster Tunnels/Pre-Con v Traylor Bros., Inc./Obayashi Corp.* (2003) 111 CA4th 1328, 4 CR3d 655, the court held that a construction contract is deemed abandoned if (1) both parties intended to disregard the contract, (2) the parties did not follow the change order process, and (3) the final project became materially different from the project contracted for. In such cases, the contractor is entitled to recover the reasonable value of all work performed in a quantum meruit action, unlimited by the contract price. The abandonment doctrine does not apply to prime contractors in public works contracts. For further discussion of the abandonment doctrine, see California Construction Contracts, Defects, and Litigation §§1.46, 6.71, 9.85-9.87 (Cal CEB 2008).

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B. Breach of Contracts for Sale of Goods

§8.74 1. Generally (Com C §§2601-2603, 2605, 2607)

Contracts for the sale of goods under the Commercial Code are subject to the "perfect tender" rule. Unless the parties agree otherwise (and subject to the special rule on installment sales in Com C §2512), if the goods or the tender of delivery are nonconforming in any respect, the goods may be accepted or rejected, or one or more commercial units of the goods may be accepted and the remainder rejected. Com C §2601. See §8.52. The potential harshness of the perfect tender rule is mitigated by several provisions that generally require the buyer to act reasonably in rejecting goods. Commercial Code §2602 governs the manner of a rightful rejection, and Com C §2603 sets forth the duties of a merchant buyer with regard to rejected goods. Commercial Code §2605(1) requires the buyer to particularize the defect on which the buyer's rejection is based or else waive it:

> (1) The buyer's failure to state in connection with rejection a particular defect which is ascertainable by reasonable inspection precludes him from relying on the unstated defect to justify rejection or to establish breach
>
> (a) Where the seller could have cured it if stated seasonably; or
>
> (b) Between merchants when the seller has after rejection made a request in writing for a full and final written statement of all defects on which the buyer proposes to rely.

Further, Com C §2508 gives the seller a right to cure a nonconforming tender provided that the seller's time for performance has not yet expired, and Com C §2614(1) allows the seller to substitute a commercially reasonable delivery method if the agreed manner of delivery becomes commercially impracticable. See §8.53.

A buyer is also required to act reasonably if the buyer wishes to assert a breach after the goods have been accepted. Commercial Code §2607(3)-(4) provides:

> (3) Where a tender has been accepted:
>
> (A) The buyer must, within a reasonable time after he or she discovers or should have discovered any breach, notify the seller of breach or be barred from any remedy; and
>
> (B) If the claim is one for infringement or the like… and the buyer is sued as a result of such a breach, the buyer must so notify the seller within a reasonable time after he or she receives notice of the litigation or be barred from any remedy over for liability established by the litigation.
>
> (4) The burden is on the buyer to establish any breach with respect to the goods accepted.

The buyer may also revoke acceptance of the goods in accordance with Com C §2608. See §8.60. Breach of installment contracts is addressed in Com C §2612. See §8.65.

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§8.75 2. Anticipatory Repudiation (Com C §2610)

Commercial Code §2610 sets forth the remedies of a party in the event of an anticipatory repudiation by the other party of performance not yet due. The remedies accrue only if the loss of the performance repudiated will substantially impair the value of the contract to the first party. In such a case, the aggrieved party may (Com C §2610(a)-(c)):

- Await performance by the repudiating party for a commercially reasonable time;
- Resort to any remedy for breach (see Com C §§2703, 2711, discussed in chap 12), even if the first party has notified the repudiating party that the first party will await the latter's performance and has urged the repudiating party to retract its repudiation; and
- In either event, suspend the first party's own performance or proceed in accordance with the provisions concerning the seller's right to identify goods to the contract notwithstanding breach or to salvage unfinished goods (see Com C §2704, discussed in §12.19).

Anticipatory repudiation under Com C §2610 means "an overt communication of intention or an action which renders performance impossible or demonstrates a clear determination not to continue with performance." Official Comment 1 to UCC §2-610. It is not necessary that performance be made literally and utterly impossible. A repudiation may consist of an action that reasonably indicates that the repudiating party is rejecting a continuing obligation. Further, a repudiation occurs automatically under Com C §2609(4) if a party fails to provide adequate assurance of performance within 30 days after a justifiable demand has been made. Official Comment 2 to UCC §2-610.

> The test chosen to justify an aggrieved party's action under [Com C §2610] is the same as that in the section on breach in installment contracts [Com C §2612]—namely the substantial value of the contract. The most useful test of substantial value is to determine whether material inconvenience or injustice will result if the aggrieved party is forced to wait and receive an ultimate tender minus the part or aspect repudiated.

Official Comment 3 to UCC §2-610. After repudiation, the aggrieved party may immediately resort to any remedy desired provided the aggrieved party proceeds in good faith. Official Comment 4 to UCC §2-610. For examples of anticipatory repudiation under the Uniform Commercial Code, see Anno, *What Constitutes Anticipatory Repudiation of Sales Contract Under UCC §2-610*, 1 ALR4th 527 (2005).

If a party believes that the other party is about to repudiate the contract, it is prudent for the first party to demand adequate written assurances of future performance in accordance with Com C §2609. If the first party's demand is justified, a failure by the repudiating party to respond with reasonable assurances of performance within 30 days constitutes a repudiation of the contract. Com C §2609(4).

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§8.76 3. Retraction of Anticipatory Repudiation (Com C §2611)

A party who has repudiated the contract may retract its repudiation in accordance with Com C §2611. Commercial Code §2611(1) provides that the repudiating party can retract its repudiation up until the time when its next performance is due under the contract, unless the aggrieved party has canceled or materially changed position based on the repudiation or otherwise indicated that the aggrieved party considers the repudiation final. The retraction can be made in any way that clearly indicates to the aggrieved party that the repudiating party intends to perform, but must include any assurances of future performance justifiably demanded by the aggrieved party under Com C §2609. Com C §2611(2). Retraction will reinstate the repudiating party's rights under the contract, but with due excuse and allowance to the aggrieved party for any delay caused by the repudiation. Com C §2611(3).

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§8.77 C. Breach of Personal Property Leases (Com C §10501)

In cases involving a lease of goods governed by Division 10 of the Commercial Code, a determination of whether the lessor or lessee is in default under a lease contract is made by reference to the lease and to Division 10. Com C §10501(a). The nondefaulting party has the remedies provided by Division 10 and by the lease, except to the extent limited by Division 10. Com C §10501(b).

The lessor is in default under the lease if it fails to deliver the goods in conformity to the lease contract (Com C §10509) or repudiates the lease contract (Com C §10402), or the lessee rightfully rejects the goods (Com C §10509) or justifiably revokes acceptance of the goods (Com C §10517). Com C §10508(a). The default operates with respect to any goods involved and, in the case of an installment lease, with respect to all of the goods if the value of the whole lease contract is substantially impaired. Com C §10510.

Division 10 includes substantially similar provisions concerning anticipatory repudiation and retraction of anticipatory repudiation as Division 2. See Com C §§10402 (see §8.75), 10403 (see §8.76).

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9

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§9.1 I. INTRODUCTION

This chapter addresses a number of issues relating to enforcement of the contract, which typically arise when litigation is contemplated. These issues may or may not be addressed in the contract itself. The issues include the applicable statutes of limitations for contract actions (§§9.2-9.6), jurisdiction, venue, and forum selection clauses (§§9.7-9.11), recovery of attorney fees and attorney fee clauses (§§9.12-9.28), the enforceability of contractual jury trial waivers (§9.29); arbitration and mediation of contract disputes and related contract clauses (§§9.30-9.55), and the doctrine of election of remedies (§§9.56-9.57). For more general information and guidance regarding civil litigation in California, see California Civil Procedure Before Trial (4th ed Cal CEB 2004); California Trial Practice: Civil Procedure During Trial (3d ed Cal CEB 1995); A Litigator's Guide to Effective Use of ADR in California (Cal CEB 2005); and other CEB civil litigation titles.

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II. CONTRACT STATUTES OF LIMITATION

§9.2 A. Written Contracts and Leases: Four Years (CCP §§337, 337.2)

The basic statute of limitations for actions on "any contract, obligation or liability founded upon an instrument in writing" is 4 years. CCP §337(1); *Tin Tin Corp. v Pacific Rim Park, LLC* (2009) 170 CA4th 1220, 1233, 88 CR3d 816. The same 4-year limitation period applies to actions on a book account, an account stated in writing, and a mutual, open, current account in writing. If the account is based on only one item, the time begins to run from the date of that item; if the account includes more than one item, the time runs from the date of the last item. CCP §337(2). The term "book account" is defined in CCP §337a. The 4-year period is also applicable to actions for rescission of a written contract. In general, the period runs from the date of the occurrence of the event that entitles the aggrieved party to rescind, but if fraud or mistake constitute the grounds for rescission, the period runs from the date of discovery of the fraud or mistake by the aggrieved party. For rescission of insurance contracts based on misrepresentation, the period runs from the time when the representation become false. CCP §337(3).

NOTE: To the extent CCP §337(1) can be read to cover promissory notes, it conflicts with Com C §3118, which provides a 6-year limitation period for any action on a note payable at a definite time. See §9.5. This issue was raised, but not resolved, in *LPP Mortgage, Ltd. v Bizar* (2005) 126 CA4th 773, 24 CR3d 598. Commercial Code §3118 is the more specific statute and should control, although no reported case has yet held so. See *Mills v Forestex Co.* (2003) 108 CA4th 625, 642, 134 CR2d 273; *Creditors Collection Serv. v Castaldi* (1995) 38 CA4th 1039, 1043, 45 CR2d 511.

The statute of limitations for actions on leases of real property in writing is 4 years, running from the earlier of (1) breach of the lease and abandonment of the property, or (2) termination of the right of the lessee to possession of the property. CCP §337.2. Four years is also the limitation period for actions to recover damages for patent deficiencies in design, surveys, plans, specifications, supervision or observation of construction, or construction of real property improvements, running from the time of substantial completion of the improvement. CCP §337.1(a)(1).

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§9.3 B. Accrual of Cause of Action for Breach

"As a general rule, a cause of action accrues and a statute of limitations begins to run when a controversy is ripe—that is, when all of the elements of a cause of action have occurred and a suit may be maintained." *Armstrong Petroleum Corp. v Tri-Valley Oil & Gas Co.* (2004) 116 CA4th 1375, 1388, 11 CR3d 412. See also *Howard Jarvis Taxpayers Ass'n v City of La Habra* (2001) 25 C4th 809, 815, 107 CR2d 369. See §8.65 for the elements of a cause of action for breach of contract.

For contract actions generally, a cause of action for breach does not accrue before the time of a breach. *Romano v Rockwell Int'l, Inc.* (1996) 14 C4th 479, 488, 59 CR2d 20; *Spear v California State Auto. Ass'n* (1992) 2 C4th 1035, 1040, 9 CR2d 381. And technically there can be no actual breach of a contract until the time specified for performance has arrived. *Romano v Rockwell Int'l, Inc., supra*; *Taylor v Johnston* (1975) 15 C3d 130, 137, 123 CR 641. But see *Tin Tin Corp. v Pacific Rim Park, LLC* (2009) 170 CA4th 1220, 1234, 88 CR3d 816 (unreasonable for party to assume it could delay onset of statute of limitations indefinitely by agreeing to wait for other party to perform). Nevertheless, if a party repudiates the contract, either expressly or impliedly, before the time for performance, an anticipatory breach occurs and the other party may seek enforcement of the contract immediately, without previously performing. *Romano v Rockwell Int'l, Inc.*, *supra*. See also CC §1440, discussed in §8.69.

In cases of anticipatory repudiation, the promisee has an election of remedies. The promisee may "treat the repudiation as an anticipatory breach and immediately seek damages for breach of contract, thereby terminating the contractual relation between the parties, or… treat the repudiation as an empty threat, wait until the time for performance arrives and exercise… remedies for actual breach if a breach does in fact occur at such time." *Romano v Rockwell Int'l, Inc.*, *supra*; *Taylor,* 15 C3d at 137. If the promisee disregards the anticipatory repudiation, the statute of limitations does not begin to run until the time when performance under the contract is otherwise due. *Brewer v Simpson* (1960) 53 C2d 567, 593, 2 CR 609; *Trypucko v Clark* (1983) 142 CA3d Supp 1, 7, 191 CR 165; *Napa Ass'n of Public Employees v County of Napa* (1979) 98 CA3d 263, 159 CR 522. Even if there is no anticipatory breach, but there are ongoing contractual obligations between the parties, the promisee may elect to rely on the contract despite a breach by the promisor, and the statute of limitations does not begin to run until the promisee elects to treat the breach as having terminated the contract. *Romano v Rockwell Int'l, Inc.*, *supra*.

If the breach of contract involves a continuing wrong, with periodic new injury to the plaintiff, courts have applied a "theory of continuous accrual." See *Howard Jarvis Taxpayers Ass'n,* 25 C4th at 822. If performance of the contract obligations is divided into intervals (*e.g.*, as in installment contracts, leases with periodic rental payments, or periodic profit-sharing arrangements), an action to enforce performance of any specific interval must be brought within the applicable limitations period after performance of that interval was due. *Armstrong Petroleum Corp. v Tri-Valley Oil & Gas Co.* (2004) 116 CA4th 1375, 1388, 11 CR3d 412. This rule represents an application of the doctrine of severability. See §5.70. If a contract is divisible so that a breach of one of its severable parts will give rise to a separate cause of action, the statute of limitations begins to run at the time of each breach, with the result that each cause of action for breach will accrue at a different time. However, if the parties do not intend the contract to be severable, but rather an entire whole, then the courts will not find it divisible even if performance under the contract is periodic. *Armstrong Petroleum Corp. v Tri-Valley Oil & Gas Co., supra*.

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§9.4 C. Special Rules (CCP §§336a, 337(1), 338, 339)

Actions on corporate bonds, notes, or debentures (or on any related coupons) issued to or held by the public are subject to a 6-year statute of limitations. CCP §336a(1). The 6-year period also applies to actions on mortgages, trust deeds, or other agreements under which the bonds, notes, or debentures were issued. CCP §336a(2).

A suit for a postforeclosure sale deficiency judgment must be brought within 3 months after the foreclosure sale. CCP §337(1). This 3-month limitation period applies only to real estate foreclosures; it does not apply to actions for a deficiency following resale of goods after breach of a contract for the sale of goods. See Com C §2725; *Massey-Furguson Credit Corp. v Casaulong* (1976) 62 CA3d 1024, 133 CR 497.

The statute of limitations for actions for breach or rescission of *oral* contracts is generally 2 years. CCP §339(1), (3). A 2-year statute of limitations also applies to actions on real estate title insurance policies or title guaranties. CCP §339(2). Actions on oral real property leases are subject to a 2-year statute, running from the earlier of (1) breach of the lease and abandonment of the property, or (2) termination of the lessee's right to possession of the property. CCP §339.5. The 2-year period, however, does not apply to actions on oral contracts for the sale of goods (see Com C §2725—the 4-year statute of limitations for actions on written or oral contracts for the sale of goods) or actions on book accounts, accounts stated in writing, or mutual, open, current accounts (see CCP §337(2); §9.5).

The statute of limitations for actions for relief (*e.g.,* rescission) based fraud or mistake is 3 years from discovery of the fraud or mistake. CCP §338. If the gravamen of the complaint is not fraud, however, but rather rests on a written contract, then the 4-year statute of CCP §337(1) applies. *San Filippo v Griffiths* (1975) 51 CA3d 640, 124 CR 399.

A 10-year statute of limitation applies to actions to recover damages for latent deficiencies in design, surveys, plans, specifications, supervision or observation of construction, or construction of real property improvements, running from the time of substantial completion of the improvement. CCP §337.15(a)(1). See, *e.g., Lantzy v Centex Homes* (2003) 31 C4th 363, 2 CR3d 655; *Gundogdu v King Mai, Inc.* (2009) 171 CA4th 310, 89 CR3d 489.

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§9.5 D. Agreements Regarding Statutes of Limitation (CCP §§360, 360.5)

Shorter statute of limitations. The parties to a contract may agree to a shorter "private statute of limitations" applicable to actions between them, provided that the period is not so short as to be unreasonable or to give the party seeking to enforce it an undue advantage. *Capehart v Heady* (1962) 206 CA2d 386, 23 CR 851 (3-month period in real estate lease not unreasonable). As stated by the court of appeal in *Moreno v Sanchez* (2003) 106 CA4th 1415, 1430, 131 CR2d 684 (citations omitted):

> California courts have afforded contracting parties considerable freedom to modify the length of a statute of limitations. Courts generally enforce parties' agreements for a shorter limitations period than otherwise provided by statute, provided it is reasonable. "Reasonable" in this context means the shortened period nevertheless provides sufficient time to effectively pursue a judicial remedy. "It is a well-settled proposition of law that the parties to a contract may stipulate therein for a period of limitation, shorter than that fixed by the statute of limitations, and that such stipulation violates no principle of public policy, provided the period fixed be not so unreasonable as to show imposition or undue advantage in some way."

See also *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 1549, 46 CR2d 33 (shorter limitations period enforced under valid Delaware choice of law clause); *West v Henderson* (1991) 227 CA3d 1578, 278 CR 570 (6-month limitation period in commercial lease not unconscionable); *C & H Foods Co. v Hartford Ins. Co.* (1984) 163 CA3d 1055, 1064, 211 CR 765 (1-year period in insurance contract valid). As noted by the court in *Moreno,* however, the cases enforcing shortened periods usually involve straightforward commercial contracts and unambiguous breaches of those contracts. An agreement to modify the statute of limitations for bringing an action must be clearly worded. *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947. Provisions shortening statutes of limitations are more likely to be questioned in employment cases or in cases such as *Moreno* that involve consumers. For example, in *Martinez v Master Protection Corp.* (2004) 118 CA4th 107, 12 CR3d 663, the court ruled that a 6-month limitation period in an employer's arbitration agreement was unenforceable because it was unconscionable and it restricted the employees' ability to vindicate their statutory rights.

Waiver of statute of limitations. Any waiver of a statute of limitations must be in writing and signed by the party to be bound. CCP §360.5; *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.*, 38 CA4th at 1547. See also CCP §360. No waiver executed either before or after expiration of the applicable limitation period will be effective for more than 4 years after the end of the period, but a waiver may be renewed for successive 4-year periods. See CCP §360.5. Any written acknowledgment or promise indicating a new or continuing contract, such as a contract modification or novation, or any payment on a secured promissory note indicating acknowledgment of a continuing contract, will be sufficient to start the running of a new limitations period. CCP §360; *Kaichen's Metal Mart, Inc. v Ferro Cast Co.* (1995) 33 CA4th 8, 39 CR2d 233. Any waiver of the statute of limitations by a debtor on a secured promissory note is also binding on junior lienholders if the waiver is given before the expiration of the original limitations period. *Kaichen's Metal Mart, Inc. v Ferro Cast Co., supra.*

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§9.6 E. UCC Statutes of Limitation (Com C §§2725, 3118, 5115, 10506)

Actions for breach of a contract for the sale of goods are subject to a 4-year statute of limitations. The parties may reduce the 4-year period in their original agreement to not less than 1 year, but may not extend it. Com C §2725(1). The action accrues when the breach occurs, even if the aggrieved party has no knowledge of the breach. Com C §2725(2). Actions for breach of warranty generally accrue on tender of the goods, but if the warranty explicitly covers future performance of the goods and the breach could not have been discovered beforehand, the action will accrue when the breach is or should have been discovered. Com C §2725(2). See *Mills v Forestex Co.* (2003) 108 CA4th 625, 642, 134 CR2d 273.

Division 3 of the California Uniform Commercial Code includes a 6-year statute of limitations for any action to enforce a debtor's payment obligation under a promissory note payable at a definite time. Com C §3118(a). The statute runs from the due date stated, or the accelerated due date (if the due date has been accelerated). For demand notes, the limitations period is 6 years after demand. Com C §3118(b). See Com C §3118(c)-(f) for applicable limitations periods for actions on other types of negotiable instruments; *e.g.,* for personal, uncertified checks, the period is 3 years after dishonor.

An action on a letter of credit must be commenced within 1 year after the later of (1) the expiration of the letter of credit, or (2) the accrual of the cause of action. The action accrues when the breach occurs, regardless of the aggrieved party's knowledge of it. Com C §5115.

An action for breach of a lease of goods is also subject to a 4-year limitation period. The parties' original lease contract may reduce the limitation period to not less than 1 year, provided that the lease is not a consumer lease. Com C §10506(a). The action accrues when the default is or should have been discovered by the aggrieved party, or when the default occurs, whichever is later. Com C §10506(b).

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III. JURISDICTION; VENUE

§9.7 A. Jurisdiction, Forum Selection Clauses

California state superior courts have original subject matter jurisdiction over breach of contract actions, conferred by the California Constitution and regulated by statute. Cal Const art VI, §10. See also CCP §410.50. Personal jurisdiction over the parties is subject to CCP §410.10 and constitutional due process requirements. For further discussion of California court jurisdiction, see California Civil Procedure Before Trial, chap 6 (4th ed Cal CEB 2004). Federal district courts also have subject matter jurisdiction based on diversity of citizenship if the amount in controversy exceeds $75,000 and the lawsuit is between citizens of different states of the U.S. or between a U.S. citizen and a citizen of another nation. See generally 28 USC §1332; Civ Proc Before Trial, chap 7.

Although contracting parties cannot confer subject matter jurisdiction on a court by contract, when two or more courts have subject matter jurisdiction, the general rule in California is that a forum selection clause limiting suits under the contract to one of them will be upheld if the contract was entered into freely and voluntarily by the parties after arm's-length negotiation and enforcement of the clause would not be unreasonable. *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 495, 131 CR 374. For further discussion of forum selection clauses, including public policy and statutory restrictions (among them, restrictions applicable to consumer contracts), see §§5.44-5.50.

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B. Venue Rules for Breach of Contract Actions (CCP §§395, 395.2, 395.5, 396a)

1. If Defendant Is an Individual Person

§9.8 a. Non-Consumer Contracts (CCP §395(a))

Code of Civil Procedure §395(a) sets forth the general venue rules for actions against individual defendants for breach of contracts other than consumer obligations subject to CCP §395(b) or §396a. (See §9.9). Subject to CCP §395(b), if an individual defendant has contracted to perform the obligation in a particular county, the action may be brought in the county (CCP §395(a)):

- Where the obligation is to be performed;
- Where the contract in fact was entered into; or
- Where the defendant (or any defendant) resides at the commencement of the action.

The county in which the obligation was incurred is deemed to be the county where it is to be performed, in the absence of a special written contract provision to the contrary. CC §395(a). The county where the last act necessary to make the contract binding occurred is deemed to be the county where the contract was in fact entered into. *Mitchell v Superior Court* (1986) 186 CA3d 1040, 231 CR 176.

NOTE: Code of Civil Procedure §395(a) authorizes a breach of contract action against an individual defendant to be brought in the county where the contract was to be performed only if the contract specifies the place of performance in writing. CCP §395(a); *Mitchell,* 186 CA3d at 1045. Otherwise the county where the obligation was incurred is deemed to be the place of performance under CCP §395(a).

For more comprehensive discussion of the venue rules applicable to breach of contract actions, see California Civil Procedure Before Trial, chap 8 (4th ed Cal CEB 2004).

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Source: Business Law/California Law of Contracts/9 Selected Enforcement Issues/§9.9 b. Consumer Obligations (CCP §§395(b)-(c), 396a)

§9.9 b. Consumer Obligations (CCP §§395(b)-(c), 396a)

Under CCP §395(b), except for actions on retail installment sales or automobile sales financing contracts, which are subject to special venue rules (see CCP §396a; CC §§1812.10, 2984.4), actions on consumer obligations may be brought only in (1) the county where the consumer in fact signed the contract, or (2) the county where the consumer resided either at the time the contract was entered into or at the time the lawsuit was commenced. Any provision of a consumer contract or obligation that purports to waive the requirements of CCP §395(b) is void and unenforceable. CCP §395(c). Code of Civil Procedure §396a sets forth venue requirements in actions involving installment or automotive sales.

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Source: Business Law/California Law of Contracts/9 Selected Enforcement Issues/§9.10 2. If Defendant Is a Corporation, an Unincorporated Association, or an Executor or Trustee (CCP §§395.1-395.2, 395.5)

§9.10 2. If Defendant Is a Corporation, an Unincorporated Association, or an Executor or Trustee (CCP §§395.1-395.2, 395.5)

Breach of contract actions against corporations must be brought in the county (1) where the contract is made or is to be performed, (2) where the obligation or liability arises, or the breach occurs, or (3) in the county where the principal place of business of the corporation is located. CCP §395.5. Note that in actions against corporations, venue is proper in the place of performance of the contract, even if the contract does not designate a place of performance.

If an unincorporated association has filed a statement with the Secretary of State designating its principal office in California, the venue rules are the same as for corporations. CCP §395.2. This statute covers actions against limited partnerships and limited liability companies formed under California law and against general partnerships that have filed a Statement of Partnership Authority (Form GP-1) with the Secretary of State under Corp C §16303. If an unincorporated association has not filed such a statement, its members would be subject to suit as individual defendants under CCP §395. Subject to Prob C §17005, an action on a claim for payment of money or recovery of personal property against an executor, administrator, guardian, conservator, or trustee must be brought in the county with jurisdiction over the estate at issue. CCP §395.1.

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§9.11 3. Venue Selection Clauses Void

Contract clauses that purport to designate the venue of any judicial proceedings to enforce the contract are void as against public policy. *Alexander v Superior Court* (2003) 114 CA4th 723, 730, 8 CR3d 111. See §5.47.

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IV. ATTORNEY FEES

§9.12 A. American Rule Prohibits Attorney Fee Award (CCP §1021)

In general, in the absence of a countervailing statute or contractual provision, each party in litigation in the United States must bear and pay his or her own attorney fees, regardless of which party prevails in the litigation. *Alyeska Pipeline Serv. Co. v Wilderness Soc'y* (1975) 421 US 240, 44 L Ed 2d 141, 95 S Ct 1612. This principle is known as the "American rule," in contrast to the "English rule" under which attorney fees are awarded to the prevailing party. See generally *Trope v Katz* (1995) 11 C4th 274, 278, 45 CR2d 241. The American rule is reflected in CCP §1021, which provides:

> Except as attorney's fees are specifically provided for by statute, the measure and mode of compensation of attorneys and counselors at law is left to the agreement, express or implied, of the parties; but parties to actions or proceedings are entitled to their costs, as hereinafter provided.

As discussed in §§9.13-9.27, if authorized by contract, reasonable attorney fees may be recovered by the prevailing party in California through the interaction of CCP §§1032 and 1033.5 and CC §1717. Certain consumer or public interest statutes also authorize the recovery of attorney fees. See §9.28. In the absence of such a statute or an express agreement, however, each party in litigation is responsible for its own attorney fees. Nonetheless, California courts will generally enforce a foreign judgment that includes attorney fees. *Java Oil, Ltd. v Sullivan* (2008) 168 CA4th 1178, 86 CR3d 177.

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B. Recovery of Attorney Fees by Contract

§9.13 1. General Rule (CCP §§1032, 1033.5; CC §1717(a))

If authorized by contract, reasonable attorney fees may be recovered by the prevailing party in litigation as part of an award of "costs" through the interaction of CCP §§1032(b) and 1033.5(a)(10) and CC §1717.

Code of Civil Procedure §1032(b) is the fundamental authority for awarding costs in civil litigation in California. It sets forth the general rule that "[e]xcept as otherwise expressly provided by statute, a prevailing party is entitled as a matter of right to recover costs in any action or proceeding."

Code of Civil Procedure §1033.5(a)(10) enumerates the items allowable as costs under CCP §1032. It lists, as one category of allowable costs, attorney fees when authorized by contract, statute, or law. CCP §1033.5(a)(10). As the California Supreme Court in *Santisas v Goodin* (1998) 17 C4th 599, 606, 71 CR2d 830, explained, "recoverable litigation costs do include attorney fees, but only when the party entitled to costs has a legal basis, independent of the cost statutes and grounded in an agreement, statute, or other law, upon which to claim recovery of attorney fees."

NOTE: Code of Civil Procedure §§1032(b) and 1033.5(a)(10) are applicable in both contract and noncontract actions. Thus, an attorney fee clause in a contract may provide for recovery of fees for actions in tort as well as contract. See §9.25.

Civil Code §1717 constitutes the substantive authority for recovery of attorney fees in contract enforcement actions when the contract so authorizes. In effect, it limits the application of CCP §1033.5(a)(10) in contract actions by providing in part (CC §1717(a)):

> In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, whether he or she is the party specified in the contract or not, shall be entitled to reasonable attorney's fees in addition to other costs.

The right to recover attorney fees under CC §1717(a) applies regardless of which party initiates the action. *Pacific Custom Pools, Inc. v Turner Constr. Co.* (2000) 79 CA4th 1254, 94 CR2d 756. If a contract sets forth a condition precedent to recovery of fees, however, a litigant who does not satisfy the condition precedent may be denied recovery. See, *e.g., Leamon v Krajkiewcz* (2003) 107 CA4th 424, 427, 132 CR2d 362 (litigant who did not comply with contractual condition precedent to seek mediation before filing suit on contract was not entitled to recover attorney fees). The court in *Leamon* ruled that the condition precedent did not violate the antiwaiver provisions of CC §1717 (see §9.16) or conflict with the concept of mutuality of remedy (see §9.14). 107 CA4th at 433.

For purposes of §1717, courts construe the term "on a contract" broadly to apply to any action that involves a contract. *Turner v Schultz* (2009) 175 CA4th 974, 979, 96 CR3d 659. Nevertheless, CC §1717(a) includes several key limitations. First, although the term "on a contract" will be liberally construed, CC §1717 does not apply to tort claims such as fraud, even when a contract between the parties contains an attorney fee clause, if the lawsuit does not also seek to enforce or avoid enforcement of the contract. *Gil v Mansano* (2004) 121 CA4th 739, 743, 17 CR3d 420. See §9.25.

Second, by its terms, CC §1717(a) operates to convert a one-way attorney fee clause into a mutual and reciprocal clause, to allow recovery by a prevailing party even if the contract authorizes only the other party to recover attorney fees. See §9.14.

Third, a party's right of recovery depends on whether that party is determined by the court to be the prevailing party. See §§9.17-9.20.

Fourth, CC §1717(a) limits recovery to "reasonable" attorney fees. See §9.22.

Finally, CC §1717(a) provides that if a contract has an attorney fee clause, the provision will be construed to apply to the *entire* contract, unless each party was represented by counsel in the negotiation and execution of the contract and the fact of that representation is specified in the contract. CC §1717(a). See *Milman v Shukhat* (1994) 22 CA4th

538, 27 CR2d 526.

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§9.14 2. CC §1717 Is Mutual and Reciprocal

Civil Code §1717 was enacted to provide mutuality of remedy when a contract provision limits recovery of attorney fees to one party only, to prevent oppressive use of one-sided attorney fees clauses. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198; *Santisas v Goodin* (1998) 17 C4th 599, 611, 71 CR2d 830; *Paul v Schoelkopf* (2005) 128 CA4th 147, 26 CR3d 766. It was intended to enable consumers and other parties in a disadvantageous bargaining position to protect their contractual rights in litigation by allowing recovery of attorney fees incurred if they prevail. *PLCM Group, Inc.,* 22 C4th at 1090. Another purpose was to avoid uncertainty and to clarify the issue of fees so that both parties can make rational decisions about the lawsuit, including the prospects for settlement. *International Billing Servs., Inc. v Emigh* (2000) 84 CA4th 1175, 101 CR2d 532. In *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 158 CR 1, the California Supreme Court held that CC §1717 gives a reciprocal remedy to a defendant in cases in which a plaintiff would clearly have been entitled to attorney fees had the plaintiff prevailed in enforcing the contract against the defendant. 25 C3d at 128. See also *Scott Co. v Blount, Inc.* (1999) 20 C4th 1103, 86 CR2d 614; *Pueblo Radiology Med. Group, Inc. v Gerlach* (2008) 163 CA4th 826, 77 CR3d 880; *Blickman Turkus, LP v MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 76 CR3d 325. In these situations, the effect of CC §1717 is to allow attorney fees to be recovered by whichever contracting party prevails, "whether he or she is the party specified in the contract or not." *Santisas v Goodin* (1998) 17 C4th 599, 610, 71 CR2d 830, quoting CC §1717(a).

Civil Code §1717 also makes a unilateral attorney fee clause reciprocal, thus ensuring mutuality of remedy, in contract actions in which the defendant successfully argues that the contract is inapplicable, invalid, nonexistent, or unenforceable. *Santisas,* 17 C4th at 611. See §9.15. But see *Brittalia Ventures v Stuke Nursery Co.* (2007) 153 CA4th 17, 62 CR3d 467 (farmer could not recover attorney fees after prevailing in action on contract that did not contain attorney fee provision, despite defendant's reliance on different contract that did contain such a provision).

NOTE: Indemnity agreements represent a special exception to the general rule of CC §1717(a) that one-sided attorney fee clauses will be deemed to be mutual and reciprocal. Indemnity agreements are inherently one-sided; they are intended by the parties to benefit the indemnitee unilaterally. Application of reciprocity principles would therefore defeat the purpose of an indemnity agreement. Hence, CC §1717(a) does not apply if recovery of attorney fees is authorized *as an item of loss or expense* in an indemnity agreement or clause. *Carr Bus. Enters., Inc. v City of Chowchilla* (2008) 166 CA4th 14, 82 CR3d 128. If, however, the indemnity clause is drafted to provide for recovery of attorney fees *for enforcement of the agreement,* CC §1717(a) will apply and the clause will be deemed to be reciprocal. *Baldwin Builders v Coast Plastering Corp.* (2005) 125 CA4th 1339, 1344, 24 CR3d 9. See also *Southern Pac. Thrift & Loan Ass'n v Savings Ass'n Mortgage Co.* (1999) 70 CA4th 634, 642, 82 CR2d 874.

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§9.15 3. Attorney Fees if Contract Is Invalid or Rescinded

Under CC §1717, a prevailing party is entitled to attorney fees only if it can show that the contract expressly provides for attorney fees to be awarded either to one of the parties or to the prevailing party. A problem arises if a plaintiff sues for breach of a contract with an attorney fee clause, but the defendant asserts there is no contract and wins. If there is no contract, there is no attorney fee clause. Nevertheless, to further the purposes of CC §1717, courts have recognized the defendant's right to recover attorney fees even if the defendant proves there was no contract, because the plaintiff would have been entitled to attorney fees if the plaintiff had succeeded in proving there *was* a contract. See *Santisas v Goodin* (1998) 17 C4th 599, 611, 71 CR2d 830; *Hsu v Abbara* (1995) 9 C4th 863, 870, 39 CR2d 824; *Yuba Cypress Hous. Partners, Ltd. v Area Developers* (2002) 98 CA4th 1077, 120 CR2d 273.

In *Santisas v Goodin* (1998) 17 C4th 599, 611, 71 CR2d 830, the court noted that arguments that the contract at issue is inapplicable, invalid, unenforceable, or nonexistent are inconsistent with a contractual claim for attorney fees under the same agreement; therefore, a party who prevails on any of these grounds normally would not be able to claim attorney fees as a contractual right. Civil Code §1717, however, applies in these cases because if it did not, the right to attorney fees would be unilateral in effect, even if the attorney fee clause was expressly reciprocal, because only a party seeking to affirm and enforce the contract could invoke its attorney fee clause. Civil Code §1717 has been consistently held to apply when a litigant prevails in an action on a contract by establishing that the contract is invalid or nonexistent, in order to ensure mutuality of remedy. The statute allows a party to recover attorney fees whenever the opposing party would have been entitled to attorney fees under the contract if it had prevailed. *Santisas,* 17 C4th at 611. See also *Leamon v Krajkiewcz* (2003) 107 CA4th 424, 132 CR2d 362.

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§9.16 4. CC §1717 Not Waivable

The provisions of CC §1717 are not subject to waiver by the contracting parties, and any clause in a contract that purports to waive attorney fees is void. CC §1717(a).

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5. Determination of "Prevailing Party" (CC §1717(b)(1); CCP §1032(4))

§9.17 a. Definition; Procedure for Determination

Civil Code §1717(b)(1) provides that the court, on notice and motion by a party, shall determine who is the prevailing party for purposes of the statute, whether or not the lawsuit proceeds to final judgment.

The term "prevailing party" is defined in CC §1717(b)(1) as follows:

> Except as provided in paragraph (2) [see §§9.18-9.20], the party prevailing on the contract shall be the party who recovered a greater relief in the action on the contract. The court may also determine that there is no party prevailing on the contract for purposes of this section.

The phrase "greater relief" does not necessarily mean greater monetary relief. *Acree v General Motors Acceptance Corp.* (2001) 92 CA4th 385, 112 CR2d 99. The term is also defined in CCP §1032(4) as follows:

> "Prevailing party" includes the party with a net monetary recovery, a defendant in whose favor a dismissal is entered, a defendant where neither plaintiff nor defendant obtains any relief, and a defendant as against those plaintiffs who do not recover any relief against that defendant. When any party recovers other than monetary relief and in situations other than as specified, the "prevailing party" shall be as determined by the court, and under those circumstances, the court, in its discretion, may allow costs or not and, if allowed may apportion costs between the parties on the same or adverse sides pursuant to rules adopted under Section 1034.

In *Hsu v Abbara* (1995) 9 C4th 863, 877, 39 CR2d 824, the court described the procedure that the trial court should follow to determine whether there is a prevailing party:

- The trial court should compare the relief awarded on the contract claims with the parties' original demands on the same claims and their litigation objectives, as disclosed by the pleadings, trial briefs, opening statements, and other matters of record in the case.
- The prevailing party determination should be made only after final resolution of the contract claims, and then by comparing the extent to which each party has succeeded or failed to succeed on its demands.
- The court should respect substance rather than form, and should be guided by equitable considerations to this extent. For example, a party who has achieved its principal litigation objective may be found to be the prevailing party, even if it is denied direct relief on one or more particular claims.
- Equitable considerations, however, should not be invoked if one party obtains a "simple, unqualified win" on the only contract claim in the action. In such a case, the trial court has no discretion to deny fees to the successful litigant, and equitable issues, such as the parties' behavior in settlement negotiations or discovery, are irrelevant (unless a statute provides otherwise).

See also *Scott Co. v Blount, Inc.* (1999) 20 C4th 1103, 1109, 86 CR2d 614; *Biren v Equality Emergency Med. Group, Inc.* (2002) 102 CA4th 125, 125 CR2d 325.

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§9.18 b. Voluntary Dismissals

Civil Code §1717(b)(2) provides that when "an action has been voluntarily dismissed or dismissed pursuant to a settlement of the case, there shall be no prevailing party for purposes of this section." In *Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830, the California Supreme Court addressed the question of whether a contractual attorney fee provision that conflicted with CC §1717(b)(2)—such as a clause expressly allowing recovery of fees in the event of voluntary dismissal or defining "prevailing party" to include a party in whose favor a dismissal has been entered—would control over CC §1717(b)(2) in such an event. The court held that it would not. "[I]n voluntary pretrial dismissal cases, CC §1717 bars recovery of attorney fees incurred in defending contract claims." 17 C4th at 602. The court ruled that CC §1717(b)(2) supersedes or nullifies conflicting contract provisions, and that when a plaintiff files an action within the scope of §1717, *i.e.,* an action to enforce a contract having an attorney fee clause, and the plaintiff thereafter voluntarily dismisses the action, §1717 bars the defendant from recovering attorney fees incurred in defending the action, even if the contract specifically authorizes recovery of those fees. 17 C4th at 617.

Following *Santisas,* the court in *Del Cerro Mobile Estates v Proffer* (2001) 87 CA4th 943, 947, 105 CR2d 5, held that the plaintiff's voluntary dismissal of its lawsuit for breach of contract prevented the defendant from recovering attorney fees incurred in defending the suit, even though the contract included an attorney fee clause that stated: "A party shall be deemed a prevailing party if the judgment is rendered in his favor or where the litigation is dismissed in his favor prior to or during the trial, unless the parties otherwise agree in the settlement or compromise." See also *Exxess Electronixx v Heger Realty Corp.* (1998) 64 CA4th 698, 707, 75 CR2d 376.

NOTE: If the lawsuit also includes tort or other noncontract claims, CC §1717(b)(2) does not apply to that extent. Attorney fees incurred in defending tort or other noncontract claims may be recoverable after a pretrial dismissal depending on the terms of the attorney fee clause in the contract. *Santisas,* 17 C4th at 602. See §9.25. In the unlawful detainer context, CC §1717(b)(2) does not apply to proceedings alleging tenant holdover, which sounds in tort, but does apply to proceedings alleging breach of the lease agreement. *Mitchell Land Improvement Co. v Ristorante Ferrantelli, Inc.* (2007) 158 CA4th 479, 70 CR3d 9.

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§9.19 c. Effect of CCP §998 Settlement Offer on Attorney Fee Award

Code of Civil Procedure §998, concerning litigation settlement offers (see §5.84), includes several provisions addressed to a party's ability to recover costs under CCP §§1031-1032 (including attorney fees if the contract so provides). The rule varies depending on which party makes the offer, and, if the offer is not accepted, whether the offeree obtains a more favorable judgment in the subsequent litigation. A comprehensive discussion of settlement offers under CCP §998 is beyond the scope of this title; counsel should refer to California Civil Procedure Before Trial, chap 47 (4th ed Cal CEB 2004) for further analysis of the statute and applicable case law.

In *Scott Co. v Blount, Inc.* (1999) 20 C4th 1103, 86 CR2d 614, the California Supreme Court addressed the question of whether CCP §998 would cut off the right of a plaintiff-offeree to recover attorney fees and other costs incurred before a §998 settlement offer under its contractual attorney fee clause and CC §1717, when the plaintiff did not obtain a judgment more favorable than the offer. Code of Civil Procedure §998(c)(1) provides in part:

> If an offer made by a defendant is not accepted and the plaintiff fails to obtain a more favorable judgment or award, the plaintiff shall not recover his or her postoffer costs and shall pay the defendant's costs from the time of the offer.

This provision, however, does not address the question of preoffer costs. The court held that the plaintiff was entitled to recover its preoffer attorney fees and costs in accordance with the parties' contract, because the plaintiff was the prevailing party even though it did not obtain a more favorable judgment. The defendant, however, was entitled to recover its postoffer attorney fees and costs under CCP §998.

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§9.20 d. Tender of Payment by Defendant

Civil Code §1717(b) further provides that the defendant will be deemed to be the prevailing party if the defendant tenders to the plaintiff and deposits in court the full amount to which the plaintiff is entitled:

> Where the defendant alleges in his or her answer that he or she tendered to the plaintiff the full amount to which he or she was entitled, and thereupon deposits in court for the plaintiff, the amount so tendered, and the allegation is found to be true, then the defendant is deemed to be a party prevailing on the contract within the meaning of this section.

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§9.21 6. Rights of Third Party Beneficiaries

Nonsignatory third party plaintiffs who prevail in an action based on a contract will be entitled to recover attorney fees only if there is a "sufficient nexus" between the third party and the signatory party-defendant such that the third party is entitled to enforce the attorney fees provision as a third party beneficiary of the contract. Conversely, if a sufficient nexus is present, the third party beneficiary may be *liable* for attorney fees if the signatory party prevails. In the latter case, the signatory party will be entitled to recover attorney fees only if the third party would have been entitled to its attorney fees had it prevailed. See *Sessions Payroll Mgmt., Inc. v Noble Constr. Co.* (2000) 84 CA4th 671, 101 CR2d 127; *Curry v Moody* (1995) 40 CA4th 1547, 1557, 48 CR2d 627; *Real Prop. Servs. Corp. v City of Pasadena* (1994) 25 CA4th 375, 30 CR2d 536 (finding sufficient nexus between lessor and sublessee to hold nonsignatory sublessee liable for attorney fees under lease). See also *Loduca v Polyzos* (2007) 153 CA4th 334, 62 CR3d 780. Thus, a court must interpret the agreement to determine whether the contracting parties intended the attorney fees provision to benefit a third party. In *Whiteside v Tenet Healthcare Corp.* (2002) 101 CA4th 693, 124 CR2d 580, the court reversed an attorney fee award because there was not a sufficient nexus between the plaintiff patient and the defendant health care corporation under a health insurance policy in which the defendant was a third party beneficiary. In *Loduca v Polyzos, supra,* however, the court found that a property owner was the intended third party beneficiary of a contract between a contractor and a subcontractor and was thus entitled to recover under the contract's attorney fee clause.

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§9.22 7. Fees Must Be "Reasonable"

One of the purposes of CC §1717(a) is to assure uniform treatment of attorney fee recoveries in actions on contracts with attorney fee clauses and to eliminate disparities based on whether the recovery was authorized by contract or by statute. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198. Accordingly, CC §1717(a) limits the amount of fees recoverable to "reasonable" fees as "fixed by the court," even if the contract clause does not limit recovery to reasonable levels.

As the California Supreme Court in *PLCM Group* explained, the trial court has broad authority to determine what are reasonable attorney fees, either with or without the aid of expert testimony. The process normally begins with a calculation of the so-called "lodestar" amount, *i.e.*, "the number of hours reasonably expended multiplied by the reasonable hourly rate." 22 C4th at 1095. The reasonable hourly rate constitutes the market rate prevailing in the community for similar legal services. *Shaffer v Superior Court* (1995) 33 CA4th 993, 1002, 39 CR2d 506. Once the lodestar amount has been calculated, the trial court considers whether the amount should be adjusted, based on a number of factors specific to the case, in order to arrive at the fair market value for the legal services provided. These factors include (*PLCM Group,* 22 C4th at 1096):

- The nature of the litigation;
- Its difficulty;
- The amount involved;
- The skill required in its handling;
- The skill employed;
- The attention given;
- The success or failure; and
- Other circumstances in the case.

This approach assures that the trial court's analysis is founded on attorney's services and that the final amount awarded will not be arbitrary. *PLCM Group v Drexler, supra*. See also *Serrano v Priest* (1977) 20 C3d 25, 49, 141 CR 315; *Gilbert v Master Washer & Stamping Co., Inc.* (2001) 87 CA4th 212, 104 CR2d 461; *Shaffer v Superior Court* (1995) 33 CA4th 993, 39 CR2d 506.

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§9.23 8. Fees on Appeal

As a general rule, statutes authorizing attorney fee awards in lower courts encompass attorney fees incurred on appeals of decisions from such lower courts. *Morcos v Board of Retirement* (1990) 51 C3d 924, 927, 275 CR 187. Thus, under CC §1717, a court may award to the prevailing party attorney fees incurred to prosecute an appeal. *Harbour Landing-Dolfann, Ltd. v Anderson* (1996) 48 CA4th 260, 264, 55 CR2d 640; *Villinger/Nicholls Dev. Co. v Meleyco* (1995) 31 CA4th 321, 37 CR2d 36. Because an award of attorney fees under §1717 is considered an element of costs rather than an independent money judgment, however, the fee award is stayed automatically on appeal under CCP §916. *Nielsen v Stumbos* (1990) 226 CA3d 301, 276 CR 272.

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§9.24 9. Costs of Litigation

Most attorney fee clauses also provide for recovery of costs and expenses by the prevailing party, and two issues arise in interpreting these cost-recovery provisions. The first question is whether costs can be recovered by the prevailing party as an element of attorney fees under CC §1717, particularly if the costs were paid out of pocket by the attorneys in the litigation. In *Hsu v Semiconductor Sys., Inc.* (2005) 126 CA4th 1330, 1342, 25 CR3d 82, the court held that costs are not recoverable as part of attorney fees—to allow this would represent "an unwarranted conflation" of attorney fees and costs. See also *Carwash of America-PO, LLC v Windswept Ventures No. 1, LLC* (2002) 97 CA4th 540, 118 CR2d 536; *Fairchild v Park* (2001) 90 CA4th 919, 109 CR2d 442; *Ripley v Pappadopoulos* (1994) 23 CA4th 1616, 28 CR2d 878.

The second question is whether a broadly worded cost-recovery provision enlarges the scope of recoverable costs beyond what is permitted by CCP §§1032 and 1033.5. There is a difference of opinion among California courts on this point. See *Hsu v Semiconductor Sys., Inc, supra*; *Arntz Contracting Co. v St. Paul Fire & Marine Ins. Co.* (1996) 47 CA4th 464, 54 CR2d 888. In *Davis v KGO-T.V., Inc.* (1998) 17 C4th 436, 71 CR2d 452, in dicta, the California Supreme Court remarked that "the effect of a contractual agreement for shifting litigation costs… turns on the intentions of the contracting parties." 17 C4th at 446 n5. In *Hsu,* the court of appeal overturned the trial court's cost award, holding that the issue of the interpretation of the contractual cost-recovery provision was a question of fact, which should have been specially pleaded and proven at trial; the costs at issue could not be awarded in a summary proceeding after the trial. *Hsu,* 126 CA4th at 1341.

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§9.25 10. Attorney Fees in Actions Including Tort or Other Noncontract Claims

By its terms, CC §1717(a) does not apply to tort or other noncontract claims. It applies only to claims based "on a contract" when the contract includes an attorney fee clause. Many suits for breach of contract, however, also join tort or other noncontract claims, such as claims for fraud or breach of fiduciary duty. Whether a prevailing party is entitled to recover attorney fees on account of noncontract claims depends on the language of the contractual attorney fee provision, *i.e.,* whether the type of claim is within the scope of the provision. *Santisas v Goodin* (1998) 17 C4th 599, 602, 71 CR2d 830; *Gil v Mansano* (2004) 121 CA4th 739, 743, 17 CR3d 420; *Thompson v Miller* (2003) 112 CA4th 327, 4 CR3d 905. See CCP §1021. A broadly worded attorney fee clause may support a fee award to the prevailing party in a tort action. "[P]arties may validly agree that the prevailing party will be awarded attorney fees incurred in any litigation between themselves, whether such litigation sounds in tort or in contract." *Gil,* 121 CA4th at 743 (citations omitted).

In *Santisas,* the court held that the defendants could not recover attorney fees under CC §1717 based on the plaintiff's contract claim because the plaintiffs had voluntarily dismissed the action. *Santisas,* 17 C4th at 606. See §9.18. Nevertheless, under the attorney fee clause of the parties' agreement, the defendants were entitled to recover their attorney fees as prevailing parties on the tort and other noncontract causes of action, as an element of costs under CCP §1032(b). See also *Topanga & Victory Partners v Toghia* (2002) 103 CA4th 775, 127 CR2d 104.

In the absence of an attorney fee clause that authorizes recovery in tort, the trial court in its discretion may apportion the fees between those incurred on the contract action and those incurred on other causes of action. The fees need not be apportioned, however, if incurred for legal representation on an issue common to both causes of action. *Erickson v R.E.M. Concepts, Inc.* (2005) 126 CA4th 1073, 25 CR3d 39.

NOTE: A special rule has developed in suits for bad faith breach of insurance contracts. In *Brandt v Superior Court* (1985) 37 C3d 813, 819, 210 CR 211, the California Supreme Court held that a successful plaintiff in a case alleging that an insurer has in bad faith denied a payment due on an insurance contract is entitled to recover attorney fees regardless of whether the contract has an attorney fee clause. The rationale for the *Brandt* decision is that a plaintiff in such a case is allowed to recover for all detriment proximately resulting from the insurer's bad faith. See *Archdale v American Int'l Specialty Lines Ins. Co.* (2007) 154 CA4th 449, 469, 64 CR3d 632. The *Brandt* court held, however, that recoverable attorney fees could not exceed the amount allocable to the attorney's efforts to obtain the insurance payment due. Any fees allocable to any other portion of the plaintiff's award cannot be recovered. See also *Cassim v Allstate Ins. Co.* (2004) 33 C4th 780, 811, 16 CR3d 374. *Brandt* fees are also available to assignees of an insured's cause of action, including *Brandt* fees incurred post-assignment. *Essex Ins. Co. v Five Star Dye House, Inc.* (2006) 38 C4th 1252, 45 CR3d 362. Note that the *Brandt* rule does not apply in lawsuits alleging bad faith in connection with ordinary commercial contracts. It applies only in suits by insureds against insurers. *Palmer v Ted Stevens Honda, Inc.* (1987) 193 CA3d 530, 539 n4, 238 CR 363.

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§9.26 11. Pro Se Litigants; In-House Counsel

An attorney who represents himself or herself in litigation may not recover attorney fees under CC §1717. *Trope v Katz* (1995) 11 C4th 274, 45 CR2d 241 (attorney litigating in propria persona does not pay, or become liable to pay, compensation for legal representation). See also *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 1092, 95 CR2d 198. The intent of CC §1717 is to allow parties to recover attorney fees actually paid or incurred. *Trope,* 11 C4th at 280. Thus, attorneys who litigate their own claims are not entitled to recover amounts on account of their time and effort. *Argaman v Ratan* (1999) 73 CA4th 1173, 1175, 86 CR2d 917. Nonattorney litigants who represent themselves are similarly prohibited from recovering attorney fees under the attorney fee provision of a contract. *Mix v Tumanjan Dev. Corp.* (2002) 102 CA4th 1318, 126 CR2d 267. Nevertheless, an attorney litigant who is represented by his or her own law firm is entitled to recover attorney fees, because the litigant will experience a reduced partnership draw to account for the time spent by his or her partners on the case. *Gilbert v Master Washer & Stamping Co., Inc.* (2001) 87 CA4th 212, 104 CR2d 461.

A party who uses in-house counsel and prevails in the litigation is entitled to recover attorney fees under CC §1717 at the market rate. *PLCM Group, Inc. v Drexler, supra*. See also *Lolley v Campbell* (2002) 28 C4th 367, 121 CR2d 571.

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§9.27 12. Attorney Fee Clauses

A model contract clause providing for an award of attorney fees to the prevailing party is as follows:

> ***Attorney Fees*. In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, in addition to any other relief to which the prevailing party may be entitled, the prevailing party shall be entitled to recover its reasonable attorney fees, costs and expenses to resolve the dispute and to enforce the final judgment.**

Note that this clause is drafted broadly to encompass tort claims as well as claims based solely on the contract. If the clause is limited to contract claims, it will not cover tort claims such as fraud or breach of fiduciary duty, even though such claims may be factually related to the contract claims. See *Gil v Mansano* (2004) 121 CA4th 739, 744, 17 CR3d 420. In *Thompson v Miller* (2003) 112 CA4th 327, 333, 4 CR3d 905, the court held that a clause providing that attorney fees were recoverable in "any dispute" under the contract was sufficient to include attorney fees incurred in defending fraud and breach of fiduciary duty causes of action. If the clause is limited to contract claims, but the action encompasses both tort and contract claims, the court may attempt to divide the time allocable to each type of claim and allow only a partial recovery of fees. See *Erickson v R.E.M. Concepts, Inc.* (2005) 126 CA4th 1073, 25 CR3d 39.

As discussed in §9.25, CC §1717 does not apply to tort claims. Thus, there is no requirement that an attorney fee clause covering tort claims be reciprocal.

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§9.28 C. Statutes Allowing Recovery

In certain cases, recovery of reasonable attorney fees by the prevailing party is authorized by statute, even if the relevant contract does not include an attorney fee clause. Some, but not all, of the statutes limit recovery to one party, *e.g.,* the buyer. Compare, *e.g.,* CC §1794(d)-(e) with CC §2983.4. Some of the statutes authorize the defendant to recover attorney fees or costs and expenses, or both, if the court finds that the action was brought in bad faith. See, *e.g.,* CC §1780(e). Note that CC §1717 (see §§9.13-9.27) does not apply if there is independent statutory authorization for an award of attorney fees. *Parrott v Mooring Townhomes Ass'n, Inc.* (2003) 112 CA4th 873, 878, 6 CR3d 116; *Damian v Tamondong* (1998) 65 CA4th 1115, 77 CR2d 262.

Statutes authorizing recovery of reasonable attorney fees in certain contract-related actions include the following. Counsel should be alert for other statutory bases for recovery of attorney fees.

- Civil Code §1354(c), concerning actions to enforce the governing documents of common interest developments.
- Civil Code §1694.4, one of a series of statutes regulating dating service contracts.
- Civil Code §1694.9, one of a series of statutes regulating weight loss contracts.
- Civil Code §1695.7, one of a series of statutes regulating home equity sales contracts.
- Civil Code §1717.5, concerning actions on contracts based on book accounts.
- Civil Code §1738.6, one of a series of statutes regulating wholesale sales representatives.
- Civil Code §1745(d), one of a series of statutes regulating the sale of fine art prints.
- Civil Code §1780(e), part of the Consumers Legal Remedies Act (CC §§1750-1784).
- Civil Code §1794(d)-(e), part of the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8).
- Civil Code §1811.1, part of the Unruh Act (CC §§1801-1812.20), concerning retail installment contracts.
- Civil Code §1812.62(a), one of a series of statutes regulating contracts for dance studio lessons and other services.
- Civil Code §1812.94, one of a series of statutes regulating health studio services.
- Civil Code §1812.123(a), one of a series of statutes regulating contracts for discount buying services.
- Civil Code §1812.218, one of a series of statutes regulating contracts for seller assisted marketing plans.
- Civil Code §1812.306, one of a series of statutes regulating membership camping contracts.
- Civil Code §2945.6, one of a series of statutes regulating mortgage foreclosure consultants.
- Civil Code §2983.4, part of the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5).
- Civil Code §2988.9, one of a series of statutes regulating vehicle lease contracts.
- Code of Civil Procedure §1021.5, the so-called "private attorney general" statute, which permits the court to award attorney fees to a successful party in any action that has resulted in the enforcement of an important right affecting the public interest, under certain conditions. See generally CCP §1021.5; *Graham v DaimlerChrysler Corp.* (2004) 34 C4th 553, 21 CR3d 331.

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§9.29 V. PREDISPUTE WAIVER OF RIGHT TO JURY TRIAL (CCP §631)

Before the California Supreme Court's decision in *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 32 CR3d 5, clauses waiving the right to trial by jury in advance of a dispute were common in many commercial contracts, including commercial loan agreements and commercial leases. Although strictly construed, such clauses were held enforceable, even though they were not listed in CCP §631(d) as one of the permissible methods for waiving trial by jury. See, *e.g., Trizec Props., Inc. v Superior Court* (1991) 229 CA3d 1616, 280 CR 885 (disapproved in *Grafton Partners L.P.,* 36 C4th at 956).

In *Grafton,* the California Supreme Court held that it was for the state legislature to decide whether and under what circumstances a predispute jury trial waiver would be enforceable in California. The court ruled that, under Cal Const art I, §16, trial by jury in civil cases may be waived only as prescribed by statute. Code of Civil Procedure §631 implements Cal Const art I, §16 by enumerating six ways that a party can waive a jury trial in civil cases. See CCP §631(d); however, CCP §631 does not authorize a predispute waiver of the right to trial by jury. The court also confirmed that its decision was retroactive. The jury trial waiver at issue in *Grafton* (in an accounting firm's engagement letter) was therefore unenforceable. *Grafton Partners L.P.,* 36 C4th at 967.

The *Grafton* court was careful to except arbitration agreements from its holding. The court noted the strong state policy favoring arbitration and the enactment of a comprehensive legislative scheme authorizing predispute arbitration agreements. See 36 C4th at 964.

NOTE: Although no legislation to overrule *Grafton* has been enacted at the time of this writing, practitioners should anticipate future legislative developments concerning predispute jury trial waivers in California.

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VI. ARBITRATION OF CONTRACT DISPUTES

§9.30 A. Introduction

Arbitration (sometimes known as "contractual arbitration" to distinguish it from judicial arbitration; see §9.53) is a voluntary nonjudicial means of dispute resolution based on an agreement of the parties. In general, the rules of law governing arbitration of contract disputes are contained in the agreement itself. See *Rifkind & Sterling, Inc. v Rifkind* (1994) 28 CA4th 1282, 1292, 33 CR2d 828 (arbitration award is private agreement governed by rules of parties' own making or selection). Written agreements to submit existing or future controversies to arbitration are valid, enforceable, and irrevocable under the California Arbitration Act (CAA) (CCP §§1280-1294.2), except to the extent that grounds exist for revocation of any contract. CCP §1281. See §9.38. Written arbitration agreements in transactions involving interstate commerce are enforceable to the same extent under the Federal Arbitration Act (FAA) (9 USC §§1-16). See 9 USC §2; §9.39. Thus, basic contract law applies to agreements to arbitrate, as it does to other agreements. See, *e.g., Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 98, 99 CR2d 745 (under California law, arbitration agreement may be invalidated only on grounds "as exist at law or in equity for the revocation of any contract"). Although an oral agreement to arbitrate is not ordinarily enforceable, an oral extension of a written agreement containing an arbitration clause will support a demand for arbitration. *Magness Petroleum Co. v Warren Resources of Cal., Inc.* (2002) 103 CA4th 901, 127 CR2d 159.

The parties may agree to submit a dispute to arbitration even in the absence of an arbitration clause in their contract. Arbitration is simply a contractual substitute for court procedures. But unless there is an arbitration agreement, neither party can compel arbitration. For further discussion of contractual arbitration, see Drafting Business Contracts: Principles, Techniques & Forms, chap 16 (Cal CEB 1994); California Civil Procedure Before Trial, chap 45 (4th ed Cal CEB 2004); California Construction Contracts, Defects, and Litigation, chap 7 (Cal CEB 2008); Advising California Employers and Employees, chap 20 (Cal CEB 2005).

Judicial arbitration, discussed in §9.53, is a special procedure that may be invoked by the court in certain cases when the amount in controversy does not exceed $50,000. Mediation, another form of alternative dispute resolution, is discussed in §§9.54-9.55.

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B. Advantages and Disadvantages of Arbitration

§9.31 1. Advantages

Among the positive aspects of arbitration are the following:

- Arbitration is usually speedier than litigation, although some arbitration proceedings continue for years without resolution. Speed can be ensured by requiring the arbitrator to submit a ruling within a specified time period.
- Arbitration is usually less expensive than litigation, but this is not always true. Essentially, the same preparations must be made for arbitration as for trial.
- Arbitration does not normally involve substantial discovery, which may simplify resolution of the dispute and lessen the cost of dispute resolution.
- Arbitration awards are not subject to time-consuming scrutiny by an appellate court.
- Experts knowledgeable about the issues in dispute (*e.g.,* architects, accountants) can serve as arbitrators.
- Arbitration can be conducted confidentially, avoiding public airing of trade secrets and other confidential matters.
- Arbitration follows less strict rules of evidence than court proceedings, *e.g.,* allowing the admission of hearsay, which may expedite resolution. See CCP §1282.2(d).
- Arbitrators have the power to make compromises in the dispute, giving each party some relief; in court, disputes must often be resolved entirely for one party or the other.
- Arbitrators, who are often compensated by the hour, do not have the same time pressures as a trial court judge to reach a decision and move on to the next case.

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§9.32 2. Disadvantages

Among the negative aspects of arbitration are the following:

- Arbitrators are free to follow broad principles of equity and need not follow the law. *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 10 CR2d 183. They also have broad powers to define the appropriate remedy, and the remedy will not be set aside by the courts as long as it bears some rational relationship to the breach. *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 381, 36 CR2d 581. A party that wants its dispute resolved in strict accordance with the law may be frustrated by arbitration.
- Arbitration awards are almost always final and not subject to effective judicial review. Even when available, judicial review does not extend to the merits of the dispute, the sufficiency of evidence to support the award, or the arbitrator's reasoning. CCP §1286.2; *Moncharsh v Heily & Blase, supra* (error of law apparent on face of complaint not reviewable). Thus, if an arbitrator ignores a legal principle that should be controlling, the losing party has no recourse. Parties cannot expand by contract the court's power to review the decision.
- There is a risk associated with having a single trier of fact, rather than the collective judgment of 12 jurors. Moreover, there is no separation between a judge who rules on the law (including whether evidence is inadmissible) and a jury that rules on the facts; the arbitrator plays both roles.
- The general lack of discovery rights in arbitration may impede a party's ability to present its case. See CCP §1283.05 (limiting depositions). This lack can be especially harmful if there is substantial expert testimony but no opportunity to depose the expert.
- If third parties are a part of the dispute but cannot be brought into the arbitration, it may be better to have all parties appear before a court than to have some parties arbitrate while others litigate.
- Arbitration agreements can spawn expensive satellite litigation. See *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v 100 Oak St.* (1983) 35 C3d 312, 323, 197 CR 581 (alleged fraud in inducing contract does not make arbitration agreement invalid); *Stirlen v Supercuts, Inc.* (1997) 51 CA4th 1519, 60 CR2d 138 (arbitration provision in adhesion contract for employment unenforceable because unconscionable).
- Unlike federal or state court judges, arbitrators receive payment for their services from the parties, usually on the basis of an hourly fee. The hourly rate for the services of an experienced arbitrator may be as much as the hourly rate of a senior law firm partner.
- The speed of arbitration may work to the parties' detriment. If the parties are forced into arbitration too quickly, they may not have time to settle the dispute on their own.
- The parties will not have access to the court's settlement procedures.
- The arbitrator can award punitive damages unless they are excluded by agreement. *Rifkind & Sterling, Inc. v Rifkind* (1994) 28 CA4th 1282, 33 CR2d 828.
- Deciding to use arbitration does not eliminate completely the role of the courts. For example, unless the arbitration clause is self-executing, a party must petition the court to appoint an arbitrator. CCP §1281.2. Moreover, arbitrators' judgments are not self-executing. The prevailing party must move to confirm the award to enforce a judgment. CCP §§1285-1287.6. There is also the risk that a party opposed to arbitrating a claim may challenge the duty to arbitrate by asserting that the contract was obtained by fraud that "permeates" the agreement (*King v Prudential-Bache Sec., Inc.* (1990) 226 CA3d 749, 755, 277 CR 214), or that the contract is unconscionable (*Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 827, 171 CR 604), or on certain other limited grounds, *e.g.,* waiver of the right to arbitrate (*Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 981, 64 CR2d 843).

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C. Drafting Arbitration Clauses

§9.33 1. AAA Forms of Arbitration Clause

The American Arbitration Association (AAA) publishes sample contractual arbitration clauses. See Drafting Dispute Resolution Clauses—A Practical Guide (American Arbitration Association, Sept. 1, 2007), available at http://www.adr.org/sp.asp?id=29159. The AAA model clause for arbitration of future disputes is as follows:

> **ANY CONTROVERSY OR CLAIM ARISING OUT OF OR RELATING TO THIS CONTRACT, OR THE BREACH THEREOF, SHALL BE SETTLED BY ARBITRATION ADMINISTERED BY THE AMERICAN ARBITRATION ASSOCIATION IN ACCORDANCE WITH ITS COMMERCIAL [OR OTHER] ARBITRATION RULES [INCLUDING THE OPTIONAL RULES FOR EMERGENCY MEASURES OF PROTECTION], AND JUDGMENT ON THE AWARD RENDERED BY THE ARBITRATOR(S) MAY BE ENTERED IN ANY COURT HAVING JURISDICTION THEREOF.**

The AAA model clause for arbitration of existing disputes is as follows:

> **WE, THE UNDERSIGNED PARTIES, HEREBY AGREE TO SUBMIT TO ARBITRATION ADMINISTERED BY THE AMERICAN ARBITRATION ASSOCIATION UNDER ITS COMMERCIAL [OR OTHER] ARBITRATION RULES THE FOLLOWING CONTROVERSY: [DESCRIBE BRIEFLY]. WE FURTHER AGREE THAT A JUDGMENT OF ANY COURT HAVING JURISDICTION MAY BE ENTERED UPON THE AWARD.**

The arbitration clauses above incorporate by reference rules of the AAA. Note that the AAA has developed specialized arbitration rules for particular types of disputes, including real estate, commercial arbitration and mediation, construction disputes, consumer cases, employment and labor cases, and international commercial disputes. See http://www.adr.org/RulesProcedures. Counsel who wish to designate the AAA as their arbitration service should become familiar with the particular AAA rules that will apply to a dispute under the contract, and specify those rules in the clause.

NOTE: It is not necessary to designate the arbitration service in advance. If desired, the parties can leave the choice of arbitration service to the party initiating the arbitration, as in the following example:

> **At the option of the first to commence an arbitration, the arbitration shall be administered either by the American Arbitration Association under its commercial [or other] arbitration rules or by JAMS under its [Comprehensive Arbitration Rules and Procedures] [Streamlined Arbitration Rules and Procedures].**

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§9.34 2. JAMS Forms of Arbitration Clause

Judicial Arbitration and Mediation Services, Inc. (now known as JAMS) also publishes sample arbitration clauses, which are available on the JAMS website. See http://www.jamsadr.com/rules/clauses.asp. The JAMS model clause for arbitration of future disputes is as follows:

> **ANY DISPUTE, CLAIM OR CONTROVERSY ARISING OUT OF OR RELATING TO THIS AGREEMENT OR THE BREACH, TERMINATION, ENFORCEMENT, INTERPRETATION OR VALIDITY THEREOF, INCLUDING THE DETERMINATION OF THE SCOPE OR APPLICABILITY OF THIS AGREEMENT TO ARBITRATE, SHALL BE DETERMINED BY ARBITRATION IN [INSERT THE DESIRED PLACE OF ARBITRATION], BEFORE [ONE] [THREE] ARBITRATOR(S). THE ARBITRATION SHALL BE ADMINISTERED BY JAMS PURSUANT TO ITS COMPREHENSIVE ARBITRATION RULES AND PROCEDURES (STREAMLINED ARBITRATION RULES AND PROCEDURES). JUDGMENT ON THE AWARD MAY BE ENTERED IN ANY COURT HAVING JURISDICTION. THIS CLAUSE SHALL NOT PRECLUDE PARTIES FROM SEEKING PROVISIONAL REMEDIES IN AID OF ARBITRATION FROM A COURT OF APPROPRIATE JURISDICTION.**
>
> [*Add if desired*]
>
> **Allocation of Fees and Costs: The arbitrator may, in the Award, allocate all or part of the costs of the arbitration, including the fees of the arbitrator and the reasonable attorneys' fees of the prevailing party.**

Like the AAA, JAMS also has specialized rules for different types of arbitrations. See http://www.jamsadr.com/rules/rules.asp. Counsel should determine which JAMS rules would be most applicable for resolution of any dispute under the contract, and specify those rules in the arbitration clause.

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§9.35 3. Self-Executing Arbitration Clauses

If the parties' arbitration clause is self-executing, arbitration may proceed without first obtaining a court order, even if one party refuses to participate in selecting an arbitrator or to appear in the arbitration proceeding. See *Weddington Prods., Inc. v Flick* (1998) 60 CA4th 793, 801 n2, 71 CR2d 265 (clause not self-executing inasmuch as it did not expressly authorize ex parte arbitration proceedings nor did it incorporate any body of established arbitral rules); *National Marble Co. v Bricklayers & Allied Craftsmen* (1986) 184 CA3d 1057, 1063, 229 CR 653 (arbitration agreement is self-executing when it allows and provides for arbitration under rules incorporated in agreement). To be self-executing, the clause should provide (1) a method for selecting the arbitrator if the other party refuses to participate, (2) a procedure for going forward if the other party does not answer, and (3) an agreement that the hearing may proceed without the other party. Arbitration clauses that designate an arbitration service are usually self-executing. An example of a self-executing provision is as follows:

> **Either party requesting arbitration under this Agreement must make a demand on the other party by registered or certified mail with a copy to _ _**[*e.g., the American Arbitration Association or JAMS*]**_ _. The arbitration will take place as noticed by _ _**[*e.g., the American Arbitration Association or JAMS*]**_ _ regardless of whether one of the parties fails or refuses to participate.**

If the clause is not self-executing and the opposing party does not respond to a demand letter or refuses to participate in arbitration proceedings, a proceeding to compel arbitration must be initiated in superior court. See CCP §1281.2; A Litigator's Guide to Effective Use of ADR in California, chap 9 (Cal CEB 2005). See, *e.g., Hotels Nevada v L.A. Pacific Ctr., Inc.* (2006) 144 CA4th 754, 50 CR3d 700.

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§9.36 4. Special Requirements

Arbitration provisions in medical services contracts in California must contain language prescribed by CCP §1295. Arbitration agreements in health services plans must comply with Health & S C §1363.1. Arbitration provisions in California real estate sales contracts, including listing agreements, are required by CCP §1298 to include specific language in a format specified by the statute. *McAvoy v Hilbert* (2009) 172 CA4th 707, 91 CR3d 437. The language of predispute arbitration agreements between securities brokers and their customers are subject to special rules of the National Association of Securities Dealers (NASD). See NASD Rule 3110(f), soon to be incorporated into the consolidated rulebook of the Financial Industry Regulatory Authority (FINRA), at http://www.finra.org.

Arbitration clauses in contracts used in other regulated industries may also be subject to special requirements—or may be prohibited outright. See, *e.g.*, *Jaramillo v JH Real Estate Partners, Inc.* (2003) 111 CA4th 394, 3 CR3d 525 (CC §1953, which prohibits residential real estate leases from including any waiver of tenant's procedural rights, establishes general rule that tenant cannot validly agree to binding arbitration in residential lease).

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§9.37 5. Discovery Provisions

In general, if an arbitration clause is silent with respect to discovery, there is no right to discovery, except as allowed by the rules of the arbitration service designated by the parties. If the parties expressly incorporate into their arbitration agreement the discovery provisions of CCP §1283.05, however, that section governs. CCP §1283.1(b). Code of Civil Procedure §1283.05 provides the right to obtain discovery just as in any civil action, subject only to the requirement that the arbitrator grant leave to take depositions. CCP §1283.05(a), (e).

The rules of most arbitration services provide for limited discovery and give the arbitrator discretion to grant additional discovery. For example, the American Arbitration Association's Commercial Arbitration Rules and Mediation Procedures (Including Procedures for Large, Complex Commercial Disputes) (June 1, 2009), R-21 (Exchange of Information), is available at http://www.adr.org/sp.asp?id=36905, provides simply that

> (a) At the request of any party or at the discretion of the arbitrator, consistent with the expedited nature of arbitration, the arbitrator may direct i) the production of documents and other information, and ii) the identification of any witnesses to be called.

See also JAMS Comprehensive Arbitration Rules and Procedures (July 15, 2009), Rule 17 (Exchange of Information), available at http://www.jamsadr.com/rules-comprehensive-arbitration.

The parties may also adopt special rules for the discovery process, either by providing for no discovery at all or by specifying the discovery procedures that will apply.

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D. Enforcement of Arbitration Clauses

§9.38 1. California Arbitration Act (CCP §§1280-1294.2)

The California Arbitration Act (CAA) (CCP §§1280-1294.2) governs arbitration agreements and arbitration proceedings under California law. As stated by the court in *Woolls v Superior Court* (2005) 127 CA4th 197, 204, 25 CR3d 426, the CAA "represents a comprehensive statutory scheme regulating private arbitration … [through which] the Legislature has expressed a strong public policy in favor of arbitration as a speedy and relatively inexpensive means of dispute resolution." See also *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 85 CR3d 817. A broad choice-of-law clause specifying that California law applies to the contract will incorporate the CAA. See *Cronus Invs., Inc. v Concierge Servs.* (2005) 35 C4th 376, 387, 25 CR3d 540.

In addition to providing for the general enforceability of arbitration agreements (see CCP §1281), the CAA addresses (among other matters) procedures to compel arbitration (CCP §1281.2), stays of pending judicial proceedings (CCP §1281.4), waivers of arbitration (CCP §1281.5), appointment of arbitrators (CCP §1281.6), ethical standards and required disclosures by arbitrators (CCP §§1281.85-1281.96), disqualification of arbitrators (CCP §1281.91), conduct of arbitration proceedings (CCP §§1282-1284.3), and enforcement of the award (CCP §1285-1294.2). Significantly, under CCP §1281.2, the petition to compel arbitration must specifically and expressly allege the existence of an agreement to arbitrate. In *Brodke v Alphatec Spine, Inc.* (2008) 160 CA4th 1569, 73 CR3d 554, the defendants attempted to compel arbitration, relying on the plaintiff's allegation of a contract containing an arbitration clause, because the defendants claimed they never entered into a contract with the plaintiffs. The court held that defendants' petition to compel arbitration was properly denied for failing to comply with §1281.2. See generally A Litigator's Guide to Effective Use of ADR in California, chap 9 (Cal CEB 2005).

NOTE: Apart from the generally applicable provisions on arbitration found in the CAA (CCP §§1280-1294.2), the Code of Civil Procedure also includes specific statutes addressed to arbitration of medical malpractice claims (CCP §1295), disputes under public construction contracts (CCP §1296), international commercial disputes (CCP §§1297.11-1297.432), disputes under real estate contracts (CCP §§1298-1298.8), and firefighter and law enforcement officer labor disputes (CCP §§1299-1299.9).

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2. Federal Arbitration Act (9 USC §§1-16)

§9.39 a. Generally

Under the Federal Arbitration Act (FAA) (9 USC §§1-16), a written arbitration provision in a maritime transaction or in any contract "evidencing a transaction involving commerce" is "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 USC §2. The standard for "involving commerce" is as broad as the commerce clause. *Southland Corp. v Keating* (1984) 465 US 1, 79 L Ed 2d 1, 104 S Ct 852. The slightest factual nexus with interstate commerce has been said to be sufficient to bring the transaction (and thus the arbitration provision) within the FAA. See *Allied-Bruce Terminix Cos. v Dobson* (1995) 513 US 265, 130 L Ed 2d 753, 115 S Ct 834.

NOTE: The provisions of the FAA do not apply to employment contracts of transportation workers. *Circuit City Stores, Inc. v Adams* (2001) 532 US 105, 149 L Ed 2d 234, 121 S Ct 1302 (FAA exemption in 9 USC §1 for "contracts of employment of seamen, railroad employees, or any other class of workers engaged in interstate commerce" applies only to transportation workers, not all workers).

The substantive provisions of the FAA (9 USC §§1-2) apply in both federal and state courts. *Vaden v Discover Bank* (2009) __ US __, 173 L Ed 2d 206, 217, 129 S Ct 1262. See also *Southland Corp. v Keating* (1984) 465 US 1, 16, 79 L Ed 2d 1, 15, 104 S Ct 852. The FAA is not an independent source of federal court jurisdiction, however; federal jurisdiction over the underlying case, *i.e.,* federal question or diversity-of-citizenship jurisdiction must exist. *Vaden v Discover Bank,* 173 L Ed 2d at 219. In *Vaden*, the Court held that federal question jurisdiction cannot be predicated on an actual or anticipated defense or counterclaim. 173 L Ed 2d at 218.

Under the FAA, the question of arbitrability is normally for the courts, not the arbitrators, to decide. *First Options of Chicago, Inc. v Kaplan* (1995) 514 US 938, 944, 131 L Ed 2d 985, 994, 115 S Ct 1920 (stating that courts should not assume that the parties agreed to arbitrate without "clear and unmistakable" evidence that they did so); *Jackson v Rent-A-Center W., Inc.* (9th Cir 2009) 581 F3d 912 (although arbitration agreement provided that enforceability of agreement was to be resolved through arbitration, challenge to arbitration agreement based on unconscionability is threshold question for court); *Cox v Ocean View Hotel Corp.* (9th Cir 2008) 533 F3d 1114, 1120. If, however, a party voluntarily requests that the arbitration panel rather than the court determine arbitrability, and submits the issue of arbitrability to the arbitrators, that party is bound by the arbitrators' decision on the issue unless it can show that the arbitrators' decision is completely irrational or constitutes a manifest disregard of the law. *PowerAgent Inc. v Electronic Data Sys. Corp.* (9th Cir 2004) 358 F3d 1187.

Section 4 of the FAA provides for a jury trial if certain material factual disputes exist regarding the existence of the arbitration agreement. 9 USC §4. Note that the California Supreme Court has held that no such right to jury trial exists in state court. *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 58 CR2d 875.

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§9.40 b. FAA Preemption of State Law

When an agreement to arbitrate is part of a contract involving interstate commerce, the Federal Arbitration Act (FAA) (9 USC §§1-16) forecloses "the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Southland Corp. v Keating* (1984) 465 US 1, 10, 79 L Ed 2d 1, 12, 104 S Ct 852. In *Preston v Ferrar* (2008) 552 US 346, 169 L Ed 2d 917, 128 S Ct 978, the U.S. Supreme Court reversed *Preston v Ferrar* (2006) 145 CA4th 440, 51 CR3d 628, review denied (Feb 14, 2007, No. S149190) 2007 Cal Lexis 1539, which had held that the California Talent Agencies Act (Lab C §§1700-1700.47) vested the Labor Commissioner with exclusive original jurisdiction over a dispute involving a contract with an arbitration clause between Ferrar, who appeared on television as "Judge Alex," and Preston, an entertainment attorney. The Court held that "when parties agree to arbitrate all questions arising under a contract, state laws lodging primary jurisdiction in another forum, whether judicial or administrative, are superseded by the FAA." 552 US at 349. See also *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892.

The FAA also precludes states from placing restrictions on arbitration provisions that are not applicable to contracts generally, if the contract in which the arbitration provision is included involves interstate commerce. *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 687, 134 L Ed 2d 902, 909, 116 S Ct 1652; *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 954, 85 CR3d 817. Thus, the FAA "generally preempts state legislation that would restrict the enforcement of arbitration agreements." *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 98, 99 CR2d 745. For example, in *Shepard v Edward MacKay Enters., Inc.* (2007) 148 CA4th 1092, 56 CR3d 326, the court of appeal held that the FAA preempted a construction defect action brought under CCP §1298.7 in which the construction project at issue involved materials from out of state. The FAA, however, does not preempt generally applicable state contract law that may lead a court to find a particular arbitration provision unconscionable and thus unenforceable. See *Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76 (FAA does not preempt California law making unenforceable at least some class action waivers in consumer adhesion contracts). See also *Shroyer v New Cingular Wireless Servs.* (9th Cir 2007) 498 F3d 976; *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818 (FAA does not preempt general California contract law; state courts are not obliged enforce contract terms that are unconscionable or contrary to public policy).

The parties to an arbitration agreement may agree that California law, including its arbitration procedures, governs their agreement. *Volt Info. Sciences, Inc. v Board of Trustees of Leland Stanford Jr. Univ.* (1989) 489 US 468, 476, 103 L Ed 2d 488, 498, 109 S Ct 1248. In *Volt,* the Supreme Court held that when the parties had agreed that California law would govern their arbitration, the FAA did not prevent the trial court from staying the arbitration under CCP §1281.2(c). "There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." 489 US at 476. See also *Cronus Invs., Inc. v Concierge Servs.* (2005) 35 C4th 376, 25 CR3d 540.

Significantly, the California Supreme Court in *Cable Connection, Inc. v DirectTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229, held that the FAA provisions for judicial review of arbitration awards do not necessarily preempt the corresponding provisions of the California Arbitration Act (CAA) (CCP §§1280-1294.2). In *Cable Connection*, the court found that the U.S. Supreme Court's holding in *Hall St. Assocs. v Mattel* (2008) 552 US 576, 170 L Ed 2d 254, 128 S Ct 1396—that the FAA provisions limiting the grounds for judicial review of arbitration awards were exclusive and that parties could not contract for more expansive judicial review—was restricted to arbitration awards governed by federal law under the FAA. The California Supreme Court held that although arbitration awards are normally final and subject only to limited judicial review under the CAA, the parties to an arbitration agreement may provide for judicial review of any legal errors in the arbitration award. 44 C4th at 1364. If, however, the arbitration agreement in a contract not involving interstate commerce provides that its interpretation shall be governed by the FAA, the court will interpret this provision to mean that the parties had not intended to contract for more expansive judicial review. *Christensen v Smith* (2009) 171 CA4th 931, 937, 90 CR3d 57. For further discussion of judicial review of arbitration awards, see §9.52.

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§9.41 3. Arbitrability; Scope of Arbitration Clause

When a petition to compel arbitration is filed, the court must decide the gateway issue of the arbitrability of the dispute, *i.e.,* whether the parties are bound by a valid, enforceable arbitration agreement. CCP §1281.2; *Howsam v Dean Witter Reynolds, Inc.* (2002) 537 US 79, 154 L Ed 2d 491, 123 S Ct 588; *First Options of Chicago, Inc. v Kaplan* (1995) 514 US 938, 944, 131 L Ed 2d 985, 994, 115 S Ct 1920 (arbitrability ordinarily for courts, not arbitrators, to decide). See also *Omar v Ralphs Grocery Co.* (2004) 118 CA4th 955, 13 CR3d 562 (trial court erred by failing to consider gateway issues of arbitrability). By a specific reference in the arbitration agreement, however, the parties may delegate to the arbitrator the issue of arbitrability. *Dream Theater, Inc. v Dream Theater* (2004) 124 CA4th 547, 21 CR3d 322. Nevertheless, "[c]ourts should not assume that the parties agreed to arbitrate arbitrability unless there is 'clear and unmistakable' evidence that they did so"; *First Options of Chicago, Inc. v Kaplan* (1995) 514 US 938, 944, 131 L Ed 2d 985, 994, 115 S Ct 1920. See also *Bruni v Didion* (2008) 160 CA4th 1272, 73 CR3d 395 (although arbitration agreement granted arbitrator power to determine agreement's validity, question of arbitrability was for court when parties opposing arbitration claimed they never knowingly agreed to arbitration agreement's allegedly unconscionable terms); *Gilbert St. Developers, LLC v La Quinta Homes, LLC* (2009) 174 CA4th 1185, 1193, 94 CR3d 918 (to apply, AAA rule giving arbitrators authority to decide their own jurisdiction must have existed when contract incorporating AAA rules was executed).

Under both the CAA and the FAA, there is a presumption in favor of arbitrability. *Ruiz v Sysco Food Servs.* (2004) 122 CA4th 520, 538, 18 CR3d 700. Arbitration is a highly favored remedy. *Amalgamated Transit Union Local 1277 v Los Angeles County Metro. Transp. Auth.* (2003) 107 CA4th 673, 684, 132 CR2d 207. Any doubts as to whether an arbitration clause applies to a particular dispute are to be resolved in favor of arbitration. *Ruiz v Sysco Food Servs., supra*; *Larian v Larian* (2004) 123 CA4th 751, 19 CR3d 916. There is no public policy, however, favoring arbitration of disputes that the parties have not agreed to arbitrate. A party cannot be compelled to arbitrate a dispute that he or she has not agreed to resolve by arbitration. *Toal v Tardif* (2009) 178 CA4th 1208, 101 CR3d 97 (attorney's signature on arbitration agreement does not bind client unless client ratified agreement); *Mitri v Arnel Mgmt. Co.* (2007) 157 CA4th 1164, 69 CR3d 223 (no agreement to arbitrate when employee handbook announced policy to arbitrate disputes and stated employees would be given copy of "signed arbitration agreement," but employer provided no evidence of signed arbitration agreement).

If an agreement to arbitrate exists, the arbitration clause should be interpreted broadly. *First Options of Chicago v Kaplan, supra* (issues will be considered arbitrable unless arbitration clause cannot be interpreted to cover dispute; any doubts about scope of arbitrable issues should be resolved in favor of arbitration). The normal means of interpreting the scope of an arbitration provision is to apply a "plain meaning" interpretation to its terms. See, *e.g., Allen v Superior Court* (2003) 111 CA4th 217, 224, 3 CR3d 377. Arbitration agreements may encompass causes of action other than breach of contract. See *Amalgamated Transit Union Local 1277,* 107 CA4th at 684. The scope of arbitration is limited only by the scope of the parties' agreement, and the power of the arbitrator is similarly defined by the parties' stipulation of submission. *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 8, 10 CR2d 183; *Flores v Axxis Network & Telecommunications, Inc.* (2009) 173 CA4th 802, 93 CR3d 1 (labor agreement carved out exception from arbitration for alleged violations of wage laws). If an agreement provides for arbitration, arbitration is the only forum available for disputes that fall within the scope of the provision unless both parties waive arbitration. *CBCO, Inc. v Grain Installation, Inc.* (1979) 95 CA3d 290, 157 CR 28. Arbitration must proceed as the parties themselves have agreed, and a party may not avoid the terms of an arbitration clause if it is unambiguous. To the extent that procedures in the arbitration agreement differ from the default procedures in the CAA, the terms of the contract will control (unless they violate public policy). *Parker v McCaw* (2005) 125 CA4th 1494, 1506, 24 CR3d 55.

An arbitrator's award may provide for any remedy that is rationally drawn from the contract as interpreted by the arbitrator. *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 36 CR2d 581. Thus, an arbitration agreement permitting the arbitrator to grant "any remedy or relief which the Arbitrator deems just and equitable and within the scope of the agreement" allows the arbitrator to grant broad equitable remedies, including specific performance that

would require detailed oversight by the arbitrator.

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E. Defenses to Enforcement of Arbitration Clause

§9.42 1. Unconscionability

Like contracts generally, an agreement to arbitrate may not be enforced if it is unconscionable. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745; CC §1670.5. See, *e.g., Discover Bank v Superior Court* (2005) 36 C4th 148, 30 CR3d 76 (in consumer adhesion contract, arbitration provision waiving class arbitration was unconscionable when disputes between parties predictably involved small amounts of damages and party with greater bargaining power allegedly deliberately cheated large number of customers out of individually small amounts); *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65 (class action waiver in arbitration agreement substantively unconscionable; waiver was unfairly one-sided because it benefited only employer, which was unlikely to sue its employees in class action); *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818 (arbitration agreement unconscionable when agreement contained class arbitration waiver contrary to public policy and inequitable arbitration selection clause that inaccurately described single arbitrator selected by employer a "panel" of arbitrators); *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471 (arbitration agreement that gave arbitrator exclusive authority to determine enforceability, required employee to pay portion of costs, and severely limited discovery was substantively unconscionable).

NOTE: Plaintiffs may not challenge an arbitration clause in the abstract; the clause must have been invoked against them or otherwise have caused damage. *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 638, 88 CR3d 859. In *Meyer*, the plaintiffs sued Sprint, alleging its arbitration agreement was unconscionable under the Consumers Legal Remedies Act (CC §§1750-1756), but they did not allege that it had damaged them. The court ruled "a plaintiff has no standing to sue under the CLRA without some allegation that he or she has been damaged by an alleged unlawful practice." 45 C4th at 638.

For a general discussion of the doctrine of unconscionability, see §§5.76-5.80.

NOTE: Federal law also recognizes unconscionability as a defense to enforcement of arbitration agreements. See *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 687, 134 L Ed 2d 902, 909, 116 S Ct 1652; *Nagrampa v Mailcoups, Inc.* (9th Cir 2006) 469 F3d 1257.

The courts have recognized that unconscionability has two aspects, procedural and substantive, and that both must exist before a contract or arbitration provision will be found unconscionable. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 113, 99 CR2d 745; *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 85 CR3d 817. Procedural unconscionability (see §§5.77, 9.43) focuses on the manner in which the agreement was negotiated, *i.e.,* because of unequal bargaining power, one party was oppressed or surprised by a contract term, while substantive unconscionability (see §§5.78, 9.44) focuses on the terms of the agreement, *i.e.,* their overly harsh or one-sided result. *Bruni v Didion* (2008) 160 CA4th 1272, 73 CR3d 395. The more procedural unconscionability present, the less substantive unconscionability is required to render a contract or clause unenforceable, and vice versa. *Armendariz*, 24 C4th at 114; *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818. Even if the arbitration clause provides that the arbitrator may not change the contract between the parties, the arbitrator can still find that certain provisions of the contract are unconscionable and should not be enforced. *J.C. Gury Co. v Nippon Carbide Indus. (USA) Inc.* (2007) 152 CA4th 1300, 62 CR3d 118.

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§9.43 a. Procedural Unconscionability

The procedural unconscionability element focuses on "oppression" or "surprise" due to unequal bargaining power. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745; *Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65 (new dispute resolution policy distributed to low-wage employees that required arbitration was procedurally unconscionable given (1) parties' inequality in bargaining power; (2) policy description written in English and Spanish inaccurately described policy as requiring mediation rather than arbitration; and (3) policy itself appeared in much smaller type and only in English); *Ontiveros v DHL Express (USA), Inc.* (2008) 164 CA4th 494, 79 CR3d 471 (one-page arbitration agreement in small font that was part of packet of hiring papers employee was told to fill out, sign, and return in order to start work was procedurally unconscionable). See also *D.C. v Harvard-Westlake Sch.* (2009) 176 CA4th 836, 98 CR3d 300 (rejecting contention that arbitration and attorney fee provisions in context of private school enrollment contract were procedurally unconscionable).

In general, procedural unconscionability is established by showing a contract of adhesion. *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 1071, 130 CR2d 892. An adhesion contract is "a standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it." *Armendariz,* 24 C4th at 113 (citations omitted). In *Bruni v Didion* (2008) 160 CA4th 1272, 1293, 73 CR3d 395, the court held that an arbitration agreement the plaintiff had to accept in order to buy a house was unenforceable as an adhesion contract when the agreement took up one page in a 30-page, single-spaced booklet buried in a "voluminous stack of [home] purchase and sale documents."

An adhesion contract or provision will not be enforced against the weaker or adhering party if it does not fall within the reasonable expectations of that party. *Armendariz,* 24 C4th at 113. Even if the contract or arbitration provision is within the reasonable expectation of the parties, it will not be enforced if, as a matter of equity, the court finds that "considered in its context, it is unduly oppressive or 'unconscionable.'" 24 C4th at 113. See, *e.g., Mitchell v American Fair Credit Ass'n* (2002) 99 CA4th 1345, 122 CR2d 193 (refusing to compel arbitration when credit services association modified its membership contract to require arbitration by simply notifying its members by mail that continued membership in association constituted acceptance of modification).

Although a finding of an adhesion contract almost always equates with a finding of procedural unconscionability, an adhesion contract or provision is *not* a prerequisite to a finding of procedural unconscionability. *Harper v Ultimo* (2003) 113 CA4th 1402, 1410, 7 CR3d 418. No contract, whether or not it is a contract of adhesion, will be enforced if it is unconscionable. See *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 828, 171 CR 604 (arbitration clause lacking minimum levels of integrity would be denied enforcement in any circumstances).

For further discussion of procedural unconscionability, see §5.77.

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§9.44 b. Substantive Unconscionability

The substantive unconscionability element focuses on "overly harsh" or "one-sided results." *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 114, 99 CR2d 745 (mandatory employment arbitration agreement that required employee, but not employer, to arbitrate claims arising out of employee's termination, in absence of reasonable business justification, was unconscionable). Relying on *Armendariz*, the court in *Bruni v Didion* (2008) 160 CA4th 1272, 73 CR3d 395, held substantively unconscionable an arbitration agreement that was unforeseeably broad and "beyond the reasonable expectations" of the homebuyer. The agreement, contained in what was labeled a warranty, purported to apply to any dispute "arising from or related to the subject home." 160 CA4th at 1294. See also *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892 (arbitration agreement's provision that only awards greater than $50,000 were subject to review was unconscionably one-sided and thus unenforceable; $50,000 threshold inordinately benefited employer and was not justified by "legitimate commercial need").

Although a wide variety of factors may contribute to making an arbitration provision substantively unconscionable, the primary factor is lack of mutuality; the key question is whether the contract terms are so one-sided or harsh as to lack basic fairness. *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 657, 9 CR3d 422. See, *e.g., Olivera v El Pollo Loco* (2009) 173 CA4th 447, 93 CR3d 65 (class action waiver in arbitration agreement substantively unconscionable; waiver was unfairly one-sided because it benefited only employer, which was unlikely to sue its employees in class action); *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818 (arbitration clause designating "panel" of arbitrators that, in reality, was only one arbitrator selected by employer was substantively unconscionable); *Martinez v Master Protection Corp.* (2004) 118 CA4th 107, 12 CR3d 663 (unconscionable employment arbitration agreement lacked mutuality, imposed unacceptable costs on employee, and imposed unfair 6-month limitation on assertion of claims); *Fitz v NCR Corp.* (2004) 118 CA4th 702, 13 CR3d 88 (arbitration agreement in employment contract was unconscionable because it did not allow for adequate discovery and required arbitration of claims likely to be brought by employee but not employer); *Gutierrez v Autowest, Inc.* (2003) 114 CA4th 77, 7 CR3d 267 (arbitration clause in automobile lease agreement was unconscionable because fees required to initiate arbitration were unaffordable and there was no provision for consumer to seek fee waiver).

For examples of arbitration agreements that were found not to be substantively unconscionable, see, *e.g., Roman v Superior Court* (2009) 172 CA4th 1462, 92 CR3d 153 (arbitration clause not substantively unconscionable when it applied to "all disputes" whether initiated by employee or employer, did not limit employees' statutory rights under FEHA, and did not impose undue limits on discovery); *Brown v Wells Fargo Bank, N.A.* (2008) 168 CA4th 938, 955, 85 CR3d 817 (arbitration agreement providing for arbitration under NASD rules approved by SEC not substantively unconscionable); *24 Hour Fitness, Inc. v Superior Court* (1998) 66 CA4th 1199, 1212, 78 CR2d 533 (arbitration clause not substantively unconscionable when it applied equally to employer and employee, allowed both parties discovery substantially equal to that in civil actions, and created no imbalance in remedies between parties); *American Software, Inc. v Ali* (1996) 46 CA4th 1386, 54 CR2d 477 (commission agreement not unconscionable; under circumstances at time contract made, agreement was not one-sided but reflected parties' reasonable expectations).

For further discussion of substantive unconscionability, see §5.78.

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§9.45 2. Fraud in Execution

Claims of fraud in the execution of the entire agreement are not arbitrable; the agreement is negated by fraud in its inception and there is no arbitration agreement to enforce. *Prima Paint Corp. v Flood & Conklin Mfg. Co.* (1967) 388 US 395, 403, 18 L Ed 2d 1270, 1277, 87 S Ct 1801; *Rosenthal v Great W. Fin. Sec. Corp.* (1996) 14 C4th 394, 416, 58 CR2d 875; *Duffens v Valenti* (2008) 161 CA4th 434, 74 CR3d 311. See, *e.g., Jones v Adams Fin. Servs.* (1999) 71 CA4th 831, 84 CR2d 151 (defendant could not compel arbitration on basis of arbitration provision in loan agreement when defendant had fraudulently induced elderly plaintiff into signing agreement).

Claims of fraud in the inducement relating to other terms of the agreement, however, do not make the arbitration provision unenforceable, even if the fraud might justify rescission of the contract. *Rosenthal v Great W. Fin. Sec. Corp., supra*; Duffens v Valenti, supra. If the arbitration clause in an agreement may reasonably be construed to encompass a fraud claim, the parties must arbitrate even if one party alleges that the agreement was procured by fraud. *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v 100 Oak St.* (1983) 35 C3d 312, 197 CR 581; *Larian v Larian* (2004) 123 CA4th 751, 19 CR3d 916; *Johnson v Siegel* (2000) 84 CA4th 1087, 1094, 101 CR2d 412. For further discussion of fraud in the inducement, see §3.11.

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§9.46 3. Waiver

A party to a contract with an arbitration clause may be able to avoid arbitration if it can establish that the other party has waived or is estopped from asserting its right to compel arbitration. Whether a party has waived the right to arbitration is a question of fact. *Berman v Health Net* (2000) 80 CA4th 1359, 1363, 96 CR2d 295; *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 64 CR2d 843. Both state and federal law require "close judicial scrutiny of waiver claims" and waiver will not be lightly inferred. *Saint Agnes Med. Ctr. v PacifiCare of Cal.* (2003) 31 C4th 1187, 1195, 8 CR3d 517. Under both state and federal law, in the absence of a specific attack on the arbitration agreement, a party that repudiates the contract containing the arbitration agreement does not necessarily waive the right to arbitrate. 31 C4th at 1198. See also *Prima Paint Corp. v Flood & Conklin Mfg. Co.* (1967) 388 US 395, 405, 18 L Ed 2d 1270, 1278, 87 S Ct 1801. Moreover, a party that first seeks to resolve the matter in court does not thereby waive its right to arbitration if the other party remains willing to arbitrate the dispute. See *Saint Agnes Med. Ctr.,* 31 C4th at 1201; *Kalai v Gray* (2003) 109 CA4th 768, 135 CR2d 449; *Doers v Golden Gate Bridge, Highway, & Transp. Dist.* (1979) 23 C3d 180, 183, 151 CR 837 ("the mere filing of a lawsuit does not constitute a waiver of the right to arbitrate").

There is no single test for whether a party's conduct amounts to a waiver of arbitration, under either state or federal law. *Wagner Constr. Co. v Pacific Mechanical Corp.* (2007) 41 C4th 19, 29, 58 CR3d 434. See also *Adams v Merrill Lynch Pierce Fenner & Smith* (10th Cir 1989) 888 F2d 696, 701. Rather, the courts consider a variety of factors in determining whether by its conduct a party has waived arbitration. These factors include whether:

- The actions of the party seeking to arbitrate are inconsistent with the right to arbitrate;
- Before notifying the opposing party of the intent to arbitrate, the parties were "well into" lawsuit preparation and had substantially invoked "the litigation machinery";
- A defendant seeking arbitration had filed a counterclaim in the litigation without seeking a stay;
- Arbitration was requested or a stay sought close to the trial date or after a long delay;
- The parties had taken important steps, such as engaging in discovery that is unavailable in arbitration; or
- The delay "affected, misled, or prejudiced" the opposing party.

Saint Agnes Med. Ctr. v PacifiCare of Cal. (2003) 31 C4th 1187, 1196, 8 CR3d 517; *Sobremonte v Superior Court* (1998) 61 CA4th 980, 72 CR2d 43. See also *Cox v Ocean View Hotel Corp.* (9th Cir 2008) 533 F3d 1114, 1124.

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§9.47 4. Unwaivable Statutory Rights

Restrictions on enforceability. Although under California and federal law the parties can usually agree to arbitrate statutory claims, "arbitration agreements that encompass *unwaivable* statutory rights must be subject to particular scrutiny." *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 100, 99 CR2d 745 (emphasis in original) (setting out conditions under which employer can require employees to arbitrate claims under Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996)); *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892 (extending *Armendariz* to arbitration of certain non-FEHA claims); *D.C. v Harvard-Westlake Sch.* (2009) 176 CA4th 836, 98 CR3d 300 (holding *Armendariz* applies to claims involving California hate crime laws). An unwaivable statutory right is one enacted for public purpose. See *Fittante v Palm Springs Motors, Inc.* (2003) 105 CA4th 708, 129 CR2d 659 (Lab C §970, which was enacted to prevent unscrupulous treatment of employees who are induced to move on promise of employment, was enacted for public purpose). See also CC §3513 (although anyone may waive a law intended solely for his or her benefit, "a law established for a public reason cannot be contravened by a private agreement"). Arbitration of federal antidiscrimination claims is not similarly restricted, however. *14 Penn Plaza LLC v Pyett* (2009) __US __, 173 L Ed 2d 398, 129 S Ct 1456 (collective bargaining agreement that required union members to arbitrate claim under Age Discrimination in Employment Act (29 USC §§621-634) was enforceable).

In *Gentry v Superior Court* (2007) 42 C4th 443, 64 CR3d 773, the California Supreme Court found that in some cases, enforcing waivers of the right to class arbitration would pose a serious obstacle to enforcement of the state's overtime laws. The court held that class arbitration waivers should not be enforced if class arbitration would be significantly more effective in vindicating the rights of affected individuals. In *Franco v Athens Disposal Co.* (2009) 171 CA4th 1277, 1282, 90 CR3d 539, the court held that a class arbitration waiver in a trash truck drivers' employment agreement was invalid with respect to alleged violations of California meal and rest period laws "given the modest size of the potential individual recovery, the potential for retaliation against members of the class [and] the fact that absent members of the class may be ill informed about their rights." Moreover, because the agreement sought to bar the plaintiff from acting as a private attorney general, it was contrary to the Labor Code Private Attorney General Act (Lab C §§2698-2699.5). See also *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818.

***Armendariz* requirements.** To ensure that the arbitration of an unwaivable statutory right permits the vindication of that right, the arbitration must meet certain standards. *Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745 (employee's claim for employment discrimination under FEHA is arbitrable if arbitration permits employee to vindicate FEHA rights). See *Little v Auto Stiegler, Inc., supra* (*Armendariz* requirements apply general state law contract principles involving unwaivability of public rights to unique context of arbitration; arbitration of claim of wrongful termination in violation of public policy must meet *Armendariz* requirements); *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 652, 9 CR3d 422. See also *Graham Oil Co. v ARCO Prods. Co.* (9th Cir 1994) 43 F3d 1244, 1246 (arbitration agreement unenforceable because arbitration clause resulted in plaintiff's forfeiting important statutorily mandated rights under Petroleum Marketing Practices Act (15 USC §§2801-2841)).

NOTE: The arbitration agreement in *Armendariz* was a mandatory employment agreement that the employee had to sign as a condition of employment. Arbitration agreements knowingly and voluntarily entered into by the parties *after* a dispute has arisen generally would not be subject to these additional *Armendariz* requirements. See *Armendariz,* 24 C4th at 103 n8.

In addition to requiring a neutral arbitrator (an essential requirement of any arbitration agreement), a contract to arbitrate an unwaivable public right under *Armendariz* must provide, at a minimum, for the following (*Armendariz,* 24 C4th at 102):

- Adequate discovery (see *Fitz v NCR Corp.* (2004) 118 CA4th 702, 13 CR3d 88 (arbitration agreement provision limiting discovery to only two depositions did not affect both parties equally and did not provide plaintiff with sufficient discovery, because employer already possessed many relevant documents and employed many relevant witnesses));
- A written decision that permits limited judicial review;

- All the types of relief that would otherwise be available in court, *e.g.,* punitive damages and attorney fees; and
- Limitations on arbitration costs, *e.g.,* when the agreement covers FEHA claims, the employer must pay all costs unique to the arbitration.

See also *Craig v Brown & Root, Inc.* (2000) 84 CA4th 416, 100 CR2d 818 (employer's dispute resolution procedures satisfied *Armendariz* requirements).

The *Armendariz* requirements also apply to claims for wrongful termination in violation of public policy. *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892. See also *D.C. v Harvard-Westlake Sch.* (2009) 176 CA4th 836, 98 CR3d 300 (holding *Armendariz* applies to claims involving California hate crime laws, which allow attorney fee awards only to plaintiffs; thus, award of arbitration fees and expenses to defendant was invalid).

It is an open question whether the *Armendariz* requirements apply to predispute agreements that were negotiated at arm's length by parties of relatively equal bargaining strength (*e.g.,* an arbitration provision in a negotiated agreement with a high-level executive).

Enforceability analysis. In analyzing whether an arbitration agreement is enforceable, the court may begin by determining whether one party seeks to arbitrate a claim arising from "unwaivable public rights"; if so, the analysis begins with whether the agreement satisfies the requirements set out in *Armendariz*. *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 652, 9 CR3d 422. Alternatively, the court may evaluate the agreement first for possible contract unconscionability; if it finds the agreement unconscionable under traditional private contract principles, it need not reach the issue of whether it meets the *Armendariz* standards for public rights. *Nyulassy v Lockheed Martin Corp.* (2004) 120 CA4th 1267, 16 CR3d 296.

Private claims. Regarding purely private claims (*e.g.,* breach of contract), only the standard contract conscionability requirements apply. *Abramson v Juniper Networks, Inc., supra.* See *Boghos v Certain Underwriters at Lloyd's of London* (2005) 36 C4th 495, 30 CR3d 787 (*Armendariz* did not apply to claim for nonpayment of benefits under insurance contract or to claim for breach of covenant of good faith and fair dealing; case remanded to determine plaintiff's unconscionability claim).

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§9.48 5. Other Defenses

Other defenses to formation are available. See chap 3. For example, an arbitration agreement contained in a document that does not look like a contract will be unenforceable for lack of mutual consent. *Metters v Ralphs Grocery Co.* (2008) 161 CA4th 696, 74 CR3d 210. A valid agreement to arbitrate must exist. *Toal v Tardif* (2009) 178 CA4th 1208, 101 CR3d 97. See §9.41. Lack of capacity may also be a defense to an arbitration agreement. See, *e.g., Flores v Evergreen at San Diego, LLC* (2007) 148 CA4th 581, 55 CR3d 823 (invalidating arbitration agreement signed by husband of incompetent nursing home patient). But see *Hogan v County Villa Health Servs.* (2007) 148 CA4th 259, 55 CR3d 450 (upholding arbitration agreement signed on behalf of incompetent by child who held power of attorney). Illegality is also a defense. See *Little v Auto Stiegler, Inc.* (2003) 29 C4th 1064, 130 CR2d 892; *Green v Mt. Diablo Hosp. Dist.* (1989) 207 CA3d 63, 254 CR 689. See also CC §1667.

All arbitration provisions in contracts conveying real property must conform to certain requirements regarding form (see §9.36; CCP §1298), and parties cannot arbitrate claims for personal injury, wrongful death, or latent defects arising from real estate sales. CCP §1298.7. There is a question, however, whether these limitations survive the Federal Arbitration Act if there is any interstate commerce nexus. See *Doctor's Assocs., Inc. v Casarotto* (1996) 517 US 681, 134 L Ed 2d 902, 116 S Ct 1652; *Hedges v Carrigan* (2004) 117 CA4th 578, 11 CR3d 787. If the arbitration clause is contained in a real estate lease, it may be unenforceable. See *Jaramillo v JH Real Estate Partners, Inc.* (2003) 111 CA4th 394, 3 CR3d 525.

Courts will not enforce arbitration agreements if to do so would invalidate a statutory scheme, such as the Consumers Legal Remedies Act (CC §§1750-1756). *Cruz v PacifiCare Health Sys., Inc.* (2003) 30 C4th 303, 133 CR2d 58. See also *Sunnyvale Unified Sch. Dist. v Jacobs* (2009) 171 CA4th 168, 89 CR3d 546 (school district's decision not to "reelect" probationary teacher was not subject to contractual arbitration; because decision allegedly violated Educational Relations Act, California Public Relations Board had authority to remedy that violation). Further, courts will not enforce arbitration agreements that are against public policy. *Marriage of Bereznak* (2003) 110 CA4th 1062, 2 CR3d 351 (future child support payments could not be subject of binding arbitration) See also *Sanchez v Western Pizza Enters.* (2009) 172 CA4th 154, 90 CR3d 818. However, a petition to compel arbitration should not be denied based on the affirmative defense that the applicable statute of limitations has run; that is an issue for the arbiter to decide. *Wagner Constr. Co. v Pacific Mechanical Corp.* (2007) 41 C4th 19, 58 CR3d 434.

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§9.49 F. Arbitration of Attorney Fee Disputes

A growing area of contract litigation concerns disputes between attorneys and their clients regarding payment for legal services. The Mandatory Fee Arbitration Act (MFAA) (Bus & P C §§6200-6206) establishes procedures for arbitrating attorney fee disputes. Generally, the client has a right to mandatory arbitration (Bus & P C §6200(c)), but the attorney may obtain arbitration only if the client agrees (Bus & P C §6200(c)). The parties may agree in writing that any decision of the arbitrator will be binding; otherwise, the arbitration is nonbinding and either party may seek a trial de novo. Bus & P C §6204(a). See generally *Aguilar v Lerner* (2004) 32 C4th 974, 12 CR3d 287 (client waived his statutory rights under MFAA by suing attorney for legal malpractice under Bus & P C §6201(d)(2)); *Law Offices of Dixon R. Howell v Valley* (2005) 129 CA4th 1076, 29 CR3d 499 (client waived MFAA rights by delay and inconsistent behavior). The MFAA did not impliedly repeal the CAA, however. *Schatz v Allen, Matkins, Leck, Gamble & Mallory* (2009) 45 C4th 557, 87 CR3d 700 (when attorney and client have contractual arbitration agreement under CAA, attorney may enforce agreement to arbitrate after proceeding with nonbinding arbitration under MFAA and after client requests trial de novo).

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§9.50 G. Obligation of Nonsignatories to Arbitrate

A third party who is not a party to an arbitration agreement may be obligated to arbitrate if there is a preexisting relationship between one party and the nonsignatory third party that makes it equitable to bind the nonsignatory party or if the nonsignatory is a third party beneficiary to the contract. *Crowley Maritime Corp. v Boston Old Colony Ins. Co.* (2008) 158 CA4th 1061, 70 CR3d 605; *Zakarian v Bekov* (2002) 98 CA4th 316, 323, 119 CR 2d 623. In *Crowley,* the liability insurers that had settled with the insured sought equitable contribution from the nonsettling insurers. The non-settling insurers sought to compel arbitration based on their arbitration agreements with the insured. The court held the settling insurer was not obligated to arbitrate because it was not suing for benefits under the insurance contracts containing the arbitration clauses, but on the noncontractual ground of equitable contribution.

To require a nonsignatory to arbitrate under a third party beneficiary theory, there must be a direct benefit to the third party under the contract with the arbitration clause. In *City of Hope v Cave* (2002) 102 CA4th 1356, 126 CR2d 283, the court held that a third party who seeks arbitration of a contract carries the burden of proving that such party is the intended beneficiary under the contract.

In *Boucher v Alliance Title Co.* (2005) 127 CA4th 262, 268, 25 CR3d 440, the court noted that federal courts have identified five legal theories under which an arbitration clause can be enforced either by or against a nonsignatory third party. These are incorporation by reference, assumption, agency, piercing the corporate veil (alter ego), and estoppel. The *Boucher* case involved equitable estoppel, and the court ruled that under both federal and California case law, a nonsignatory third party defendant may invoke an arbitration clause to compel a signatory plaintiff to arbitrate its claims if the claims against the nonsignatory third party are "intimately founded in and intertwined" with the underlying contract obligations. 127 CA4th at 272 (citations omitted). An equitable estoppel claim was also at issue in *Goldman v KPMG, LLP* (2009) 173 CA4th 209, 92 CR3d 534. *Goldman* involved fraudulent tax shelter schemes; the court held that defendant accountants and lawyers who were nonsignatories to operating agreements containing arbitration clauses could not compel arbitration based on an equitable estoppel theory. One of the tax shelter schemes involved formation of limited liability companies in which the plaintiffs and their investment advisors were members. These LLCs had standard operating agreements with broad arbitration clauses. The court concluded that the obligations in the operating agreements were unrelated to the plaintiffs' claims of misconduct against the nonsignatory accountants and lawyers. But see *Turtle Ridge Media Group, Inc. v Pacific Bell Directory* (2006) 140 CA4th 828, 44 CR3d 817 (arbitration clause in contract between defendant and prime contractor was binding on plaintiff subcontractor when prime contract had been incorporated by reference into agreement between prime contractor and subcontractor).

If the nonsignatory party has no relationship with a party to the agreement, however, the nonsignatory party cannot be forced to arbitrate. *Matthau v Superior Court* (2007) 151 CA4th 593, 60 CR3d 93 (nonsignatory son of deceased actor not bound by his father's agreement to arbitrate; none of the legal principles that may bind nonsignatory applied); *Zakarian v Bekov, supra*; *Buckner v Tamarin* (2002) 98 CA4th 140, 119 CR2d 489 (arbitration agreement between physician and deceased patient did not require third party survivors to arbitrate wrongful death claim against physician, because decedent was not agent of survivors); *Hollister v Benzl* (1999) 71 CA4th 582, 587, 83 CR2d 903 (independent contractor physician not bound by contract between his medical group and plaintiff's health plan).

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§9.51 H. Scope of Arbitrator's Authority to Grant Relief

Arbitrators have broad discretion to craft an award to fit the circumstances of the case. In *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 36 CR2d 581, an arbitrator in a dispute between two microchip manufacturers awarded the claimant a permanent, royalty-free license to any intellectual property in a particular microchip and a 2-year extension of certain patent and copyright licenses. The award was sustained by the California Supreme Court because it was rationally related to the contract and the breach—but this is a minimal standard: An award will be deemed "rationally related" to a breach if it is aimed at compensating for or alleviating the effects of the breach. "The required link may be to the contractual terms as actually interpreted by the arbitrator, to an interpretation implied in the award itself, or to a plausible theory of the contract's general subject matter, framework or intent." *County of Solano v Lionsgate Corp.* (2005) 126 CA4th 741, 748, 24 CR3d 362 (citing *Advanced Micro Devices,* 9 C4th at 381).

Arbitrators have the power to award damages. *Charles J. Rounds Co. v Joint Council of Teamsters No. 42* (1971) 4 C3d 888, 899, 95 CR 53. Moreover, unless the arbitration agreement provides otherwise, an arbitrator may award punitive damages and civil penalties. *County of Solano v Lionsgate Corp.* (2005) 126 CA4th 741, 24 CR3d 362; *Rifkind & Sterling, Inc. v Rifkind* (1994) 28 CA4th 1282, 33 CR2d 828 (punitive damages and attorney fees); *J. Alexander Sec., Inc. v Mendez* (1993) 17 CA4th 1083, 21 CR2d 826 (punitive damages award upheld although agreement did not expressly permit or exclude punitive damage awards).

Arbitrators may also award equitable relief. *California State Council of Carpenters v Superior Court* (1970) 11 CA3d 144, 159, 89 CR 625 (enforcement of collective bargaining agreement). In *David v Abergel* (1996) 46 CA4th 1281, 54 CR2d 443, an arbitrator, empowered under an arbitration clause to grant "any remedy or relief" available under California law, denied all relief sought by the claimant and awarded $75,000 in sanctions to the responding party on the ground that the claimant's action was frivolous within the meaning of CCP §128.5. The court of appeal held that the arbitrator had the authority to award the sanctions. However, in *Comedy Club, Inc. v Al Copeland Invs. Inc.* (9th Cir 2009) 553 F3d 1277 (applying California law), a trademark dispute, the court ruled that an arbitrator exceeded his authority when he attempted to bind a trademark licensee's nonparty relatives and ex-spouses to the award and enjoin them from owning or operating comedy clubs.

An exception to the general rule assigning broad powers to arbitrators exists if the parties "expressly and unambiguously limit those powers." *Gueyffier v Ann Summers, Ltd.* (2008) 43 C4th 1179, 77 CR3d 613. In *Gueyffier*, the parties agreed the arbitrator would have no power to modify or change any material term of the franchise contract, including the notice and cure provisions. The arbitrator excused the franchisee's failure to give notice and opportunity to defendant to cure its breaches, because as a result of those breaches the franchisee's store opened to immediate and disastrous results and had to close. The appellate court held the arbitrator had violated the parties' agreement limiting his powers. The California Supreme Court reversed, holding that excusing performance under specific factual circumstances did not amount to modifying or changing a material term of the franchise contract.

Unless the parties have agreed otherwise, costs and expenses of arbitration are allocated in accordance with CCP §1284.2. Under §1284.2, fees and expenses are divided pro rata, except that fees and expenses incurred for the benefit of a party are paid by that party. The parties may provide in the arbitration clause or submission agreement that costs will be allocated in a manner other than as required by statute. Arbitration agreements often provide that costs, expenses, and attorney fees will be awarded to the prevailing party or allocated as the arbitrator determines. See, *e.g., Kahn v Chetcuti* (2002) 101 CA4th 61, 123 CR2d 606.

An arbitrator lacks authority to award attorney fees without a provision permitting the award in the arbitration agreement. *Thompson v Jespersen* (1990) 222 CA3d 964, 272 CR 132. If attorney fees are wrongfully awarded in excess of the arbitrator's jurisdiction, the award may be subject to correction under CCP §1286.6 or to vacation under CCP §1286.2. 222 CA3d at 967.

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§9.52 I. Finality of Arbitration Award; Judicial Review

Generally, the arbitrator's decision is final and binding whether or not it is correct in law or in fact, even if the "error appears on the face of the award and causes substantial injustice to the parties." *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 6, 10 CR2d 183. See also *Oakland-Alameda County Coliseum Auth. v CC Partners* (2002) 101 CA4th 635, 124 CR2d 363. Both the California Arbitration Act (CAA) (CCP §§1280-1294.2) and the Federal Arbitration Act (FAA) (9 USC §§1-16) provide only limited grounds for judicial review of arbitration awards. See CCP §1286.2(a); 9 USC §10(a). In *Moore v First Bank* (2000) 22 C4th 782, 783, 94 CR2d 603, the California Supreme Court held that an arbitrator's erroneous failure to award attorney fees to the prevailing party could not be judicially corrected, even though the same order made by a court would have been reversible error, because the parties' entitlement to attorney fees was within the scope of the arbitration agreement.

The sufficiency of the evidence is not reviewable. *Case v Alperson* (1960) 181 CA2d 757, 761, 5 CR 635. The award will be upheld if it is "even arguably based on the contract; it may be vacated only if the reviewing court is *compelled* to infer the award was based on an extrinsic source." *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 381, 36 CR2d 581.

The sole statutory grounds for vacation of the award under the CAA are listed in CCP §1286.2(a) and include fraud or some other fundamental defect in the process itself. See, *e.g., Gebers v State Farm Gen. Ins. Co.* (1995) 38 CA4th 1648, 45 CR2d 725 (interested appraiser appointed by party); *Pacific Crown Distribs. v Brotherhood of Teamsters & Auto. Truck Drivers* (1986) 183 CA3d 1138, 228 CR 645 (fraud).

Another limit on the arbitrator's authority is that an arbitrator's award may not extend beyond the issues that were arbitrable under the contract between the parties. In *California Faculty Ass'n v Superior Court* (1998) 63 CA4th 935, 75 CR2d 1, a collective bargaining agreement directed an arbitrator to determine if a university president's decision denying tenure and promotion to a probationary faculty member was based on reasoned judgment. The court held that the arbitrator exceeded his authority under the agreement by undertaking an independent evaluation of the faculty member's performance and qualifications.

There is a further limited exception to the finality rule for an error that is so egregious that it yields a result entirely beyond the parties' expectations, *e.g.,* when the arbitrator exceeds his or her powers by arbitrarily remaking the contract under which the arbitration occurs (*PG&E v Superior Court* (1993) 15 CA4th 576, 19 CR2d 295) or when finality of the award would be inconsistent with protection of a party's statutory rights (*Board of Educ. v Round Valley Teachers Ass'n* (1996) 13 C4th 269, 52 CR2d 115; *Advanced Micro Devices, Inc. v Intel Corp., supra*). In *Moncharsh v Heily & Blase, supra,* the supreme court allowed judicial review and invalidation of an arbitration award that in effect violated public policy. This public policy exception was successfully argued in *Jordan v DMV* (2002) 100 CA4th 431, 123 CR2d 122 (arbitration award violated clear expression of public policy against making gifts of public funds). See also *City of Palo Alto v Service Employees Int'l Union* (1999) 77 CA4th 327, 91 CR2d 500.

The FAA also restricts the grounds on which an award may be reviewed to, *e.g.,* fraud; corruption; misconduct; material miscalculation of figures; material mistake in the description of any person, thing, or property referred to in the award; and awards based on a matter not submitted or matter of form not affecting the merits of the controversy. 9 USC §§10-11. In contrast to review of awards under the CAA, the FAA's provisions limiting the grounds for vacating or modifying arbitration awards are exclusive and parties cannot contract for more expansive review. *Hall St. Assocs. v Mattel* (2008) 552 US 576, 170 L Ed 2d 254, 128 S Ct 1396.

It is important to note, however, that the FAA provisions for judicial review of arbitration awards do not necessarily preempt California law. In *Cable Connection, Inc. v DirectTV, Inc.* (2008) 44 C4th 1334, 82 CR3d 229, the California Supreme Court ruled that the U.S. Supreme Court's holding in *Hall Street* was restricted to arbitration awards based on federal law under the FAA. In *Cable Connection*, the parties' arbitration agreement provided that the award was subject to judicial review for legal error, and the court held that the parties' agreement was enforceable.

In drafting arbitration agreements, practitioners should decide whether an arbitrator's errors of law should be subject to judicial review and explicitly address this issue in the arbitration clause. For example, if an arbitrator's legal error

should be grounds for review, a clause such as the following should be included:

> **The arbitrators shall prepare in writing and provide to the parties an award including factual findings and the reasons on which their decision is based. The arbitrators shall not have the power to commit errors of law or legal reasoning, and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error.**

In *Christensen v Smith* (2009) 171 CA4th 931, 937, 90 CR3d 57, the court held that a clause stating that the arbitrator "shall render an award in accordance with substantive California law" was not express and not specific enough to provide for judicial review for legal error.

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§9.53 J. Judicial Arbitration (CCP §§1141.10-1141.31)

Statutory arbitration under CCP §§1141.10-1141.31 is generally referred to as "judicial arbitration." This phrase is somewhat of a misnomer, however, because the arbitration is neither judicially conducted nor binding. Sitting judges do not act as arbitrators, and the right to trial de novo under CCP §1141.20 removes the finality associated with contractual arbitration. According to some courts, a more appropriate term for judicial arbitration is "extrajudicial mediation." See *Parker v Babcock* (1995) 37 CA4th 1682, 44 CR2d 602.

Mandatory judicial arbitration under CCP §1141.11 applies when the monetary damages claim is less than $50,000. Mandatory judicial arbitration will be ordered "if the amount in controversy, in the opinion of the court, will not exceed fifty thousand dollars ($50,000) for each plaintiff." CCP §1141.11. If a case is sent to arbitration and the plaintiff believes that the award may exceed $50,000, counsel should ask the court to lift the $50,000 cap.

Judicial arbitration under CCP §§1141.10-1141.31 differs from arbitration by agreement under CCP §§1280-1288.8 in several ways. For example, contractual arbitration under CCP §1280 is binding, whereas any party who is dissatisfied by a judicial arbitration award retains the right to trial de novo. CCP §1141.20. Rules of evidence not typically used in CCP §1280 arbitration cases apply to judicial arbitration cases, subject to specific modifications under the California Rules of Court. See Cal Rules of Ct §3.823(b). Superior courts retain jurisdiction over CCP §1141.10 cases when judicial arbitration is pending, while in CCP §1280 cases judicial authority can be compelled only by petition. Moreover, parties in judicial arbitration possess complete discovery rights, but in §1280 proceedings discovery is usually limited.

For further information on mandatory judicial arbitration, see California Civil Procedure Before Trial, chap 37 (4th ed Cal CEB 2004).

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VII. MEDIATION

§9.54 A. Generally

Mediation is a voluntary process involving an impartial third party who acts as a *facilitator* rather than a decision maker to help disputing parties reach a decision. Mediation procedures are not defined statutorily; parties relying on mediation choose the style of dispute resolution and the rules to be followed. The AAA publishes a series of mediation procedures. See Commercial Arbitration Rules and Mediation Procedures (Including Procedures for Large, Complex Commercial Disputes) (American Arbitration Association, June 1, 2009), available at http://www.adr.org/RulesProcedures. Other mediation services may implement their own special procedures.

Discussions of the parties during the course of mediation are generally inadmissible as evidence and not subject to discovery in any civil action or administrative proceeding, unless the parties agree otherwise. Evid C §§1119(a), 1122. Similarly, the mediated agreement is generally inadmissible as evidence, unless the agreement provides otherwise or the parties consent to its admissibility. Evid C §§1119(b), 1123. The agreement is admissible, however, to show fraud, duress, or illegality. Evid C §1123(d). See *Fair v Bakhtiari* (2006) 40 C4th 189, 199, 51 CR3d 871; *Rael v Davis* (2008) 166 CA4th 1608, 83 CR3d 745; *Estate of Thottan* (2008) 165 CA4th 1331; 81 CR3d 856. Mediation is a nonbinding procedure, but once an agreement has been reached and documented, that agreement is binding on the parties and can be enforced. Mediation has proven to be an effective procedure for resolving disputes that cannot be resolved through direct, unassisted negotiations. Mediation services are provided by several government and private nonprofit agencies, small private companies, and larger organizations, such as the AAA and JAMS. The mediator designated by the parties may but need not be a lawyer. Some participants prefer retired judges for their experience in deciding disputes.

For a more comprehensive discussion of mediation as an alternative dispute resolution procedure, see Advising California Employers and Employees, chap 20 (Cal CEB 2005).

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§9.55 B. Forms of Mediation Clauses

The AAA publishes sample contractual mediation clauses. See Drafting Dispute Resolution Clauses—A Practical Guide (American Arbitration Association, Sept. 1, 2007), available at http://www.adr.org/sp.asp?id=29159. The AAA model clause for mediation of future disputes is as follows:

> **If a dispute arises out of or relates to this contract, or the breach thereof, and if the dispute cannot be settled through negotiation, the parties agree first to try in good faith to settle the dispute by mediation administered by the American Arbitration Association under its Commercial Mediation Procedures before resorting to arbitration, litigation, or some other dispute resolution procedure.**

JAMS also publishes sample contract mediation clauses, available on the JAMS website. See http://www.jamsadr.com/rules/clauses.asp. The JAMS model clause for mediation of future contract disputes is as follows:

> **Except as provided herein, no civil action with respect to any dispute, claim or controversy arising out of or relating to this Agreement may be commenced until the matter has been submitted to JAMS for mediation. Either party may commence mediation by providing to JAMS and the other party a written request for mediation, setting forth the subject of the dispute and the relief requested. The parties will cooperate with JAMS and with one another in selecting a mediator from [a] JAMS panel of neutrals, and in scheduling the mediation proceedings. The parties covenant that they will participate in the mediation in good faith, and that they will share equally in its costs. All offers, promises, conduct and statements, whether oral or written, made in the course of the mediation by any of the parties, their agents, employees, experts and attorneys, and by the mediator and any JAMS employees, are confidential, privileged and inadmissible for any purpose, including impeachment, in any litigation or other proceeding involving the parties, provided that evidence that is otherwise admissible or discoverable shall not be rendered inadmissible or non-discoverable as a result of its use in the mediation. Either party may seek equitable relief prior to the mediation to preserve the status quo pending the completion of that process. Except for such an action to obtain equitable relief, neither party may commence a civil action with respect to the matters submitted to mediation until after the completion of the initial mediation session, or 45 days after the date of filing the written request for mediation, whichever occurs first. Mediation may continue after the commencement of a civil action, if the parties so desire. The provisions of this Clause may be enforced by any Court of competent jurisdiction, and the party seeking enforcement shall be entitled to an award of all costs, fees and expenses, including attorneys' fees, to be paid by the party against whom enforcement is ordered.**

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VIII. ELECTION OF REMEDIES

§9.56 A. Scope of Doctrine

Election of remedies refers to a plaintiff's right to choose, or the plaintiff's act of choosing, between two or more available but inconsistent remedies based on the same state of facts. *Denevi v LGCC, LLC* (2004) 121 CA4th 1211, 1218, 18 CR3d 276; *Wallis v Superior Court* (1984) 160 CA3d 1109, 1114, 207 CR 123. For example, damages and specific performance are separate, normally inconsistent remedies for breach of contract, and in general, a plaintiff cannot receive both. A plaintiff can request alternative remedies for legal damages or equitable relief in her or his complaint, but may not be awarded both to the extent that such an award would constitute a double recovery. *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 123 CR2d 432. For example, if a seller breaches a real estate sales contract and refuses to convey the property, the buyer cannot recover both the property itself through a decree of specific performance and also damages measured by the payments that he or she made towards the purchase price. *Rogers v Davis* (1994) 28 CA4th 1215, 34 CR2d 716; *BD Inns v Pooley* (1990) 218 CA3d 289, 266 CR 815.

NOTE: As discussed in §11.12, a buyer seeking specific performance may, in addition, recover incidental damages (*e.g.*, rents and profits lost during the period when the defendant wrongfully refused to convey the property) as necessary to vindicate the buyer's contractual rights. *Rogers v Davis, supra*; *BD Inns v Pooley*, *supra*.

Because the doctrine of election of remedies can be harsh in application, it is viewed with disfavor by the courts. It is based on principles of equitable estoppel, and its application is therefore limited by considerations of equity. First, it applies only when pursuit of alternative and inconsistent remedies would substantially prejudice the defendant. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 137, 135 CR 802. Second, it operates only when the plaintiff must choose between *inconsistent,* rather than merely different, remedial rights. *Denevi v LGCC, LLC, supra.* The remedies in question must be "necessarily repugnant to or a repudiation of" each other. *City of Orange v San Diego County Employees Retirement Ass'n* (2002) 103 CA4th 45, 59, 126 CR2d 405 (doctrine did not apply when plaintiff sought to join breach of contract claim with claims for restitution but was precluded from doing so by trial court's order for summary judgment). Third, it is applicable only if the remedy initially pursued is an actual remedy available to the plaintiff. If the plaintiff is mistaken and attempts to pursue a remedy to which he or she is not legally entitled, the plaintiff is not thereby precluded from pursuing the alternative remedy. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co., supra*. See also *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655 (plaintiff who attempted to rescind contract, but did not do so effectively, did not lose his right to maintain action for damages based on contract's affirmance). Finally, the doctrine may be limited by statute. For example, CC §1692 (discussed further in §11.57) expressly provides that a claim for damages is not inconsistent with a claim for rescission. Civil Code §1692 instructs the court to award complete relief to the plaintiff, including any consequential damages to which the plaintiff may be entitled, but not including duplicate or inconsistent items of recovery.

NOTE: One area of California law where the doctrine of election of remedies retains significant continuing vitality is real estate financing. Under the "security first" and "one action" rules (CCP §726(a)) and the antideficiency statutes (CCP §§580a, 580b, 580d), a creditor holding a deed of trust or other form of real property security has narrowly circumscribed remedial choices in the event of a borrower's default and can be sanctioned for electing improper enforcement techniques. The antideficiency legislation discourages and sometimes flatly prohibits a creditor from recovering anything beyond its security, even if the value of the security is less than the amount of the debt. This topic is beyond the scope of this title, but is comprehensively discussed in California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009).

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§9.57 B. When Made

Ordinarily, a plaintiff need not elect, and cannot be compelled to elect, between inconsistent remedies during the course of trial. *Denevi v LGCC, LLC* (2004) 121 CA4th 1211, 1221, 18 CR3d 276; *Wallis v Superior Court* (1984) 160 CA3d 1109, 1114, 207 CR 123. A plaintiff may plead inconsistent, mutually exclusive remedies, such as breach of contract and specific performance, in the same complaint. *Walton v Walton* (1995) 31 CA4th 277, 292, 36 CR2d 901; *Brandolino v Lindsay* (1969) 269 CA2d 319, 324, 75 CR 56. Moreover, a plaintiff may be granted a preliminary injunction to preserve the status quo, even if permanent injunctive relief would be inconsistent with other relief sought by the plaintiff. See *Southern Christian Leadership Conf. v Al Malaikah Auditorium Co.* (1991) 230 CA3d 207, 223, 281 CR 216.

If, however, a plaintiff has unequivocally and with knowledge elected to proceed on one of the alternative remedies sought, the plaintiff may be barred recourse to the other remedy. In this situation, the plaintiff is estopped based on his or her conduct or election, and the doctrine of election of remedies acts as a bar to prevent the plaintiff from pursuing an inconsistent remedy. *Wallis v Superior Court, supra.* Accepting a benefit under one alternative theory of relief that renders continued pursuit of the other alternative unfair or prejudicial to the defendant may constitute an election of remedies. *Southern Christian Leadership Conference v Al Malaikah Auditorium Co., supra*; *Perry v Robertson* (1988) 201 CA3d 333, 341, 247 CR 74.

Even if the plaintiff has not made an affirmative election, at some point in the proceedings an election of the appropriate remedy will have to be made so that the relief awarded is internally consistent. *Denevi v LGCC, LLC, supra*; *Walton v Walton, supra*. Some courts have held that an election should not be compelled before satisfaction of judgment, unless the plaintiff has gained some other benefit or advantage that would make it inequitable to allow the plaintiff to continue to pursue another, otherwise available remedy. *Denevi v LGCC, LLC*, *supra*; *Smith v Golden Eagle Ins. Co.* (1999) 69 CA4th 1371, 1375, 82 CR2d 300; *Southern Christian Leadership Conference v Al Malaikah Auditorium Co., supra*. Of course, based on principles of res judicata, a judgment in an action for breach of contract will bar subsequent action for additional relief based on the same breach. *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 905, 123 CR2d 432; *Tomaselli v Transamerica Ins. Co.* (1994) 25 CA4th 1766, 1770, 31 CR2d 224.

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Remedies: Damages

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§10.1 I. INTRODUCTION

In California, damages for breach of contract are governed generally by CC §§3300-3302 and 3353-3360. See §§10.3-10.11. Interest as an additional element of damages, if recoverable, is governed by CC §§3287 and 3289-3290. See §§10.22-10.28. Exemplary or punitive damages are not recoverable for breach of contract, even if the defendant's conduct was malicious, willful, or fraudulent, unless an independent tort is also involved. See §§10.48-10.51; CC §3294(a); *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 86 CR2d 855; *Power Standards Lab, Inc. v Federal Express Corp.* (2005) 127 CA4th 1039, 26 CR3d 202.

In addition to the general Civil Code provisions cited above, there are many other statutes governing particular types of contracts, which specify (and sometimes limit) damages and other remedies available for breach. See §10.2. See also §§6.38, 11.58.

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Source: Business Law/California Law of Contracts/10 Remedies: Damages/§10.2 II. DAMAGES FOR BREACH OF PARTICULAR TYPES OF CONTRACTS

§10.2 II. DAMAGES FOR BREACH OF PARTICULAR TYPES OF CONTRACTS

Following is a nonexclusive list of California and federal legislation governing remedies for breach of contract in particular kinds of transactions. See also §§6.38, 11.58. Remedies for breach of contracts for the sale or lease of goods subject to the Uniform Commercial Code are discussed in chap 12. When analyzing a particular contract dispute, it is important first to determine whether the contract is subject to special regulation under statutes such as those listed below, because these statutes take precedence over the more general principles discussed in §§10.3-10.11.

Type of Contract or Transaction	California Code Sections
Mobilehome rental agreements	CC §§798-799.11 (Mobilehome Residency Law)
Consumer purchases	CC §1722 (up to $600 recoverable by consumer in small claims court for lost wages and other expenses if retailer fails to deliver merchandise within agreed 4-hour delivery period or if utility or cable television company fails to provide service within agreed 4-hour period)
	CC §§1750-1784 (Consumers Legal Remedies Act)
	CC §§1790-1795.8 (Song-Beverly Consumer Warranty Act)
Retail sales	CC §1723 (right to refund or exchange of retail goods)
Dealings with credit service organizations	CC §§1789.10-1789.24 (Credit Services Act of 1984)
Retail installment sales	CC §§1801-1812.20 (Unruh Act)
Credit disability insurance	CC §§1812.400-1812.409
Real property lease—breach by lessee	CC §§1951-1954 (applicable to real estate leases executed on or after July 1, 1971)
Sureties	CC §§2787-2855
Homeowner's request for reconveyance under trust deed	CC §2941
Automobile financing	CC §§2981-2984.4 (Rees-Levering Act)
Contract to pay money	CC §3302
Real estate contract—breach of covenant of seizin, right to convey, warranty, or quiet enjoyment	CC §3304
Real estate contract—breach of covenant against encumbrances	CC §3305
Real estate contract—breach of agreement to convey	CC §§3306 (see §10.20), 3307
Real estate contract—breach of	CC §3306a

agreement to deliver quitclaim	
Real estate contract—breach of agreement to purchase	CC §3307
Real or personal property lease—breach by lessee	CC §3308 (not applicable to real estate leases executed on or after July 1, 1971, or to personal property leases subject to Division 10 of Commercial Code)
Obligations of common carriers	CC §§3315-3317
Agency agreement—breach of warranty of agent's authority	CC §3318
Private construction contracts	CC §3319
Public works contracts	CC §§3320-3321
Insurance policies	Ins C §10111
Investment securities	Corp C §§25000-25704
Commercial paper	Com C §§3101-3805
Franchises	Corp C §§31300-31306; Bus & P C §§20035-20036; 20999-20999.4; 21140.3-21140.4
Home improvement contracts	Bus & P C §§7150-7166
Swimming pool contracts	Bus & P C §7165-7173
Type of Contract or Transaction	**United States Code Sections**
Air freight	49 USC §41713 (Airline Deregulation Act of 1978)
Consumer purchases	15 USC §§1601-1667f (Truth in Lending Act)
	15 USC §§2301-2312 (Magnuson-Moss Warranty Act)
	15 USC §§41-58 (Federal Trade Commission Act)
Investment securities	15 USC §§77a-77aa (Securities Act of 1933); 15 USC §§78a-78oo (Securities Exchange Act of 1934)
Bills of lading issued by interstate motor carriers and freight forwarders	49 USC §14706

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III. DAMAGES FOR BREACH OF CONTRACT: GENERAL PRINCIPLES

§10.3 A. Benefit of the Bargain (CC §3300)

The goal of contract damages is to put the aggrieved party in the same position that it would have been in had the other party fully performed. Contract damages are often referred to as "expectation," "benefit of the bargain," or "compensatory" damages. The general measure of damages in California for breach of contract is set forth in CC §3300 as follows:

> For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.

This general principle governing damages for breach of contract was recently reiterated by the California Supreme Court in *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 967, 22 CR3d 340 (citations omitted):

> Damages awarded to an injured party for breach of contract "seek to approximate the agreed-upon performance."… The goal is to put the plaintiff "in as good a position as he or she would have occupied" if the defendant had not breached the contract.… In other words, the plaintiff is entitled to damages that are equivalent to the benefit of the plaintiff's contractual bargain.

See also *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 515, 28 CR2d 475; *Lu v Grewal* (2005) 130 CA4th 841, 848, 30 CR3d 623; Restatement (Second) of Contracts §347 (1981).

This "expectancy" goal of contract damages permeates the rules that apply to particular contract damage issues. An attorney handling a claim for breach of contract should begin his or her analysis by calculating all the benefits the client would have had if full performance had not been denied by the breach. Whenever application of precedent to the particular facts of a case does not give the aggrieved party all of these benefits, the attorney should review CC §3300 and the general principle of expectancy. This general principle should govern unless there is a specific statute or other rule of law to the contrary.

NOTE: Although promissory estoppel is a cause of action distinct from breach of contract, the principles governing recovery of damages and the proof requirements in each case are essentially the same. *US Ecology, Inc. v State* (2005) 129 CA4th 887, 906, 28 CR3d 894. Promissory estoppel is discussed in §3.53.

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§10.4 B. Requirement of Foreseeability (CC §3300)

In stating that recoverable damages for breach of a contract must be "proximately caused" by or "likely to result" from the breach, CC §3300 embodies the principle of reasonable foreseeability at the time of contracting, described in the classic case of *Hadley v Baxendale* (1854) 9 Ex 341, 156 Eng Rep 145, as follows:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered as either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

This contract rule of foreseeability is a principle that attempts to allocate risk fairly. If the parties could not reasonably foresee a potential loss, then the risk of that loss could not have been addressed and allocated in the contract. As stated by the California Supreme Court in *Erlich v Menezes* (1999) 21 C4th 543, 550, 87 CR2d 886:

> Contract damages are generally limited to those within the contemplation of the parties when the contract was entered into or at least reasonably foreseeable by them at that time; consequential damages beyond the expectation of the parties are not recoverable.…This limitation on available damages serves to encourage contractual relations and commercial activity by enabling parties to estimate in advance the financial risks of their enterprise.

See, *e.g., US Ecology, Inc. v State* (2005) 129 CA4th 887, 28 CR3d 894 (plaintiff-developer was selected by State of California to construct radioactive waste facility on land to be acquired from federal government; state failed to acquire site, but there was insufficient evidence that plaintiff's damages were caused by state's actions; evidence did not support conclusion that federal government would have transferred site on state's request). In *US Ecology, Inc.,* the court of appeal explained that the test for causation is whether the breach was a "substantial factor" in causing the damages. There must be a reasonably certain causal connection between the defendant's breach and the plaintiff's damages. "A proximate cause of loss or damage is something that is a substantial factor in bringing about that loss or damage.… The term 'substantial factor' has no precise definition, but 'it seems to be something which is more than a slight, trivial, negligible, or theoretical factor in producing a particular result.'" 129 CA4th at 909 (citations omitted).

In *Vu v California Commerce Club, Inc.* (1997) 58 CA4th 229, 68 CR2d 31, plaintiff-card players sued a card club alleging that their losses were attributable to the club's failure to provide security and investigate cheating by other players. The court held that the plaintiffs failed to prove that their damages were proximately caused by the club's alleged breach. The court reasoned that winning or losing at card games is the product of factors such as individual skill and luck, and it could not be said with reasonable certainty that the intervention of cheating was the cause of their losing hands.

In *Postal Instant Press, Inc. v Sealy* (1996) 43 CA4th 1704, 51 CR2d 365, the court reversed a judgment in favor of a franchisor against a franchisee for damages for lost future profits. The franchisee failed to pay royalties due, and the franchisor terminated the agreement. The court held that the franchisee's breach was not the direct or proximate cause of the franchisor's lost future profits. Rather, it was the franchisor's own decision to terminate the agreement that deprived it of its right to receive future royalty payments. But see *Radisson Hotels Int'l, Inc. v Majestic Towers, Inc.* (ND Cal 2007) 488 F Supp 2d 953 (distinguishing *Postal Instant Press, Inc.,* and awarding lost profits provided for in liquidated damages provision).

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§10.5 C. Requirement of Reasonableness (CC §3359)

Civil Code §3359 provides that "[d]amages must, in all cases, be reasonable, and where an obligation of any kind appears to create a right to unconscionable and grossly oppressive damages, contrary to substantial justice, no more than reasonable damages can be recovered." See *State v Pacific Indem. Co.* (1998) 63 CA4th 1535, 1551, 75 CR2d 69 (for breach of insurer's contractual duty to defend, state awarded damages measured by outside law firm's normal hourly rates rather than contingency fee arrangement). In *Postal Instant Press, Inc. v Sealy* (1996) 43 CA4th 1704, 1714, 51 CR2d 365 (also noted in §10.4), citing CC §3359, the court found that the franchisor's entitlement to its past due royalties, along with attorney fees and costs, and its right to install a new franchisee immediately in what had been the defendant's exclusive territory provided it with "reasonable" damages. But to grant the franchisor an additional award of lost future royalty payments would give the franchisor disproportionate compensation—in effect, a double recovery—that would be unreasonable and an "unconscionable and grossly oppressive" imposition on the defendant. To do so would be "contrary to substantial justice" between franchisors and franchisees in general as well as the franchisor and the defendant in this case.

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§10.6 D. Requirement of Reasonable Certainty (CC §3301)

Civil Code §3301 prohibits speculative damages. It provides that "[n]o damages can be recovered for a breach of contract which are not clearly ascertainable in both their nature and origin." CC §3301. See *Erlich v Menezes* (1999) 21 C4th 543, 558, 87 CR2d 886 (damages for emotional distress are speculative and not recoverable as consequential or special damages in action for breach of contract to construct house); *Auerbach v Great W. Bank* (1999) 74 CA4th 1172, 1191, 88 CR2d 718 (court reversed as "pure speculation" a jury's award of damages for breach of agreement to negotiate loan modification).

Although damages must be "clearly ascertainable" (CC §3301), the amount of damages need not be proven with absolute certainty if the fact of damage is clear. *Acree v General Motors Acceptance Corp.* (2001) 92 CA4th 385, 398, 112 CR2d 99; *DePalma v Westland Software House* (1990) 225 CA3d 1534, 1543 n10, 276 CR 214. "The law requires only that some reasonable basis of computation be used, and the result reached can be a reasonable approximation." *Acree,* 92 CA4th at 398. The theory underlying this principle is that a party whose wrongful conduct makes exact proof difficult should not be able to complain about certainty of proof. "[O]ne whose wrongful conduct has rendered difficult the ascertainment of damages cannot complain because the court must make an estimate of damages rather than an actual computation." *Gulf Ins. Co. v Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 CA4th 114, 136, 93 CR2d 534. Nevertheless, even though a plaintiff's proof of the amount of damage need not be mathematically precise, it must not be speculative. *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 969, 22 CR3d 340.

Toscano v Greene Music (2004) 124 CA4th 685, 21 CR3d 732, was a promissory estoppel case in which the plaintiff quit his job in reliance on an unfulfilled promise of employment. Analogizing to lost profits cases (see §§10.14-10.21), the court held that the plaintiff could recover the lost future wages he would have expected to earn from his former employer but for the defendant's promise—as long as the amount was not speculative, remote, or contingent and was supported by substantial evidence. "The only limitation on Toscano's recovery is that the fact and extent of his lost future earnings must be proven with reasonable certainty." 124 CA4th at 695. Because the plaintiff was an at-will employee, the court ruled that he was not entitled to an award of lost wages up until his retirement.

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§10.7 E. Rule Against Windfalls (CC §3358)

Civil Code §3358 embodies the general principle that the damages awarded for breach of contract cannot be excessive. This section expresses a rule against windfalls: "Except as provided by statute, no person can recover a greater amount in damages for the breach of an obligation, than he could have gained by the full performance thereof on both sides." CC §3358. It is a corollary of the rule in CC §3359 that contract damages must be reasonable. See §10.5. The nonbreaching party's damages cannot exceed what that party would have received had the contract been fully performed. "This limitation of damages for breach of a contract 'serves to encourage contractual relations and commercial activity by enabling parties to estimate in advance the financial risks of their enterprise.'" *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 986, 22 CR3d 340 (citation omitted). See also *Amelco Elec. v City of Thousand Oaks* (2002) 27 C4th 228, 243, 115 CR2d 900 (discussing importance of predictability regarding the cost of contractual relationships to our commercial system); *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 468, 277 CR 40. In *Lewis Jorge,* the California Supreme Court held that the parties' bargain did not include the plaintiff's potential profits on future construction projects that it had not bid on or been awarded.

In *DePalma v Westland Software House* (1990) 225 CA3d 1534, 1540, 276 CR 214, the plaintiff had taken an investment tax credit on computer hardware and software supplied by the defendant, which later malfunctioned. The defendant attempted to argue that the plaintiff's tax benefit constituted a windfall that should have been offset against the trial court's compensatory damage award for breach of contract. Rejecting this argument, the court of appeal held that, in breach of contract cases, tax consequences should not be considered as a mitigating factor in compensatory damages calculations, for several reasons: "the federal 'tax benefit rule' cancels out most windfalls to plaintiffs … estimating tax consequences is not useful because it is speculative, time-consuming, and confusing …[and] public policy is better served by having defendants pay the full amount of the damages they have caused by breaching their contracts." 225 CA3d at 1540.

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F. General and Special Damages

§10.8 1. General Damages

Damages for breach of contract are often characterized as one of two types: either general damages (sometimes called direct damages) or special damages (sometimes called consequential damages). *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 968, 22 CR3d 340.

General damages are deemed to flow directly and necessarily from a breach of contract or to arise naturally from the breach. See CC §3300 (damages that "in the ordinary course of things, would be likely to result" from the breach); §10.3. Because general damages are considered a necessary and natural consequence of a breach of contract, they are often described as being within the reasonable contemplation of the parties to the contract. Their occurrence is ordinarily predictable; therefore, the parties are deemed to have contemplated them at the time of contracting. *Lewis Jorge Constr. Mgmt., Inc.* 34 C4th at 968; *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 455, 277 CR 40.

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§10.9 2. Special Damages

Special damages are losses that would not arise inevitably from a breach of a similar contract. Rather, they are derivative or secondary losses that arise from the unique circumstances of the parties or of the particular contract at issue. For a plaintiff to recover special damages, either the special circumstances from which they arose must have been communicated to, or known by, the defaulting party, or else the defaulting party should have been aware of those circumstances at the time the contract was entered into. The former alternative is a subjective test; the latter is an objective test. Special damages are never presumed to have occurred merely from the fact of the breach, but instead represent losses that followed or arose from the initial damages caused by the breach. Special damages are considered part of the compensatory damages that are foreseeable and proximately caused by the breach. *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 968, 22 CR3d 340.

As stated by the California Supreme Court in *Lewis Jorge,* "a party assumes the risk of special damages liability for unusual losses arising from special circumstances only if it was 'advised of the facts concerning special harm which might result' from breach—it is not deemed to have assumed such additional risk… simply by entering into the contract." 34 C4th at 969 (citations omitted). The requirement of advance notice or knowledge as one of the prerequisites for recovery of special damages is founded on the principle that a contracting party does not assume unlimited responsibility for all consequences of a breach of contract. A party must be informed at the time of contracting of any special harm that might befall the other party in the event of a breach so that he or she may properly evaluate whether to accept the risk of entering into the contract. *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 456, 277 CR 40. See also *Millikan v American Spectrum Real Estate Servs. Cal., Inc.* (2004) 117 CA4th 1094, 1104, 12 CR3d 459.

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§10.10 G. Nominal Damages (CC §3360)

Civil Code §3360 states that: "[w]hen a breach of duty has caused no appreciable detriment to the party affected, he may yet recover nominal damages." There is a conflict of authority concerning whether this rule applies in breach of contract actions. *Xebec Dev. Partners, Ltd. v National Union Fire Ins. Co.* (1993) 12 CA4th 501, 576, 15 CR2d 726, disapproved in part on other grounds in *Essex Ins. Co. v Five Star Dye House, Inc.* (2006) 38 C4th 1252, 45 CR3d 362, as well as some earlier cases, *e.g., Sweet v Johnson* (1959) 169 CA2d 630, 632, 337 P2d 499, held that a plaintiff in a breach of contract action is entitled to recover nominal damages, even without proof of actual damages, because the defendant's failure to perform the contract is, in itself, a legal wrong that is distinct from any actual damage. Yet the court in *Bramalea Cal., Inc. v Reliable Interiors, Inc.* (2004) 119 CA4th 468, 473, 14 CR3d 302, stated that a "breach of contract is not actionable without damage." See also *Ruiz v Gap, Inc.* (ND Cal 2009) 622 F Supp 2d 908, 917 (breach of contract claim requires showing of "appreciable and actual damages"); *Strait v Wilkins* (1914) 23 CA 774, 139 P 911 (plaintiff suffered no actual damage in breach of contract case; judgment for nominal damages denied). In *Ruiz*, the court held that the plaintiff, who had suffered an increased risk of identity theft, had standing to bring a federal lost data case, but could not recover for breach of contract because his identity had not been stolen; an increased risk of identity theft was not "appreciable and actual damage." 622 F Supp 2d at 917.

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§10.11 H. Distinguished From Tort Damages

Contract damages are normally limited to damages within the actual contemplation of the parties at the time of contracting (or damages that were reasonably foreseeable by them at that time). Consequential damages that were beyond the expectations of the parties are not recoverable. See §§10.4, 10.9. "This limitation… serves to encourage contractual relations and commercial activity by enabling parties to estimate in advance the financial risks of their enterprise." *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 515, 28 CR2d 475. See also *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 98, 44 CR2d 420. In comparison, tort damages are intended to fully compensate the victim for all injury suffered. *Erlich v Menezes* (1999) 21 C4th 543, 550, 87 CR2d 886.

The distinction between tort and contract is founded in common law, and the remedies available in each area of law reflect different objectives. Contract damages are awarded to enforce the intent of the parties to the agreement, while tort law is principally designed to vindicate social policy. *Erlich,* 21 C4th at 551. As stated in *Freeman & Mills, Inc.,* 11 C4th 85 at 106:

> The restrictions on contract remedies serve purposes not found in tort law. They protect the parties' freedom to bargain over special risks and they promote contract formation by limiting liability to the value of the promise. This encourages efficient breaches, resulting in increased production of goods and services at lower cost to society.

Although the goals of contract and tort law are distinct, the boundary line between them is often uncertain. *Erlich* (discussed more fully in §10.31) involved a negligent breach of contract for which the plaintiffs sought to recover damages for emotional distress—but the court refused to allow recovery. The court noted the policy reasons for denying tort recovery in contract cases, including "the different objectives underlying tort and contract breach; the importance of predictability in assuring commercial stability in contractual dealings; the potential for converting every contract breach into a tort, with accompanying punitive damage recovery, and the preference for legislative action in affording appropriate remedies." *Erlich,* 21 C4th at 553. See also *Freeman & Mills,* 11 C4th at 97.

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§10.12 IV. MITIGATION OF DAMAGES

The rule that contract damages should put the aggrieved party in as good a position as full performance would have done is coupled with the requirement for mitigation of damages, so that this compensatory goal is achieved with minimal cost to the defendant. See *Valle de Oro Bank, N.A. v Gamboa* (1994) 26 CA4th 1686, 1691, 32 CR2d 329; Restatement (Second) of Contracts §350 (1981). "The doctrine of mitigation of damages holds that '[a] plaintiff who suffers damage as a result of either a breach of contract or a tort has a duty to take reasonable steps to mitigate those damages and will not be able to recover for any losses which could have been thus avoided.'" *Shaffer v Debbas* (1993) 17 CA4th 33, 114, 21 CR2d 110. See also *Royal Thrift & Loan Co. v County Escrow, Inc.* (2004) 123 CA4th 24, 33, 20 CR3d 37. A plaintiff cannot recover damages that are avoidable through the exercise of ordinary care and reasonable efforts. *Lu v Grewal* (2005) 130 CA4th 841, 849, 30 CR3d 623; *Mayes v Sturdy N. Sales, Inc.* (1979) 91 CA3d 69, 85, 154 CR 43, disapproved on other grounds in *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 521 n10, 28 CR2d 475. The doctrine of mitigation of damages comes into play when the event causing damage has already occurred; it then becomes the obligation of the injured party to make reasonable efforts to avoid continuing or enhanced damages.

NOTE: The aggrieved party may recover as mitigation damages the costs of its attempts to mitigate. *Millikan v American Spectrum Real Estate Servs. Cal., Inc.* (2004) 117 CA4th 1094, 1105, 12 CR3d 459; *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 277 CR 40 (accountant recovered as mitigation damages his business losses incurred in starting accountancy practice after defendant breached joint venture agreements for another practice; mitigation damages offset against plaintiff's eventual profits earned in new practice resulted in net mitigation offset in defendant's favor).

The duty to mitigate damages does not require an injured party to do what is unreasonable or impracticable. *Valencia v Shell Oil Co.* (1944) 23 C2d 840, 846, 147 P 840; *Lu,* 130 CA4th at 849. A plaintiff is not required to mitigate damages if financially unable to do so. *Berge v International Harvester Co.* (1983) 142 CA3d 152, 190 CR 815 (defective truck failed to operate properly, causing plaintiff's business to fail). A plaintiff is not required to incur expenses in trying to mitigate damages that are out of proportion to the damages that result from the defendant's breach or that may be beyond his or her financial means. It is sufficient if the plaintiff acts reasonably, with due diligence and in good faith. *Royal Thrift & Loan Co. v County Escrow, Inc.* (2004) 123 CA4th 24, 33, 20 CR3d 37.

The doctrine of mitigation of damages does not apply if its effect would be to require the nonbreaching party to sacrifice and surrender important and valuable rights. *Seaboard Music Co. v Germano* (1972) 24 CA3d 618, 623, 101 CR 255. Nonetheless, a plaintiff has an obligation to avoid an unwarranted enhancement of damages "through passive indifference or stubborn insistence upon a conceived legal right." *Green v Smith* (1968) 261 CA2d 392, 398, 67 CR 796.

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V. SPECIFIC ITEMS RECOVERABLE

§10.13 A. Failure to Pay Money Due (CC §3302)

Civil Code §3302 provides that "[t]he detriment caused by the breach of an obligation to pay money only, is deemed to be the amount due by the terms of the obligation, with interest thereon." This section codifies the common law rule of damages for breach of a contract to pay a sum certain. *Weaver v Bank of America* (1963) 59 C2d 428, 30 CR 4. Interest as an item recoverable is discussed in §§10.22-10.28.

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B. Lost Profits

§10.14 1. Generally

Breach of contract actions often include claims for lost profits. As a general rule, lost profits—either present or anticipated future profits—are recoverable if they are a direct and natural consequence of the breach and the occurrence and amount of lost profits can be shown with reasonable certainty. *Resort Video, Ltd. v Laser Video, Inc.* (1995) 35 CA4th 1679, 1698, 42 CR2d 136; *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 277 CR 40. As discussed in §10.3, under the general measure of damages for breach of contract, the nonbreaching party is ordinarily entitled to damages sufficient to place that party in the same position as if the breach had not occurred. Contract damages may include profits that the breach prevented the nonbreaching party from earning, to the extent the profits can be estimated with reasonable certainty. *Postal Instant Press, Inc. v Sealy* (1996) 43 CA4th 1704, 1708, 51 CR2d 365.

If recoverable, lost profits are ordinarily classified as special rather than general damages (see §§10.8-10.9) and are subject to certain limitations. Lost profits must be pled with particularity, and must be proven to be certain both as to their occurrence and their extent, although not with "mathematical precision." *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 975, 22 CR3d 340.

Lost profits recoverable are net profits, *i.e.,* gains made from sales "after deducting the value of the labor, materials, rents, and all expenses, together with the interest of the capital employed." *Resort Video, Ltd. v Laser Video, Inc.* (1995) 35 CA4th 1679, 1700, 42 CR2d 136 (citations omitted). See also *Carrey v Boyes Hot Springs Resort, Inc.* (1966) 245 CA2d 618, 54 CR 199. The plaintiff must show a loss of net income or gain, not simply a loss of gross revenues. *Resort Video, Ltd. v Laser Video, Inc., supra*. The offset need not include remote costs, such as overhead, that continue before and after the breach. *Oakland Cal. Towel Co. v Sivils* (1942) 52 CA2d 517, 126 P2d 651.

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§10.15 2. Requirement of Proximate Causation

Under contract damages principles, the nonbreaching party is entitled to recover only those damages, including lost profits, that are proximately caused by the defendant's breach. *St. Paul Fire & Marine Ins. Co. v American Dynasty Surplus Lines Ins. Co.* (2002) 101 CA4th 1038, 124 CR2d 818; *Postal Instant Press, Inc. v Sealy* (1996) 43 CA4th 1704, 51 CR2d 365. The lost profits sought must be "the natural and direct consequences of the breach." *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 457, 277 CR 40.

In some cases, it can be presumed that lost profits will necessarily result from a breach of the contract. In *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 971, 22 CR3d 340, the California Supreme Court noted that contracts involving crops, goods intended for resale, and agreements creating exclusive sales agencies are examples of transactions in which the likelihood of lost profits is so obvious that the breaching party must have contemplated them when the contract was entered into. "[T]he nature of the contract or the circumstances in which it is made may compel the inference that the defendant should have contemplated the fact that such a loss would be 'the probable result' of the defendant's breach." 34 C4th at 970 (citations omitted).

Proximate cause may be presumed in cases such as *Brandon & Tibbs, supra,* that involve a breach of a partnership or joint venture agreement, because partnerships and joint ventures are by definition associations for profit. See Corp C §16101(9). Like *Brandon & Tibbs, James v Herbert* (1957) 149 CA2d 741, 309 P2d 91, was an action for breach of a joint venture agreement. In each case, the defendants objected that lost profits were not within the contemplation of the parties, but the courts in both cases held it would be presumed that the parties contemplated lost profits (*Brandon & Tibbs,* 226 CA3d at 457):

> [W]here the object of the contract is profits[,] the lost profits are therefore recoverable as damages.…Where the prospective profits are the natural and direct consequences of the breach of the contract they may be recovered. Profits are part and parcel of the contract itself, entering into and constituting a portion of its very element; something stipulated for, the right to the enjoyment of which is just as clear and plain as to the fulfillment of any other stipulation. They are presumed to have been taken into consideration and deliberated upon before the contract was made, and formed, perhaps, the only inducement to the arrangement.

See also *James,* 149 CA2d at 749. But see *Hartley v Weller* (1951) 104 CA2d 118, 231 P2d 133 (lost profits from prospective oil well drilling contract by proposed partnership deemed too speculative).

In *Copeland v Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1262, 117 CR2d 875, the court ruled that the damages recoverable for breach of a contract to negotiate an agreement are limited to the injury the plaintiff suffered in relying on the defendant to negotiate in good faith. The damages would include the plaintiff's out-of-pocket costs in conducting the negotiations and may or may not include lost opportunity costs. The plaintiff, however, cannot recover for lost expectations or profits on the agreement proposed to be negotiated, because there is no way of knowing what the terms of that agreement would have been, or even whether the negotiations would have led to an ultimate agreement.

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§10.16 3. Evidence of Lost Profits; Measure of Damages

Lost profits of an established business are recoverable if the evidence shows their occurrence and extent with reasonable certainty. *Fisher v Hampton* (1975) 44 CA3d 741, 748, 118 CR 811. The plaintiff has the burden of producing the best evidence available to attempt to establish a lost profits claim. *S. C. Anderson, Inc. v Bank of America* (1994) 24 CA4th 529, 536, 30 CR2d 286. In meeting this burden, the plaintiff must prove that the lost profits are the natural and direct consequence of the specific breach of contract at issue. *Postal Instant Press, Inc. v Sealy* (1996) 43 CA4th 1704, 1709, 51 CR2d 365. Lost profits were not allowed in *Postal Instant Press,* which was an action by a franchisor who terminated the franchise agreement after the franchisee failed to make required monthly franchise fee payments. The court found that, under the circumstances, the potential loss of future fees was not proximately caused by the franchisee's breach, but instead by the franchisor's own decision to terminate the agreement.

Once the existence of lost profits has been established, recovery will not be denied simply because the amount cannot be shown with mathematical precision. *Westrec Marina Mgmt., Inc. v Jardine Ins. Brokers* (2000) 85 CA4th 1042, 1051, 102 CR2d 673; *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 889, 93 CR2d 364. "One whose wrongful conduct has rendered difficult the ascertainment of the damages cannot escape liability because the damages could not be measured with exactness." *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 458, 277 CR 40 (citations omitted).

If the fact of damage is certain, the trial court has discretion to select an appropriate measure to calculate damages. For example, the extent of lost profits may be measured by "the past volume of business and other provable data relevant to the probable future sales." *Shade Foods, Inc.,* 78 CA4th at 889. Lost profits may also be based on the profits earned by substantially similar businesses operating under similar circumstances. *Sanchez-Corea v Bank of America* (1985) 38 C3d 892, 907, 215 CR 679; *Berge v International Harvester Co.* (1983) 142 CA3d 152, 190 CR 815. In *Brandon & Tibbs,* the lost profits award was based on the expert testimony of a certified public accountant, who reviewed the actual income and expenses of the defaulting joint venturer's business and projected the results over a period of years. 226 CA3d at 457.

In *GHK Assocs. v Mayer Group, Inc.* (1990) 224 CA3d 856, 274 CR 168, the parties entered into contracts under which some developers undertook to build a condominium on an owner's property and agreed to pay the property owner 40 percent of the profits. The developer breached the contract by building an entirely different complex, using a different ownership and financing structure than that originally agreed on. The trial judge awarded the owner 40 percent of the profits of the project as built rather than 40 percent of the projected profits of the original project. The court of appeal affirmed, holding that the award was permissible notwithstanding its lack of certainty, particularly because the difficulty of calculating damages was largely attributable to the defendant's wrongful acts.

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§10.17 4. Breach of Contract Versus Tort Measures

Lost profits are recoverable in tort cases as well as in cases involving a breach of contract. See, *e.g., J'Aire Corp v Gregory* (1979) 24 C3d 799, 157 CR 407; *Kids' Universe v In2labs* (2002) 95 CA4th 870, 882, 116 CR2d 158. Under CC §3333, the tort measure of damages is "the amount which will compensate for all the detriment proximately caused [by the tort], whether it could have been anticipated or not." Contract damage principles, however, do not allow recovery for unanticipated injuries. *Lewis Jorge Constr. Mgmt., Inc. v Pomona Unified Sch. Dist.* (2004) 34 C4th 960, 969, 22 CR3d 340. See §10.11. Thus, there is a greater prospect for recovery under tort theories of liability. As the California Supreme Court in *Lewis Jorge Constr. Mgmt.* (a contract case) explained: "[D]amages for breach of contract are limited to losses that were either actually foreseen … or were "reasonably foreseeable" when the contract was formed." 34 C4th at 969.

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§10.18 5. Interruption or Destruction of Business

Damages for lost profits to a business that suffers an interruption of operations are generally confined to the period of time reasonably necessary to restore the business to its previous operational capacity. This usually means that the damages are limited to the period of interruption. Once the business is operating again, any profits allegedly lost afterwards are not necessarily due to the defendant's conduct, and become matters of speculation. *Blake v E. Thompson Petroleum Repair Co.* (1985) 170 CA3d 823, 834, 216 CR 568 (tort damages from fire on neighbor's property resulted in business interruption). See also *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 277 CR 40 (lost profits during business interruption are generally recoverable if shown to have been foreseeable and reasonably certain).

If a breach of contract causes an existing business to be terminated, *e.g.,* through termination of a lease, license, distributorship, or agency agreement, the plaintiff may recover the present value of profits that the business would have earned in the future (less any profits earned in mitigation). See *Daum Dev. Corp. v Yuba Plaza, Inc.* (1970) 11 CA3d 65, 89 CR 458, disapproved on other grounds in *Ninety Five Ten v Crane* (1991) 231 CA3d 36, 41, 282 CR 141.

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§10.19 6. Lost Profits of New Businesses

As discussed in §10.6, contract damages must be established with reasonable certainty. Accordingly, courts in some cases have ruled that the anticipated future profits of a new business are too speculative and conjectural to allow damages to be recovered for their alleged loss. See *Alder v Drudis* (1947) 30 C2d 372, 382, 182 P2d 195; *Macmorris Sales Corp. v Kozak* (1968) 263 CA2d 430, 442, 69 CR 719. This rule is not hard and fast, however. Lost future profits of a new business may be recovered if there is evidence that shows with reasonable certainty both their occurrence and their extent. "Uncertainty as to the *fact* of whether any damages were sustained at all is fatal to recovery, but uncertainty as to the *amount* is not." *Fisher v Hampton* (1975) 44 CA3d 741, 748, 118 CR 811 (emphasis in original). See also *Brandon & Tibbs v George Kevorkian Accountancy Corp.* (1990) 226 CA3d 442, 277 CR 40; *A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114.

Courts view the issue as one presenting problems of proof. See *Parlour Enters., Inc. v Kirin Group* (2007) 152 CA4th 281, 61 CR3d 243 (discussing how and why plaintiffs failed to present adequate evidence of lost profits); *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 889, 93 CR2d 364 (upholding award of contract damages for lost future profits of 3-month-old company); *Resort Video, Ltd. v Laser Video, Inc.* (1995) 35 CA4th 1679, 1698, 42 CR2d 136 (evidence of lost profits lacking). See also *Kids' Universe v In2labs* (2002) 95 CA4th 870, 882, 116 CR2d 158 (discussing availability of tort damages for lost future profits for new or unestablished business); *S. C. Anderson, Inc. v Bank of America* (1994) 24 CA4th 529, 536, 30 CR2d 286 ("Lost anticipated profits cannot be recovered if it is uncertain whether any profit would have been derived at all from the proposed undertaking.").

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§10.20 7. Contract Price/Market Value Differential

The contract price-market value differential (sometimes shortened to contract-market or market-contract differential) refers to a measure of damages applicable in sales transactions in the event a seller defaults by failing to convey the property. Assuming the buyer elects damages rather than specific performance or rescission as a remedy, the buyer is entitled to receive (1) the purchase price, if and to the extent previously paid, and (2) the difference between the fair market value of the property at the time of the breach and the contract purchase price. *Al-Husry v Nilsen Farms Mini-Market, Inc.* (1994) 25 CA4th 641, 650, 31 CR2d 28. See also *Resort Video, Ltd. v Laser Video, Inc.* (1995) 35 CA4th 1679, 42 CR2d 136. For real estate transactions, this rule is reflected in CC §3306, which provides:

> The detriment caused by the breach of an agreement to convey an estate in real property, is deemed to be the price paid, and the expenses properly incurred in examining the title and preparing the necessary papers, the difference between the price agreed to be paid and the value of the estate agreed to be conveyed at the time of the breach, the expenses properly incurred in preparing to enter upon the land, consequential damages according to proof, and interest.

The rule also appears in Division 2 of the California Commercial Code for sales of goods. See Com C §§2711(1), 2713(1), discussed in §§12.71-12.73, 12.93. The rule similarly applies in lease transactions. *Sanders Constr. Co. v San Joaquin First Fed. Sav. & Loan Ass'n* (1982) 136 CA3d 387, 186 CR 218, involved a breach by a tenant-builder of an agreement to lease land for construction of a building. The court ruled that the landlord was entitled to the present value of the promised rental payment stream less the present value of the depreciated value of the building that was to have remained on the land after termination of the lease.

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§10.21 8. Loss of Goodwill

A plaintiff may obtain compensatory damages for loss of goodwill of a business. *Walpole v Prefab Mfg. Co.* (1951) 103 CA2d 472, 230 P2d 36. See also *Baker v Pratt* (1986) 176 CA3d 370, 222 CR 253 (former shareholder in construction company brought action against other shareholder based on defendant's wrongful exclusion of plaintiff from corporate enterprise; court held that damages were awardable to corporation for unlawful use of corporation's goodwill); *Tamarind Lithography Workshop, Inc. v Sanders* (1983) 143 CA3d 571, 193 CR 409 (court awarded compensatory damages and injunctive relief for loss of publicity to film producer who did not receive screen credit agreed on in film production contract).

The general rule is that a plaintiff cannot recover damages for injury to his or her reputation as a result of a breach of contract. In *Colvig v RKO Gen., Inc.* (1965) 232 CA2d 56, 42 CR 473, however, the court held that general damages for wrongful discharge as a radio announcer could include not only loss of salary but also loss of public standing in the plaintiff's profession. *Colvig* has been held not to support a claim for specific performance of a contract as a means of compensating the plaintiff for damage to his reputation. *Barndt v County of Los Angeles* (1989) 211 CA3d 397, 405, 259 CR 372.

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C. Interest (CC §§3287, 3289, 3289.5)

§10.22 1. Express Contractual Provision for Interest (CC §§3289(a), 3289.5)

Civil Code §3289(a) provides that any legal rate of interest stipulated in a contract remains chargeable after its breach. See *Roodenburg v Pavestone Co.* (2009) 171 CA4th 185, 192, 197 CR3d 558 (express obligation to pay prejudgment interest enforced). The term "contract" in CC §3289 does not include a note secured by a deed of trust on real property. CC §3289. The rate of interest for damages for breach of a retail installment contract subject to the Unruh Act (CC §§1801-1812.20) is deemed to be the rate of the finance charge specified in the contract. CC §3289.5.

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§10.23 2. No Contractual Provision But Damages Certain or Calculable (CC §3287(a))

In the absence of an express contractual provision for interest, CC §3287(a) states the general rule concerning the right to recover prejudgment interest for a breach of contract. A party may recover interest on the amount of damages for breach of contract from the date when the contractual obligation becomes due if the damages are certain or are capable of being made certain by calculation and the obligation is due on a particular date. CC §3287(a). See also CC §3302. Prejudgment interest under CC §3287(a) is not discretionary with the court but must be awarded if there is a breach of contract and the claim is liquidated. *North Oakland Med. Clinic v Rogers* (1998) 65 CA4th 824, 76 CR2d 743. For contracts entered into after January 1, 1986, the rate of interest in such cases is 10 percent per year. CC §3289(b).

Civil Code §3287(a) reflects a general principle that interest should not be awarded on unliquidated damages. If there is conflicting evidence on the calculation or determination of damages, interest is generally not recoverable. *Distefano v Hall* (1968) 263 CA2d 380, 69 CR 691. As the California Supreme Court stated in *Olson v Cory* (1983) 35 C3d 390, 402, 197 CR 843, "Generally, the certainty required of [CC §3287(a)], is absent when the amounts due turn on disputed facts, but not when the dispute is confined to the rules governing liability." Nonetheless, prejudgment interest is awardable "if the amount due can be determined by reference to a fixed standard." *Marine Terminals Corp. v Paceco, Inc.* (1983) 145 CA3d 991, 995, 193 CR 687. For examples of decisions upholding interest awards under CC §3287(a), see *Doppes v Bentley Motors, Inc.* (2009) 174 CA4th 1004, 1006, 94 CR3d 797 (prejudgment interest award for violation of Song-Beverly Consumer Warranty Act (CC §§1790-1795.8)); *County of Solano v Lionsgate Corp.* (2005) 126 CA4th 741, 24 CR3d 362; *Track Mortgage Group, Inc. v Crusader Ins. Co.* (2002) 98 CA4th 857, 120 CR2d 228. For an example of a decision upholding denial of an interest award under CC §3287(a), see *Wisper Corp. v California Commerce Bank* (1996) 49 CA4th 948, 962, 57 CR2d 141.

NOTE: If the contract provides for the payment of interest, prevailing parties "need not resort to [CC §3287(a)] to obtain prejudgment interest." *Roodenburg v Pavestone Co.* (2009) 171 CA4th 185, 192, 197 CR3d 558.

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§10.24 3. No Contractual Provision; Damages Unliquidated (CC §3287(b))

Under CC §3287(b), even if the amount of damages is unliquidated, the plaintiff in a breach of contract action may recover prejudgment interest in the court's discretion, running from any date before entry of judgment that the court may fix, but not earlier than the date when the action was filed. *North Oakland Med. Clinic v Rogers* (1998) 65 CA4th 824, 76 CR2d 743. For an example of a decision upholding an interest award under CC §3287(b), see *A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114. Civil Code §3287(b) was added to allow the court some flexibility to award interest on unliquidated claims. *Moreno v Jessup Buena Vista Dairy* (1975) 50 CA3d 438, 123 CR 393. Under §3287(b), interest is recoverable when the court in its discretion so orders, but the interest does not begin to run prior to the filing of the action. See *A & M Produce Co. v FMC Corp., supra* (upholding trial court's discretionary award of prejudgment interest under CC §3287(b) in view of (1) the substantial length of time (7 years) between filing the action and judgment, (2) the defendant's use of the judgment money during that period in which market interest rates were much higher than the then-existing 7-percent legal rate on judgments, and (3) the plaintiff's offer to settle the case before trial that the defendant had not accepted).

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§10.25 4. Date From Which Interest Runs

Under CC §3287(a), prejudgment interest begins to run from the date when the obligation becomes due (*Flynn v California Casket Co.* (1951) 105 CA2d 196, 233 P2d 131) or from the date when damages are certain or are capable of being calculated to a certainty (*Moreno v Jessup Buena Vista Dairy* (1975) 50 CA3d 438, 123 CR 393). The certainty test has been reduced to two tests: (1) whether the debtor knows the amount owed, or (2) whether the debtor would be able to compute the damages. *Chesapeake Indus. v Togova Enters.* (1983) 149 CA3d 901, 911, 197 CR 348. Reasoning that "where a defendant does not know what amount he owes and cannot ascertain it except by accord or judicial process, he cannot be in default for not paying it," courts have held that the plaintiff must supply the debtor with a statement and supporting data so that the debtor can ascertain the damages. *Polster, Inc. v Swing* (1985) 164 CA3d 427, 435, 210 CR 567.

If the court awards interest under CC §3287(b), it runs from the date fixed by the court, but not earlier than the date of filing of the action.

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§10.26 5. Prejudgment Interest in Indemnity Actions

Prejudgment interest may be awarded in an action for equitable indemnity under *American Motorcycle Ass'n v Superior Court* (1978) 20 C3d 578, 146 CR 182, running from the date of payment of the primary judgment, because the amount of that payment is certain even if the portion for which the defendant-indemnitor is liable is uncertain. *E.L. White, Inc. v City of Huntington Beach* (1982) 138 CA3d 366, 187 CR 879. In an action for implied contractual indemnity, however, prejudgment interest may be awarded from the date of entry of the underlying judgment against the indemnitee, because that is the date on which the plaintiff's right to indemnity vests and the damages become certain. The date when the indemnitee files an action against the indemnitor is irrelevant. *Bear Creek Planning Comm. v Title Ins. & Trust Co.* (1985) 164 CA3d 1227, 1247, 211 CR 172, overruled in part on other grounds in *Bay Dev., Ltd. v Superior Court* (1990) 50 C3d 1012, 269 CR 720, and *Prince v Pacific Gas & Elec. Co.* (2009) 45 C4th 1151, 90 CR3d 732.

In an action for wrongfully withheld pension payments, prejudgment interest is recoverable on each such payment from the date it fell due. *Austin v Board of Retirement* (1989) 209 CA3d 1528, 258 CR 106. But see *Weber v Board of Retirement* (1998) 62 CA4th 1440, 73 CR2d 769 (retroactive lump-sum pension benefits do not constitute damages entitled to prejudgment interest under CC §3287(a) when petitioners had not been wrongfully denied benefits).

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§10.27 6. Cost of Borrowing

Occasionally, the plaintiff may seek to recover the cost of borrowing money as an element of contract damages, *e.g.,* if the plaintiff is required to borrow money and pay interest as a result of the defendant's breach. This type of recovery is not ordinarily permitted unless the contracting parties expressly agree that that cost may be included as an element of damages or if the borrowing was a foreseeable consequence of the breach. See *C. Norman Peterson Co. v Container Corp.* (1985) 172 CA3d 628, 650, 218 CR 592; *Mendoyoma, Inc. v Mendocino* (1970) 8 CA3d 873, 87 CR 740. In *Ninety Five Ten v Crain* (1991) 231 CA3d 36, 282 CR 141, the court held that a creditor may not recover prejudgment interest on interest-only installment payments due on a standard promissory note. There are, however, a number of cases that have awarded to a wronged buyer of real estate in a specific performance context the differential in interest rates that the buyer has to pay a lender as the result of the seller's breach of contract. See *Housing Auth. v Monterey Sr. Citizen Park* (1985) 164 CA3d 348, 356, 210 CR 497; *Stratton v Tejani* (1982) 139 CA3d 204, 187 CR 231; *Hutton v Gliksberg* (1982) 128 CA3d 240, 180 CR 141.

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§10.28 7. Postjudgment Interest

After a judgment is entered, interest accrues at the rate of 10 percent per year on the principal amount remaining unsatisfied. CCP §§685.010(a), 685.020(a). If a judgment is payable in installments, interest accrues on each installment on the date it becomes due, unless the judgment provides otherwise. CCP §685.020(b). For further discussion of postjudgment interest, see Debt Collection Practice in California §7.41 (2d ed Cal CEB 1999).

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§10.29 D. Out-of-Pocket Expenses; Reliance Damages

In general, expenses necessarily incurred by the nonbreaching party in good faith, in anticipation of, or in preparation for, performance by the other party are recoverable as an element of damages for breach of contract. *Walpole v Prefab Mfg. Co.* (1951) 103 CA2d 472, 230 P2d 36. See also *Atchison, Topeka & Santa Fe R.R. Co. v James Stewart Co.* (1966) 246 CA2d 821, 55 CR 316; *B. C. Richter Contracting Co. v Continental Cas. Co.* (1964) 230 CA2d 491, 41 CR 98. This rule is an outgrowth of the general concept of damages for breach of contract as compensatory, with the goal of enabling the plaintiff to recover his or her expectancy interest in the original bargain. See generally *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 515, 28 CR2d 475; §10.3.

In certain cases, when the foregoing general measure of contract damages is inappropriate, courts may allow the nonbreaching party to recover damages, including out-of-pocket expenses, based on his or her "reliance" interest. See, *e.g., Copeland v Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1262, 117 CR2d 875 (for breach of contract to negotiate agreement, plaintiff could have recovered out-of-pocket costs in conducting negotiations and possibly lost opportunity costs). In *Copeland,* it was impossible for the court to award lost expectancy damages (*i.e.,* lost profits), because there was no way of knowing what the final terms of the agreement between the parties would have been, or even whether they would have reached a final agreement at all. Although the plaintiff would have been entitled to "reliance damages" as an alternative, the plaintiff did not seek them in his complaint, so the court affirmed summary judgment for the defendant.

Restatement (Second) of Contracts (1981) §349 describes reliance damages as follows:

> As an alternative to the measure of damages stated in §347 [benefit of the bargain], the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed.

The comments to Restatement (Second) of Contracts (1981) §349 indicate that reliance damages may be appropriate when lost profits cannot be proved with reasonable certainty or in promissory estoppel cases.

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E. Tort Damages

§10.30 1. Generally

Certain cases in which breach of contract is alleged may also permit recovery in tort, including recovery of punitive damages under CC §§3294-3296, if the conduct at issue also violates a duty arising under tort law that is independent of the contract. *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 989, 22 CR3d 352; *Erlich v Menezes* (1999) 21 C4th 543, 87 CR2d 886. For example, tort damages may be recoverable in the following types of contract cases (*Robinson Helicopter Co. v Dana Corp., supra*):

- If the breach of contract itself causes physical injury or is otherwise tortious, for example, if it involves deceit or undue coercion;
- When the breach is accompanied by another actionable tort, such as fraud or conversion;
- In insurance contract cases, for a breach of the covenant of good faith and fair dealing;
- In employment cases, for wrongful discharge in violation of fundamental public policy;
- When the contract was fraudulently induced;
- When a party breaches the contract intentionally, knowing or intending that the breach will cause severe, unmitigable harm in the form of mental anguish, personal hardship, or substantial consequential damages.

In analyzing these types of cases, the courts will focus on intentional conduct. "If every negligent breach of a contract [gave] rise to tort damages the limitation would be meaningless, as would the statutory distinction between tort and contract remedies." *Erlich v Menezes,* 21 C4th at 554. See also *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 95, 44 CR2d 420; §10.11. As a general rule, "conduct amounting to a breach of contract becomes tortious only when it also violates a duty independent of the contract arising from principles of tort law." *Butler-Rupp v Lourdeaux*, (2005) 134 CA4th 1220, 1227, 36 CR3d 685. The so-called economic loss rule limits a party's recovery to contract law for purely economic losses resulting from disappointed expectations, unless the party can demonstrate harm above and beyond a broken contractual promise. *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 988, 22 CR3d 352.

In *Robinson Helicopter,* the breach of contract consisted of the defendant's delivery of faulty helicopter parts. In addition, the defendant issued false FAA certificates of conformance, which constituted affirmative misrepresentations that the plaintiff justifiably relied on to its detriment. The California Supreme Court affirmed that the defendant's tortious conduct was separate and independent of its breach of contract, allowing the plaintiff to recover in tort as well as contract.

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§10.31 2. Damages for Emotional Distress

If a breach of contract directly causes physical injury, damages resulting from those injuries are recoverable. *Erlich v Menezes* (1999) 21 C4th 543, 556, 87 CR2d 886. In *Erlich,* the court gave an example of a beam falling on a homeowner during a construction project. If the incident were caused by a breach of the construction contract, the homeowner could recover tort damages for his or her physical injuries. As a general rule, however, damages for emotional distress are not recoverable in an action for breach of an ordinary commercial contract. 21 C4th at 558.

As discussed in §10.11, contract damages are normally limited to damages within the actual contemplation of the parties at the time of contracting (or damages that were reasonably foreseeable by them at the time). Consequential damages that were beyond the reasonable expectations of the parties are not recoverable. See §10.4. In comparison, tort damages are intended to fully compensate the victim for all injury suffered. *Erlich,* 21 C4th at 550.

In *Erlich,* homeowners sued the contractor who built their new house for breach of contract, fraud, negligent misrepresentation, and negligent construction, alleging that they suffered emotional distress as a result of the defective condition of the house and the defendant's invasive and unsuccessful repair attempts. The jury found that the defendant breached the construction contract by constructing the house negligently, but had not committed fraud or negligent misrepresentation. The California Supreme Court held that because the defendant's negligence directly caused only economic injury and property damage, and did not breach a duty independent of the contract, the plaintiffs could not recover damages for emotional distress based on a breach of the construction contract. The damages available for defective construction were limited to the cost of repairing the home or the diminution in its value. *Erlich,* 21 C4th at 553.

The court in *Erlich* noted that tort damages may be available when "one party intentionally breaches the contract intending or knowing that such a breach will cause severe, unmitigable harm in the form of mental anguish, personal hardship, or substantial consequential damages." 21 C4th at 554 (citations omitted). In particular, if the express object of the contract is the emotional or mental well-being of one of the parties, damages for emotional distress may be recovered. See generally *Selden v Dinner* (1993) 17 CA4th 166, 172, 21 CR2d 153. Contract cases in which recovery for emotional distress was allowed (or ruled allowable) include *Ross v Forest Lawn Mem. Park* (1984) 152 CA3d 971, 203 CR 468 (cemetery's agreement to keep burial service private and to protect grave from vandalism); *Wynn v Monterey Club* (1980) 111 CA3d 789, 799, 168 CR 878 (agreement of two gambling clubs to exclude husband's gambling-addicted wife from clubs and not to cash her checks); *Windeler v Scheers Jewelers* (1970) 8 CA3d 844, 851, 88 CR 39 (bailment for heirloom jewelry when jewelry's great sentimental value was made known to bailee).

NOTE: Civil Code §2941(d) allows a homeowner to recover tort damages, including damages for emotional distress, from a trustee, beneficiary, or mortgagee of a deed of trust for failing to execute and deliver a full reconveyance after the underlying obligation is satisfied. *State ex rel Bowen v Bank of America* (2005) 126 CA4th 225, 234, 23 CR3d 746; *Pintor v Ong* (1989) 211 CA3d 837, 259 CR 577. In *Pintor,* a homeowner recovered $15,000 for emotional distress resulting from a 2½-year delay in recording the reconveyance.

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3. Breach of Implied Covenant of Good Faith and Fair Dealing

§10.32 a. General Rule

As a general rule, tort damages are not available for breach of the covenant of good faith and fair dealing, because the covenant is a contract term that is implied to carry out the parties' express agreement. See §§6.33-6.36; *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 86 CR2d 855. When a court enforces the implied covenant of good faith and fair dealing, it is essentially acting to protect the interest of the contracting parties in having their mutual promises performed, which is traditionally the role of an action for breach of contract, rather than to protect a general duty to society or public policy interest independent of the contract. *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 689, 254 CR 211. Conduct that amounts to a breach of contract is also tortious only if it also violates an independent duty founded on tort law principles. *Erlich v Menezes* (1999) 21 C4th 543, 551, 87 CR2d 886; *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 44 CR2d 420.

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§10.33 b. Insurance Cases

An exception to the general rule prohibiting tort damages for breach of the implied covenant of good faith and fair dealing has been recognized in insurance cases. See, *e.g., Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 1180, 26 CR2d 8; *Egan v Mutual of Omaha Ins. Co.* (1979) 24 C3d 809, 818, 169 CR 691; *Benavides v State Farm Gen. Ins. Co.* (2006) 136 CA4th 1241, 39 CR3d 650. An insured may recover damages for emotional distress if the insurer has acted in bad faith and may further recover punitive damages if there has been oppression, fraud, or malice by the insurer. Tort recovery in the insurance context is considered appropriate because an insurance policy is characterized by elements of adhesion, public interest, and fiduciary responsibility. Moreover, if an insurer, acting in bad faith, refuses to pay a claim, the insured—unlike other contracting parties who may seek recourse in the marketplace in case of a breach—will not be able to find another insurance company willing to cover a loss that has already occurred. *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 43, 86 CR2d 855. In *Cates,* the California Supreme Court ruled that the insurance exception did not extend to performance bonds or other types of suretyship contracts.

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§10.34 c. Other Circumstances

Following the California Supreme Court's decision in *Seaman's Direct Buying Serv., Inc. v Standard Oil Co.* (1984) 36 C3d 752, 206 CR 354, which was squarely overruled in *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 44 CR2d 420, some California decisions allowed tort damages for breach of the implied covenant of good faith and fair dealing outside of the insurance context if a fiduciary or special relationship existed between the contracting parties. See, *e.g., Wallis v Superior Court* (1984) 160 CA3d 1109, 207 CR 123 (employer's agreement to pay termination benefits to laid-off employee). In *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211, however, the California Supreme Court held that "tort remedies are not available for breach of the implied covenant [of good faith and fair dealing] in an employment contract to employees who allege they have been discharged in violation of the covenant." See also *Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 26 CR2d 8 (no tort damages for employer misrepresentations made to induce termination of employment); §10.36.

The so-called "*Seaman's* tort" of bad faith denial of the existence of a contract was abolished in *Freeman & Mills, Inc. v Belcher Oil Co., supra*. In *Freeman,* the defendant retained a law firm with the understanding that the defendant would pay for the law firm's costs incurred on the defendant's behalf, including accountant's fees. The law firm hired the plaintiff accountants to work on the defendant's matter. The defendant eventually terminated the law firm. Neither the law firm nor the defendant paid the plaintiffs for their services. The plaintiffs brought suit, alleging breach of contract, bad faith denial of contract, and quantum meruit. The supreme court affirmed dismissal of the plaintiffs' claim of bad faith denial of contract, holding that, as a general rule, there is no tort recovery for breach of a noninsurance contract, in the absence of a violation of an independent duty arising out of tort law principles other than the bad faith denial of the existence of, or liability under, the contract.

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F. Damages for Breach of Employment or Service Contracts

§10.35 1. Contract Measure of Damages

When an employee is wrongfully prevented from full performance of his or her employment contract, the employee may elect to rescind the contract and sue on a quantum meruit theory to recover the reasonable value of the services he or she has performed, even if this value exceeds the contract price. The contract price, however, is competent evidence of the reasonable value of the services. If the injured party has fully performed his or her services under the contract or a severable part of it for which the injured party is entitled to a liquidated sum of money, the measure of damages is the amount that he or she is entitled to under the contract. *Oliver v Campbell* (1954) 43 C2d 298, 302, 273 P2d 15.

A wrongfully discharged employee may recover the salary agreed on for the period of service concerned, less the amount that the employer proves he or she earned or with reasonable effort might have earned from other employment. Before projected earnings from other employment not sought or accepted by the employee can be applied in mitigation, however, the employer must show that the other employment was comparable to that of which the employee was deprived. *Parker v Twentieth Century-Fox Film Corp.* (1970) 3 C3d 176, 89 CR 737. The employer has the burden of proof concerning mitigation of damages in the employment context. *Chyten v Lawrence & Howell Invs.* (1993) 23 CA4th 607, 46 CR2d 459.

A wrongfully discharged employee may accept temporary menial work without waiving the future right to refuse employment less than comparable to the original position. To hold otherwise would "senselessly" penalize the employee who is already suffering the distress of unemployment. *Rabago-Alvarez v Dart Indus.* (1976) 55 CA3d 91, 99, 127 CR 222. Recovery from the former employer is not reduced by any unemployment compensation received by the employee. *Billetter v Posell* (1949) 94 CA2d 858, 211 P2d 621. Nor is recovery from a former employer reduced by any compensation received by the employee from any subsequent employer when the employment contract provides for a salary "guarantee." *National Football League Players' Ass'n v National Football League Mgmt. Council* (1986) 188 CA3d 192, 233 CR 147.

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§10.36 2. Tort Remedies

In *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 688, 254 CR 211*,* the California Supreme Court held that tort remedies are not available for breach of the implied covenant of good faith and fair dealing in an employment contract to employees who allege they have been discharged in violation of the covenant. 47 C3d at 700. Yet *Foley* left intact the basic holding of *Tameny v Atlantic Richfield Co.* (1980) 27 C3d 167, 164 CR 839, that an individual may seek relief through tort remedies when an employer's discharge of that individual contravenes dictates of public policy. *Foley,* 47 C3d at 666. After *Foley,* the issue remains when an employer's conduct does so. On the facts involved in *Foley,* the court held that discharging an employee because he reported what he knew about his supervisor, who was under investigation for embezzlement by the FBI, did not justify tort remedies.

Cases decided after *Foley* have begun to indicate the circumstances under which tort remedies might still be available to a wrongfully discharged employee. In *Guz v Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 352, 100 CR2d 352, the court stated:

> A breach of the contract may also constitute a breach of the implied covenant of good faith and fair dealing. But insofar as the employer's acts are directly actionable as a breach of an implied-in-fact contract term, a claim that merely realleges that breach as a violation of the covenant is superfluous. This is because… the remedy for breach of an employment agreement, including the covenant of good faith and fair dealing implied by law therein, is *solely contractual*. In the employment context, an implied covenant theory affords no separate *measure of recovery*, such as tort damages.… Allegations that the breach was wrongful, in bad faith, arbitrary, and unfair are unavailing; there is no tort of "bad faith breach" of an employment contract.

The court ruled that the plaintiff's claim was invalid to the extent it sought to impose limits on the defendant's termination rights beyond those to which the parties actually agreed, and was superfluous to the extent it sought merely to invoke terms to which the parties did agree. The plaintiff's remedy, if any, would depend on proof that there were contract terms to which the parties actually agreed.

In *Turner v Anheuser-Busch, Inc.* (1994) 7 C4th 1238, 32 CR2d 223, the court emphasized that to sustain a claim of wrongful discharge in violation of a fundamental public policy, the employee must prove that the dismissal violated a policy that is (1) fundamental, (2) beneficial for the public, and (3) embodied in a statute or constitutional provision. See also *Grinzi v San Diego Hospice Corp.* (2004) 120 CA4th 72, 79, 14 CR3d 893; *Badih v Myers* (1995) 36 CA4th 1289, 43 CR2d 229.

In *Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 26 CR2d 8, the court held that wrongful termination of employment ordinarily does not give rise to a cause of action for fraud or deceit, even if some misrepresentation is made in the course of the employee's dismissal. Tort recovery is available only if the employee can establish all of the elements of fraud with respect to misrepresentation that is separate from the termination of the employment contract, *i.e.,* when fraud damages cannot be said to result from the termination itself. For examples of decisions permitting an employee to sue his or her former employer for promissory fraud, see *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377, and *Agosta v Astor* (2004) 120 CA4th 596, 15 CR3d 565.

In *Gould v Maryland Sound Indus., Inc.* (1995) 31 CA4th 1137, 37 CR2d 718, the court held that a plaintiff stated causes of action for tortious discharge by alleging that his employment was terminated to avoid paying him accrued commissions and vacation pay and in retaliation for reporting to management the violation of overtime wage laws applicable to other employees. But see *Brewer v Premier Golf Props., LP* (2008) 168 CA4th 1243, 1256, 86 CR3d 225 (distinguishing *Gould* and holding punitive damages were not available for violations of Labor Code provisions governing meal and rest breaks, minimum wages, and pay stubs).

At least one court has held that tort remedies are not available for breach of a franchise contract. See *Harris v Atlantic Richfield Co.* (1993) 14 CA4th 70, 17 CR2d 649 (stating that current case law does not recognize cause of action under *Tameny v Atlantic Richfield Co.* (1980) 27 C3d 167, 164 CR 839, outside employment relationship).

For further discussion of the availability of tort remedies in the context of wrongful termination of employment, see Wrongful Employment Termination Practice (2d ed Cal CEB 1997).

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§10.37 G. Attorney Fees (CC §1717)

Attorney fees may be recoverable in an action on a contract as an element of costs of suit if specifically provided for in the contract in accordance with CC §1717. See generally *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198. Attorney fee awards are discussed in §§9.12-9.28.

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§10.38 H. Expert Witness Fees

Code of Civil Procedure §998(c)(1) permits expert witness fees to be recovered as costs when the prevailing party receives a judgment more favorable than an offer to compromise submitted under that section. Code of Civil Procedure §998 applies to settlement offers to resolve contractual arbitrations under CCP §§1281 and 1295 as well as civil cases in court. If a prevailing party receives a judgment or arbitration award less favorable than a rejected offer of settlement, under CCP §998 expert witness fees may be awarded at the court's discretion to the nonprevailing party as costs. For a discussion on the standards governing the court's discretion in this context, see *People ex rel Lockyer v Fremont Gen. Corp.* (2001) 89 CA4th 1260, 1270, 108 CR2d 127. For discussion of different types of expert witness fees that may be recoverable under §998, see *Goodstein v Bank of San Pedro* (1994) 27 CA4th 899, 32 CR2d 740, and *Evers v Cornelson* (1984) 163 CA3d 310, 209 CR 497. For further discussion of CCP §998, see §5.97.

Two appellate courts have recognized that contracting parties may provide for the recovery of expert witness fees by appropriate contract language and that such fees are recoverable if the parties specifically plead and prove their right to recover them. See *First Nat'l Bank v Mountain Cascade, Inc.* (2000) 77 CA4th 871, 878, 92 CR2d 145; *Ripley v Pappadopoulos* (1994) 23 CA4th 1616, 1627, 28 CR2d 878. This reasoning has been applied to plaintiffs and defendants. *Carwash of America-PO, LLC v Windswept Ventures No. 1, LLC* (2002) 97 CA4th 540, 118 CR2d 536.

Certain expert witness fees may be recovered by the prevailing party as costs of suit under CCP §§1032(b) and 1033.5.

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VI. LIQUIDATED DAMAGES

§10.39 A. Introduction

Except in consumer goods and certain real property transactions, or contracts predating July 1, 1978, damages for breach of contract may be determined in advance by the parties ("liquidated") and provided for in the contract, unless the contract provision was unreasonable at the time of contracting. CC §1671(b). In consumer goods contracts and residential leases, liquidated damage clauses are void unless "from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage." CC §1671(d). See §10.46. Liquidated damages in real property purchase contracts are addressed in CC §§1675-1681. See §10.47.

The California law on liquidated damages was revised effective as of July 1, 1978 (Stats 1977, ch 198), and the law now applicable depends on the type of contract and the date when the contract was executed. All contracts entered into before July 1, 1978, remain governed by prior law. Moreover, consumer contracts and certain real property transactions remain subject to the prior legal standard. The California Law Revision Commission described the effect of the amendments as follows: "Section 1671 is amended to provide in subdivision (b) a new general rule favoring the enforcement of liquidated damages provisions except against a consumer in a consumer case. In a consumer case, the prior law under former §§1670 and 1671 continued in subdivision (d) still applies." Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1750 (Dec. 1976).

Apart from current CC §1671 (and former CC §§1670-1671), there are a number of other California statutes addressing liquidated damages in particular types of contracts. See §10.43. These statutes were not affected by the 1978 revision.

NOTE: For a contract charge to be considered liquidated damages, it must be triggered by a breach of contract. In *Morris v Redwood Empire Bankcorp* (2005) 128 CA4th 1305, 27 CR3d 797, the court held that a provision for a termination fee of $150 in a credit card merchant account agreement was not an unenforceable liquidated damages clause, but rather an enforceable deferred charge. The merchant was free to terminate the contract at any time without breaching the contract. See also *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378 (discussing loan prepayment fees).

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§10.40 B. Contracts Made Before July 1, 1978 (Former CC §§1670-1671)

Before July 1, 1978, former CC §1670 provided that "[e]very contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section." Former CC §1671 provided that "[t]he parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix actual damage." All contracts entered into before July 1, 1978, except those governed by the Commercial Code (or other special statutes), remain subject to former CC §§1670-1671. In effect, a liquidated damages clause predating July 1, 1978, will be enforceable only if it would have been impracticable or extremely difficult for the parties to determine the actual damages. *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378.

As noted in §10.39, the pre-July 1, 1978 standard remains applicable for consumer contracts. In *Utility Consumers' Action Network, Inc. v AT&T Broadband of S. Cal., Inc.* (2006) 135 CA4th 1023, 37 CR3d 827 (a consumer contract case), the court of appeal described the analysis under former CC §§1670-1671 for determining the validity of a liquidated damages clause as involving a two-part test:

- The first leg of the test tracks the statutory language. Fixing the amount of actual damages must have been impracticable or extremely difficult for the parties. 135 CA4th at 1029. See former §1671.
- The second leg of the test has developed in judicial decisions. The amount designated as liquidated damages must "represent a reasonable endeavor by the parties to estimate fair compensation for the loss sustained." 135 CA4th at 1029 (citation omitted). Determining whether the parties made a reasonable endeavor depends on (1) their motivation and purpose in fixing the amount of damages, and (2) the effect of doing so. If the amount selected is intended to exceed by a significant margin the probable amount of actual damages, and its main purpose is to serve as a threat to force compliance by imposing an amount having little or no relationship to the actual loss, then the liquidated damages provision is a invalid as an attempt to impose a penalty. 135 CA4th at 1029.

See also *McCarthy v Tally* (1956) 46 C2d 577, 297 P2d 981; *Better Food Mkts. v American Dist. Tel. Co.* (1953) 40 C2d 179, 187, 253 P2d 10. The court in *Utility Consumers' Action Network* held that the reasonable endeavor test does not require both parties to a standard form contract to expressly negotiate the amount of liquidated damages. The amount may be set forth in the printed form, and it will be valid if it meets the test for enforceability described above.

In *H.S. Perlin Co. v Morse Signal Devices* (1989) 209 CA3d 1289, 258 CR 1, the owner of a stamp and coin store sued a burglar alarm company to recover the value of stamps and coins lost in a burglary. The trial court limited the plaintiff's recovery to $250, based on a liquidated damages clause in the burglar alarm contract. The court of appeal upheld the ruling under both the language of former CC §1671 and the post-July 1, 1978 version of the statute. The appellate court also ruled that the contract was not unconscionable.

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C. Contracts Made On or After July 1, 1978 (CC §1671(b))

§10.41 1. General Rule

Except for contracts subject to other law (see §10.43) and consumer contracts subject to CC §1671(c)-(d), liquidated damages provisions in all contracts made on or after July 1, 1978, are governed by CC §1671(b). Civil Code §1671(b) sets forth the general rule applicable to nonconsumer contracts as follows: "Except as provided in subdivision (c) [relating to consumer contracts], a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made." In effect, CC §1671(b) provides that reasonable liquidated damages provisions are presumptively valid.

The California Law Revision Commission's report on liquidated damages (Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739 (Dec. 1976)) was adopted by the state legislature in 1977 without change. The Commission's report is therefore given substantial weight by the courts in interpreting CC §1671. *Utility Consumers' Action Network, Inc. v AT&T Broadband of S. Cal., Inc.* (2006) 135 CA4th 1023, 1029, 37 CR3d 827. See also *Edwards v Symbolic Int'l, Inc.* (SD Cal, Apr. 30, 2009, No. 07-CV-1826-JMA) 2009 US Dist Lexis 37523 (citing this treatise).

The Commission report makes clear that, when CC §1671(b) applies, the burden of proof on the question of reasonableness is on the party seeking to invalidate the liquidated damages clause. See also *El Centro Mall, LLC v Payless Shoe Source, Inc.* (2009) 174 CA4th 58, 63, 94 CR3d 43; *Weber, Lipshie & Co. v Christian* (1997) 52 CA4th 645, 653, 60 CR2d 677. The report also emphasizes that CC §1671(b) limits the matters that may be taken into account in determining reasonableness to those in existence "at the time the contract was made." See also *El Centro Mall, supra*. The validity of a liquidated damages clause depends on its reasonableness at the time the contract was entered into and not as it may appear in hindsight. As a consequence, the amount of damages actually suffered by the plaintiff has no bearing on the validity of the liquidated damages provision. In contrast, CC §1675(e)(2) (see §10.47) allows a subsequent sale to be considered on the issue of the reasonableness of a clause liquidating the seller's damages in the event of a default by a buyer of residential property.

The Commission report further states that under CC §1671(b), the parties have considerable leeway in determining the amount of liquidated damages for breach. See also *El Centro Mall*, *supra*.

The report continues that, in evaluating the reasonableness of a liquidated damages clause, courts should consider all of the circumstances existing at the time of the making of the contract, including, without limitation, the following:

- The relationship that the damages provided in the contract bear to the range of harm that reasonably could be anticipated at the time of the making of the contract;
- The relative equality of the bargaining power of the parties;
- Whether the parties were represented by lawyers at the time the contract was made;
- The anticipation of the parties that proof of actual damages would be costly or inconvenient;
- The difficulty of proving causation and foreseeability; and
- Whether the liquidated damages provision is included in a form contract.

See Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1751 (Dec. 1976). See also *El Centro Mall*, 174 CA4th at 64 (liquidated damages clause that specified amount per square foot per day for each day tenant did not operate was reasonable when evidence showed amount compensated landlord for loss of "synergy, goodwill, and patronage" in addition to lost rent).

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Source: Business Law/California Law of Contracts/10 Remedies: Damages/§10.42 2. Rule Against Penalties or Forfeitures (CC §3275)

§10.42 2. Rule Against Penalties or Forfeitures (CC §3275)

In general, a liquidated damages provision will be considered unreasonable, and therefore unenforceable, if it does not bear a reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach. The amount established as liquidated damages "must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. [Citation.] In the absence of such relationship, a contractual clause purporting to predetermine damages 'must be construed as a penalty.'" *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378 (citations omitted).

In *Ridgley*, the loan agreement at issue required the borrowers to pay the lender a prepayment fee equal to 6 months' interest when the real property collateral was sold if the borrowers had been more than 15 days late with any scheduled interest payment (or had defaulted on any other contract provision). The borrowers sold the property before the loan matured, and repaid the loan principal along with the prepayment fee on the lender's demand (the borrowers had been late with one interest payment). The court held that the prepayment fee clause was a penalty and was unenforceable because it bore no relationship to the potential damages that the lender would incur from a late interest payment. Under the clause, any late interest payment would result in a severe penalty—the borrowers' inability to sell the property without payment of a significant predetermined amount. Unlike conventional prepayment fee clauses, the purpose of this provision was to coerce timely payment of interest, not to compensate the lender for interest payments lost through prepayment of principal.

Similarly, in *Harbor Island Holdings, L.L.C. v Kim* (2003) 107 CA4th 790, 132 CR2d 406, the court held a provision of a commercial lease allowing the landlord to collect double rent on default by the tenant was not reasonably related to actual damages that the parties should have anticipated would flow from the tenant's breach. It was therefore an unreasonable penalty provision rather than an enforceable liquidated damages clause. See also *Greentree Fin. Group, Inc. v Execute Sports, Inc.* (2008) 163 CA4th 495, 78 CR3d 24; *Morris v Redwood Empire Bankcorp* (2005) 128 CA4th 1305, 27 CR3d 797.

Civil Code §3275 reflects the equitable rule against forfeitures, by providing relief from forfeiture even if the party seeking relief has breached the contract. It states that:

> Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful, or fraudulent breach of duty.

Under §3275, any contractual provision by which money or property could be forfeited regardless of the actual damage suffered may be unenforceable as a penalty. If a liquidated damages clause is found to be a penalty, the party that has suffered damage may collect only the amount of actual damages it has sustained. *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378. The statute may be raised as an equitable defense to enforcement of the contract or serve as the basis for relief in an action for restitution of the forfeited property. *Freedman v The Rector* (1951) 37 C2d 16, 230 P2d 629.

One way to attempt to avoid enforcement issues concerning a liquidated damages clause is to provide for a true alternative performance. In *Ridgley,* 17 C4th at 978, the California Supreme Court noted that, in general, contractual charges for prepayment of loan principal are deemed to be valid provisions for alternative performance, rather than liquidated damages or penalties for breach. Repayment of a loan before maturity is not a breach of the loan agreement, but simply an alternative mode of performance by the borrower. For that reason, the prepayment charge is not a penalty imposed for default, but instead an agreed form of compensation to the lender for interest lost through prepayment. See also *Williams v Fassler* (1980) 110 CA3d 7, 167 CR 545 (50-percent prepayment penalty was not unconscionable because it was reasonably related to obligee's anticipated risk of increased tax liability if prepayment occurred). In *Western Camps, Inc. v Riverway Ranch Enters.* (1977) 70 CA3d 714, 138 CR 918, the court held that an agreement by the lessor to pay $60,000 to the lessee if the lessor exercised its right to terminate the lease was a valid, bargained-for alternative and not a penalty. The court distinguished other cases in which the payment of a charge bore

no relation to actual damages.

The rule against forfeitures is also discussed in §11.3.

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Source: Business Law/California Law of Contracts/10 Remedies: Damages/§10.43 D. Liquidated Damages Under Other Applicable Law (CC §1671(a))

§10.43 D. Liquidated Damages Under Other Applicable Law (CC §1671(a))

Civil Code §1671(a) provides that the general rules of CC §1671 do "not apply in any case where another statute expressly applicable to the contract prescribes the rules or standard for determining the validity of a provision in the contract liquidating the damages for the breach of the contract." The California Law Review Commission Comment included the following list of examples of such statutes:

- CC §1675-1681 (contracts to purchase real property);
- Com C §2718 (transactions for the sale of goods under Division 2 of the Commercial Code);
- Statutes limiting late payment charges, *e.g.,* Bus & P C §10242.5 (certain real estate loans), CC §1803.6 (retail installment sales), CC §2954.4 (loans on single-family, owner-occupied dwellings), CC §2982 (automobile sales finance), Fin C §14852 (credit unions), and Fin C §18631 (industrial loan companies);
- Statutes regulating liquidated damages in construction contracts for late completion, *e.g.,* Ed C §90226 (construction contracts for state university and colleges), Ed C §92050 (construction contracts for University of California), Govt C §14376 (state public works contracts), and Govt C §53069.85 (contracts with cities, counties, and districts); and
- Statutes providing certain penalties for nonpayment, *e.g.,* Govt C §54348 (penalty for nonpayment of local agency charges) and Pub Res C §6224 (penalty for nonpayment to State Lands Commission).

See Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1750 (Dec. 1976). Further, CC §1671 is not applicable if the validity of the liquidated damages provision is governed by federal law or regulation. For example, federal regulations limit the maximum late payment fees that may be charged by national banks or federally chartered savings and loan associations. See, *e.g., Pacific Trust Co. TTEE v Fidelity Fed Sav & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269.

Of course, if there are exceptions to the coverage of some statutes governing liquidated damages in certain types of contracts, CC §1671 does apply, *e.g.,* Fin C §22053 (exception to Fin C §22480).

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§10.44 E. Security Deposits as Liquidated Damages

The California Law Revision Commission's report on liquidated damages (Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1752 (Dec. 1976)) also addresses the issue of contractual deposits. Rather than agreeing to pay a sum certain as liquidated damages in the event of a breach, a party may make a deposit as security for the performance of his or her contractual obligations. If the contract provides that the deposit will constitute liquidated damages for breach, the issue of whether the provision is valid—whether the deposit may be retained in case of breach—is determined in accordance with the standards set forth in CC §1671. See also CC §§1675-1681 (real property purchase contracts). If, however, the parties do not intend that the deposit will be liquidated damages in case of a breach, the deposit merely serves as a fund to secure payment of actual damages (if any). See, *e.g.,* CC §1950.5 (payment or deposit to secure performance of rental agreement); CC §1951.5 (liquidation of damages authorized in real property lease). *Lowe v Massachusetts Mut. Life Ins. Co.* (1976) 54 CA3d 718, 127 CR 23, was an action against an insurance company lender by assignees of a real estate loan applicant for return of a deposit made concurrently with the lender's approval of the loan application. The court held that the deposit was an option and not an unenforceable liquidated damage provision or a penalty. The lender was therefore entitled to retain the deposit after the applicant failed to take down the loan, because neither the application nor the lender's loan commitment bound the applicant to do so. In fact, the applicant remained free to take a loan from another lender, subject only to the loss of its stand-by deposit. The deposit constituted the agreed consideration for the lender's commitment to make the loan.

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§10.45 F. Commercial Code Contracts

Liquidated damages clauses in contracts for the sale of goods or in personal property leases are addressed in §§12.92-12.97 and 12.111.

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§10.46 G. Consumer Contracts (CC §1671(c)-(d))

Civil Code §1671(c) provides that liquidated damages clauses are governed by CC §1671(d), and not CC §1671(b), if liquidated damages are sought to be recovered from either:

> (1) A party to a contract for the retail purchase, or rental, by such party of personal property or services, primarily for the party's personal, family, or household purposes; or
> (2) A party to a lease of real property for use as a dwelling by the party or those dependent upon the party for support.

NOTE: Civil Code §1671(d) applies only if the defendant in an action to recover liquidated damages is a consumer. If the defendant is not a consumer, CC §1671(b) controls (see §10.41), even if the other party to the contract is a consumer. Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1752 (Dec. 1976).

Civil Code §1671(d) states the rule applicable in consumer cases:

> In the cases described in subdivision (c), a provision in a contract liquidating damages for the breach of the contract is void except that the parties to such a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

As noted in §§10.39-10.40, CC §1671(d) carries forward the legal standards applicable to liquidated damages clauses before July 1, 1978, if liquidated damages are sought to be recovered under a contract for the retail purchase, or rental, of personal property or services primarily for personal, family, or household purposes, or for the lease of real property for use as a dwelling by the party or persons dependent on the party for support. Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1752 (Dec. 1976). In *Utility Consumers' Action Network, Inc. v AT&T Broadband of S. Cal., Inc.* (2006) 135 CA4th 1023, 37 CR3d 827, the court of appeal noted that because the current law governing liquidated damages in consumer contracts is a continuation of prior law on the topic, decisions interpreting former CC §1671 remain applicable.

Under CC §1671(d), there is a presumption that a liquidated damages clause in a consumer contract is void unless it meets the test for enforceability discussed in §10.40, *i.e.,* it must have been impracticable or extremely difficult to fix actual damages, and the amount selected must be the result of a reasonable endeavor by the parties to estimate a fair compensation for any loss incurred. See *Utility Consumers' Action Network v AT&T Broadband of S. Cal., Inc., supra*; *Hitz v First Interstate Bank* (1995) 38 CA4th 274, 44 CR2d 890. In *Hitz,* the court found that the bank's late and overlimit fees were not the product of a reasonable endeavor to estimate potential loss, but rather an effort to generate new revenue, and hence were invalid liquidated damages.

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Source: Business Law/California Law of Contracts/10 Remedies: Damages/§10.47 H. Real Property Purchase Contracts (CC §§1675-1681)

§10.47 H. Real Property Purchase Contracts (CC §§1675-1681)

Liquidated damages in contracts for the purchase and sale of real property are regulated in CC §§1675-1681. If a liquidated damages provision is valid under these sections, the measure of damages for breach of an agreement to purchase real estate set forth in CC §3307 does not apply. Recommendation Relating to Liquidated Damages, 13 Cal L Rev'n Comm'n 1739, 1755 (Dec. 1976).

There are two different statutory tests for validity of a liquidated damages clause in a real property purchase and sale contract, depending on whether the contract involves residential property.

NOTE: The two tests are applicable only to provisions for liquidated damages to the seller if the buyer fails to complete the purchase. The validity of any other provisions for liquidated damages in the contract are determined under CC §1671. CC §1679. Moreover, the tests do not apply to liquidated damages clauses in installment land contracts. CC §§1681, 2985.

The term "residential property" is defined in CC §1675(a) as a dwelling that meets both of the following requirements: (1) the dwelling has not more than four residential units, and (2) the buyer intends to occupy the dwelling (or one of its units) as a residence at the time the contract is made.

If the contract does not involve residential property (as defined), a contract provision liquidating damages to the seller if the buyer fails to complete the purchase is valid under CC §1676 if:

- It satisfies the requirements of CC §1671(b) (see §10.41); and
- In accordance with CC §1677:
- The clause is separately signed or initialed by each party to the contract, and
- If the clause is part of a printed contract, it is set forth in at least 10-point bold type or in contrasting red print in at least 8-point bold type.

See generally *Hong v Somerset Assocs.* (1984) 161 CA3d 111, 207 CR 597 (applying CC §§1676-1677).

If the contract does involve residential property (as defined), and it provides that all or part of a payment made by the buyer will constitute liquidated damages to the seller on the buyer's failure to complete the purchase, the contract provision is valid under CC §1675(b) to the extent that the payment is actually made in the form of cash or check (including a postdated check), if it meets the following requirements:

- In accordance with CC §1677:
- The provision is separately signed or initialed by each party to the contract, and
- If the clause is part of a printed contract, it is set forth in at least 10-point bold type or in contrasting red print in at least 8-point bold type;
- If more than one payment is to constitute liquidated damages, the amount of any payment after the first one is valid only if the total of all such payments satisfies CC §1675 and a separate clause satisfying the requirements of CC §1677 is separately signed or initialed by each party for each payment;
- If the amount actually paid does not exceed 3 percent of the purchase price, under CC §1675(c) the clause is valid to the extent that the payment is actually made unless the buyer establishes that the amount is unreasonable as liquidated damages;
- If the amount actually paid exceeds 3 percent of the purchase price, under CC §1675(d) the clause is invalid unless the party seeking to enforce the clause establishes that the amount actually paid is reasonable as liquidated damages.

The reasonableness of an amount paid as liquidated damages is determined under CC §1675(e) by taking into account both (1) the circumstances at the time the contract was made, and (2) the price in any other circumstances of any subsequent sale (or contract to sell) if made within 6 months after the buyer's default. For a case in which CC §1675(b) was applied to require the seller in a residential property transaction to refund part of the buyer's payment, see *Allen v Smith* (2002) 94 CA4th 1270, 114 CR2d 898.

NOTE: A series of special rules that override CC §1675(c) and (d) apply to liquidated damages clauses in contracts for the initial sale of newly constructed attached condominium units in structures of 10 or more units in the event of a buyer default. The rules require the seller to perform an accounting of costs and revenues allocable to the construction and sale of the unit if the amount paid by the buyer exceeds 3 percent of the purchase price. The seller is also required to make reasonable efforts to mitigate damages. See CC §1675(f). Special rules also apply to newly constructed condominium units with sales prices exceeding $1 million in certain structures of 20 or more units if the amount paid to the seller under the liquidated damages provision exceeds 6 percent of the purchase price. See CC §1675(g).

Nothing in CC §§1675-1681 restricts any right that a party to a real estate sales contract may have to obtain specific performance. CC §1680. See *Allen,* 94 CA4th at 1978.

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VII. EXEMPLARY (PUNITIVE) DAMAGES (CC §§3294-3296)

§10.48 A. Generally

Civil Code §3294(a) provides that a plaintiff in an action not arising from breach of contract may recover exemplary damages (often referred to as punitive damages) when the defendant has been guilty of oppression, fraud, or malice. As a general rule, however, in the absence of an independent tort, punitive damages may not be recovered in an action for breach of a noninsurance contract, even if the defendant's conduct in breaching the contract was willful, fraudulent, or malicious. *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 61, 86 CR2d 855; *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 102, 44 CR2d 420; *JRS Prods., Inc. v Matsushita Elec. Corp.* (2004) 115 CA4th 168, 179, 8 CR3d 840.

The primary purpose of the limitation of CC §3294 to a "breach of an obligation not arising from contract" is to avoid injecting questions of fraud, malice, or oppression into contract actions because most contract breaches arise from inability to perform or uncertainty concerning the scope of the obligation, and the defendant is subject to strict liability on showing of breach regardless of his or her intent. See *Haurat v Superior Court* (1966) 241 CA2d 330, 50 CR 520.

NOTE: Certain statutes may allow recovery of punitive damages in specified circumstances. For example, the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) allows a buyer of consumer goods who is damaged by a seller's willful failure to comply with the Act's provisions to collect a civil penalty of up to two times the amount of actual damages. See CC §1794(c). Further, the Consumers Legal Remedies Act (CC §1750-1784) expressly allows recovery of punitive damages by any consumer who suffers damage as a result of a method, act, or practice that is unlawful under the Act. See CC §1780(a)(4).

Exemplary damages cannot be awarded in the absence of actual damages. However, courts appear split on whether this means that there must be an award of compensatory damages or if proof of some damage only is necessary. Compare *Gagnon v Continental Cas. Co.* (1989) 211 CA3d 1598, 1603 n5, 260 CR 305, and *Esparza v Specht* (1976) 55 CA3d 1, 127 CR 493 (award of compensatory damages not necessary), with *Berkley v Dowds* (2007) 152 CA4th 518, 530, 61 CR3d 304 (exemplary damage award must be accompanied by award of compensatory damages or equivalent, such as restitution, offset, damages presumed by law, or nominal damages) and *Cheung v Daley* (1995) 35 CA4th 1673, 1677, 42 CR2d 164 (concluding that any award of punitive damages must be accompanied by award of compensatory damages).

A sum awarded as exemplary damages must bear a reasonable relationship to the actual damages. In *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513, the United States Supreme Court reversed a punitive damage award of $145 million when the compensatory award was only $1 million. The Court stated that there was a presumption against the 145-to-1 ratio in the case before it and that punitive-to-compensatory ratios that exceed single digits generally risk being considered excessive under constitutional due process, strongly suggesting that a 4-to-1 ratio between punitive and compensatory damages would normally be at the upper end of appropriate. Nonetheless, the Court refused to rule out completely the possibility that some conduct might be so reprehensible as to justify a higher ratio. See *Honda Motor Co., Ltd. v Oberg* (1994) 512 US 415, 129 L Ed 2d 336, 114 S Ct 2331 (due process requires that size of punitive damage awards be subject to judicial review).

In *Simon v Sao Paolo U.S. Holding Co.* (2005) 35 C4th 1159, 29 CR3d 379, the California Supreme Court interpreted and applied the *State Farm* decision, stating (35 C4th at 1172):

> In deciding whether an award of punitive damages is constitutionally excessive under *State Farm*… , we are to review the award de novo, making an independent assessment of the reprehensibility of the defendant's conduct, the relationship between the award and the harm done to the plaintiff, and the relationship between the award and civil penalties authorized for comparable conduct.

The court's discussion of ratios between punitive damages and the plaintiff's actual or potential compensatory damages is useful (35 C4th at 1182):

> We understand the court's statement in *State Farm* that "few awards" significantly exceeding a single digit ratio will satisfy due process to establish a type of presumption: ratios between the punitive damages award and the plaintiff's actual or potential compensatory damages significantly greater than nine or 10 to one are suspect and, absent special justification (by, for example, extreme reprehensibility or unusually small, hard-to-detect or hard-to-measure compensatory damages), cannot survive scrutiny under the due process clause.... Multipliers *less* than nine or 10 are not, however, presumptively *valid* under *State Farm*.

Based on the facts in *Simon* and the factors in *State Farm,* the California Supreme Court concluded that the maximum permissible punitive damage award in *Simon* was a sum equal to 10 times the compensatory award. In *Roby v McKesson Corp*. (2009) 47 C4th 686, 101 CR3d 773, a harassment case, the court ruled that a one-to-one ratio between compensatory and punitive damages was the constitutional limit under the circumstances of the case, given the low level of reprehensibility of the employer and the relatively high compensatory damages award.

In *Exxon Shipping Co. v Baker* (2008) ___ US ___, 171 L Ed 2d 570, 598, 128 S Ct 2605, which involved punitive damages awarded as a result of the Exxon Valdez oil spill off the Alaska coast, the U.S. Supreme Court held that, under federal common law, a 1:1 ratio of compensatory to punitive damages is the upper limit in maritime cases. Applying that ratio, the court reduced the punitive damages award of $5 billion to $507.5 million, the district court's calculation of the total relevant compensatory damages.

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§10.49 B. Cases Involving Breach of Insurance Contract or Existence of Independent Tort

As noted in §10.48, exemplary damages may be recovered in certain cases involving breach of an insurance contract, and in cases involving breach of a noninsurance contract and an independent tort. *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (breach of contract and intentional misrepresentation or fraud); *Fletcher v Western Nat'l Life Ins. Co.* (1970) 10 CA3d 376, 89 CR 78 (breach of insurance contract and bad faith); *Wetherbee v United Ins. Co.* (1971) 18 CA3d 266, 95 CR 678; *Wetherbee v United Ins. Co.* (1968) 265 CA2d 921, 71 CR 764 (breach of insurance contract and bad faith). In the latter two cases, the award of exemplary damages turned on the defendant's bad faith in failing to pay its insured's claim. But see *Silberg v California Life Ins. Co.* (1974) 11 C3d 452, 113 CR 711, in which the supreme court determined that the defendant's failure to pay benefits constituted bad faith but that the trial court did not abuse its discretion in ruling that there was insufficient evidence to support an award of exemplary damages. Exemplary damages may also be awarded against one who fraudulently induces another to enter into a contract. *Kuchta v Allied Builders Corp.* (1971) 21 CA3d 541, 98 CR 588.

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§10.50 C. Not Available for Bad Faith Denial of Contract's Existence

Controversy has existed over whether damages in tort, including exemplary damages, are available for the bad faith denial that a contract exists. In *Seaman's Direct Buying Serv., Inc. v Standard Oil Co.* (1984) 36 C3d 752, 769, 206 CR 354, the California Supreme Court held that a party to a contract may be subject to tort damages when, in addition to breaching the contract, it seeks to shield itself from liability by denying in bad faith and without probable cause that the contract exists. In *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 44 CR2d 420, however, the California Supreme Court expressly overruled *Seaman's* in favor of a general rule prohibiting tort recovery for breach of noninsurance contracts, in the absence of violation of an independent duty arising under tort law.

In *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 86 CR2d 855, the court followed the *Freeman* decision, refusing to permit tort recovery against a surety for breach of the implied covenant of good faith and fair dealing in the context of a construction project surety bond. The court distinguished surety contracts from traditional insurance contracts (see §10.33) and disallowed tort recovery. The court reversed the award of punitive damages, holding that "[i]n the absence of an independent tort, punitive damages may not be awarded for breach of contract 'even where the defendant's conduct in breaching the contract was willful, fraudulent or malicious.'" 21 C4th at 61 (citations omitted).

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§10.51 D. Proof of Defendant's Financial Condition

Courts are required to consider meaningful evidence of a defendant's financial condition before awarding punitive damages. *Adams v Murakami* (1991) 54 C3d 105, 118, 284 CR 318. The plaintiff has the burden of producing such evidence. 54 C3d at 119. Cases decided after *Adams* have elaborated on its meaning. See *Rich v Schwab* (1998) 63 CA4th 803, 815, 75 CR2d 170 (*Adams'* rule, that defendant's financial condition must be considered before assessment of punitive damages, does not apply when statute sets minimum and maximum penalty; however, defendant may show evidence of financial condition in mitigation); *Stevens v Owens-Corning Fiberglass Corp.* (1996) 49 CA4th 1645, 1660, 57 CR2d 525 (amount of defendant's profits does not limit punitive damage award); *Lara v Cadag* (1993) 13 CA4th 1061, 16 CR2d 811 (evidence of defendant's income alone is inadequate); *Cummings Med. Corp. v Occupational Med. Corp.* (1992) 10 CA4th 1291, 13 CR2d 585 (punitive damages may be based on profitability of defendant's misconduct). In *Mike Davidov Co. v Issod* (2000) 78 CA4th 597, 608, 92 CR2d 897, the court agreed with *Cummings* and awarded punitive damages in a case in which the trial court ordered the defendant to produce financial records, but the defendant failed to do so. But see *Kenly v Ukegawa* (1993) 16 CA4th 49, 19 CR2d 771, which criticized *Cummings* and held that, in most cases, an award of punitive damages cannot be justified solely on the profitability of the defendant's misconduct.

Civil Code §3295 permits a defendant to ask the court to preclude any evidence of the defendant's financial condition until after malice, oppression, or fraud has been proved.

Before a trial court may enter an order allowing discovery of financial condition information under CC §3295(c), it must weigh the evidence presented by both sides and make a finding that it is "very likely" the plaintiff will prevail on the punitive damages claim. *Jabro v Superior Court* (2002) 95 CA4th 754, 755, 115 CR2d 843. For an illustration of the type of financial documents that may be discoverable concerning the punitive damages issue, see *Weingarten v Superior Court* (2002) 102 CA4th 268, 125 CR2d 371.

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VIII. CONSUMERS LEGAL REMEDIES ACT (CC §§1750-1784)

§10.52 A. Application (CC §§1751, 1754, 1761, 1770)

The Consumers Legal Remedies Act (CC §§1750-1784) applies in transactions for the sale or lease of goods "primarily for personal, family or household purposes," including fixtures, and for services "for other than a commercial or business use, including services furnished in connection with the sale or repair of goods." CC §§1761(a)-(b). It defines and establishes as unlawful a number of unfair methods of competition and unfair or deceptive acts, including, without limitation, passing off goods or services as those of another, representing that goods are new if they are reconditioned or used, misrepresenting the quality of goods, advertising goods or services with intent not to sell them as advertised, misrepresenting the terms of rebates or discounts, inserting unconscionable provisions in a contract, disseminating certain unsolicited prerecorded messages by telephone, charging an unreasonable fee to help secure public social services, and certain home solicitations of senior citizens. See CC §1770(a), (b). The unfair or deceptive acts may be oral or written. *Wang v Massey Chevrolet* (2002) 97 CA4th 856, 869, 118 CR2d 770. The transaction need not involve a formal enforceable contract. CC §1761(e). The Act does not apply to transactions relating to the construction or sale of residences or commercial or industrial properties or to the sale of lots or parcels of land. CC §1754. Further, it does not apply to life insurance. *Fairbanks v Superior Court* (2009) 46 C4th 56, 92 CR3d 279; *Broberg v Guardian Life Ins. Co.* (2009) 171 CA4th 912, 924, 90 CR3d 225.

Any purported waiver of the provisions of the Act is void as against public policy. CC §1751. In *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699, the court held that the forum selection and choice of law clauses in AOL's service agreement were the functional equivalent of a contractual waiver of the Consumers Legal Remedies Act, and violated California public policy. The clauses were therefore unenforceable. See also *Doe 1 v AOL LLC* (9th Cir 2009) 552 F3d 1077.

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§10.53 B. Remedies (CC §1780)

The Act specifies a number of remedies available to consumers who suffer damage as a result of the use or employment by any person of any of the methods, acts, or practices that the Act declares unlawful. CC §1780(a). A consumer must suffer actual, as opposed to prospective, damage in order to have standing to sue under the Act. *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 638, 88 CR3d 859. Special notice and demand procedures must be followed before an action may be commenced. See §10.54. The remedies provided by the Act are not exclusive. CC §1752. Civil Code §1780(a) lists the following specific remedies available:

- Actual damages (in a class action, actual damages must total at least $1000);
- Injunctive relief;
- Restitution of property;
- Punitive damages; and
- Any other relief that the court deems proper.

If the plaintiff is a senior citizen or is disabled (as defined in CC §1761(f)-(g)), he or she may recover up to $5000 in addition to the remedies noted above if he or she suffered substantial physical, emotional, or economic damage from the defendant's conduct and one or more other special factors are present. See CC §1780(b). Treble damages are available when a plaintiff proves by a preponderance of the evidence that the defendant charged an unreasonable fee to advise on or assist in securing public social services. CC §1780(c).

A prevailing plaintiff may also recover court costs and attorney fees. Reasonable attorney fees may be awarded to a prevailing defendant if it can show that the plaintiff's prosecution of the action was not in good faith. CC §1780(e). See *Kim v Euromotors W./The Auto Gallery* (2007) 149 CA4th 170, 56 CR3d 780; *Hayward v Ventura Volvo* (2003) 108 CA4th 509, 510, 133 CR2d 514.

No damages may be recovered if the person alleged to have employed or committed an unlawful method, act, or practice (1) proves that the violation was unintentional and resulted from a bona fide error, notwithstanding the use of reasonable procedures adopted to avoid such errors, and (2) makes an appropriate correction, repair, or replacement of the goods or takes other appropriate remedial action. CC §1784.

An action based on the Consumers Legal Remedies Act may be filed in the county in which the defendant resides, has its principal place of business, or is doing business, or in the county where the transaction or any substantial part of it took place. The complaint must be accompanied by an affidavit showing that the action was filed in the proper place. CC §1780(d). An action brought under the Consumers Legal Remedies Act must be commenced within 3 years after the unlawful act was committed. CC §1783.

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§10.54 C. Special Notice and Demand Procedures (CC §1782)

At least 30 days before a consumer may commence an action for damages under the Consumers Legal Remedies Act, he or she is required to notify the prospective defendant of the particular violations complained of, and demand that the goods or services alleged to be in violation be repaired, replaced, or otherwise corrected. The notice must be in writing and sent by certified or registered mail to the place where the transaction occurred or to the person's principal place of business in California. CC §1782(a). The consumer cannot maintain an action for damages if an appropriate correction, repair, replacement, or other remedy has been given (or agreed to be given within a reasonable time) within 30 days after receipt of the notice. CC §1782(b).

No notice or demand is required for an action for injunctive relief under a specific provision of CC §1770. See *Morgan v AT&T Wireless Servs., Inc.* (2009) 177 CA4th 1235, 1260, 99 CR3d 768. The consumer may amend the complaint without leave of court to include a request for damages, but must wait at least 30 days after the filing of the initial complaint and must also comply with the notice and demand requirements of CC §1782(a). CC §1782(d); 177 CA4th at 1260.

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Source: Business Law/California Law of Contracts/10 Remedies: Damages/§10.55 D. Class Actions (CC §1781)

§10.55 D. Class Actions (CC §1781)

The Consumers Legal Remedies Act includes special provisions for class actions, but these provisions are not exclusive and do not limit any right to bring a class action under other applicable law, such as CCP §382. See CC §§1752, 1781. Under CC §1781(a), an injured consumer may bring an action against a defendant on behalf of himself and other consumers if (1) it is impracticable to bring all members of the class before the court; (2) the questions of law or fact common to the class predominate over the questions affecting individual members; (3) the claims or defenses of the representative plaintiffs are typical of the claims or defenses of the class; and (4) the representative plaintiffs will fully and adequately protect the interests of the class. CC §1781(b). See *Willens v TD Waterhouse Group, Inc.* (2003) 120 CA4th 746, 753, 15 CR3d 271 (class action not proper because each class member would have had to litigate numerous unique questions to determine his or her individual right to recover).

A class action for damages cannot be maintained if the defendant can show that (CC §1782(c)):

- All similarly situated consumers have been identified (or a reasonable effort to identify those consumers has been made);
- The identified consumers have been notified that, on their request, the defendant will make the appropriate correction, repair, or replacement, or take other remedial action with respect to the goods or services at issue;
- The correction, repair, replacement, or other remedy requested by the plaintiffs has been made, or will be made in a reasonable time; and
- The defendant has stopped engaging in the prohibited practices or, if immediate cessation is impossible or unreasonably expensive under the circumstances, the defendant will stop within a reasonable time.

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Remedies: Injunctive and Declaratory Relief; Other Remedies

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§11.1 I. INTRODUCTION

A contract's expectancy interest cannot always be protected by an action for monetary damages. Recovery of damages is subject to (a) the *Hadley* rule of foreseeability, requiring the damages to have been within the contemplation of the parties at the time the contract was made (CC §3300; *Hadley v Baxendale* (1854) 9 Ex 341, 156 Eng Rep 145); (b) the requirement of certainty, which prevents recovery of damages that are speculative (CC §3301); and (c) other constraints affecting proof of damages. See generally chap 10. Equitable relief, however, is more flexible by nature. "In actions founded on contract, courts have available for use in appropriate cases, in addition to specific performance, equitable remedies based on reformation, excuse of conditions and rescission… , as well as quasi-specific performance by constructive trust… , and indirect enforcement of a covenant by negative decree." *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 390, 36 CR2d 581 (citations omitted). A plaintiff's breach of contract recovery may be designed to restore whatever the plaintiff has paid over or delivered to the defendant or to allow recovery of losses resulting from expenditures made by the plaintiff in reliance on the contract. Specific performance may be an appropriate remedy whenever a damage action would fail to compensate a plaintiff adequately for harm actually incurred from the breach.

Civil Code §3274 recognizes that damages are the preferred remedy, but that specific or preventive relief may also be had in the circumstances specified in the Civil Code:

> As a general rule, compensation is the relief or remedy provided by the law of this state for the violation of private rights, and the means of securing their observance; and specific and preventive relief may be given in no other cases than those specified in this part of the Civil Code.

Further, CC §3366 provides that "[s]pecific or preventive relief may be given as provided by the laws of this state."

This chapter surveys the principal remedies available for breach of contract other than money damages, which is the subject of chap 10. Injunctive relief is reviewed generally in §§11.2-11.6. The remedy of specific performance is discussed in §§11.7-11.39. Declaratory relief is discussed in §§11.40-11.45. Rescission is covered in §§11.46-11.58, cancellation in §11.59-11.60, abandonment in §11.61, and reformation in §§11.62-11.64. The statute providing a right of action for a lost or destroyed instrument is noted briefly in §11.65. Finally, this chapter discusses quasi-contract and the remedy of restitution, which may be available if a contract is void or unenforceable. See §§11.66-11.73.

NOTE: If the plaintiff's cause of action is essentially one in equity and the relief sought depends on application of equitable doctrines, the parties are not entitled to a jury trial. *C & K Eng'g Contractors v Amber Steel Co.* (1978) 23 C3d 1, 8, 151 CR 323; *Caira v Offner* (2005) 126 CA4th 12, 24 CR3d 233. If the case involves both legal and equitable issues, the trial court may try the equitable issues first, without a jury, and if the court's decision on the equitable issues is also dispositive of the legal issues, nothing further remains for trial by a jury. *Raedeke v Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 671, 111 CR 693; *Walton v Walton* (1995) 31 CA4th 277, 293, 36 CR2d 901.

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Source: Business Law/California Law of Contracts/11 Remedies: Injunctive and Declaratory Relief; Other Remedies/ II. INJUNCTIVE RELIEF GENERALLY/§11.2 A. Specific or Preventive Relief (CC §§3367-3368, 3422)

II. INJUNCTIVE RELIEF GENERALLY

§11.2 A. Specific or Preventive Relief (CC §§3367-3368, 3422)

"Specific" and "preventive" relief are defined in CC §§3367-3368. Civil Code §3367 provides that:

> Specific relief is given:
> 1. By taking possession of a thing, and delivering it to a claimant;
> 2. By compelling a party himself to do that which ought to be done; or,
> 3. By declaring and determining the rights of parties, otherwise than by an award of damages.

Subsections (1) and (2) of CC §3367 refer to different aspects of the remedy of specific performance. If the requirements for specific performance are met, affirmative covenants in a contract may be enforced by specific performance (in effect, a mandatory injunction), as discussed in §§11.7-11.39. Subsection (3) of CC §3367 refers to declaratory relief, which is discussed in §§11.40-11.45.

Civil Code §3368 states that "[p]reventive relief is given by prohibiting a party from doing that which ought not to be done," and CC §3420 provides that "[p]reventive relief is granted by injunction, provisional or final." See also CCP §525, which defines the term "injunction" as "a writ or order requiring a person to refrain from a particular act" (in effect, a prohibitory injunction). In general, preventive relief is available to restrain or prevent a breach of contract, when monetary damages would be inadequate or would be extremely difficult to ascertain. *Pacific Decision Sciences Corp. v Superior Court* (2004) 121 CA4th 1100, 1110, 18 CR3d 104. Civil Code §3422 provides in part that:

> Except where otherwise provided by this title, a final injunction may be granted to prevent the breach of an obligation existing in favor of the applicant:
> 1. Where pecuniary compensation would not afford adequate relief;
> 2. Where it would be extremely difficult to ascertain the amount of compensation which would afford adequate relief;….

Negative covenants in a contract are generally enforced by preventive relief, *i.e.,* an injunction, but a plaintiff might also seek indirect enforcement of an affirmative covenant that cannot be enforced directly by the coercive force of a negative injunction. For example, in *Long Beach Drug Co. v United Drug Co.* (1939) 13 C2d 158, 88 P2d 698, the plaintiff had an exclusive dealership agreement with the defendant drug manufacturer covering the city of Long Beach. In the contract, the defendant also agreed not to sell its products to any other dealer in the city as long as the plaintiff performed the terms of the dealership. Specific performance was not available to enforce the affirmative exclusive dealership arrangement because performance of that agreement was continuous over an indefinite time period. See §11.39. Nonetheless, the trial court granted the plaintiff an order permanently enjoining the defendant from selling products to any other dealer in Long Beach. The California Supreme Court reversed, holding that when a contract contains both affirmative and negative covenants, a court of equity will not issue an injunction to prevent a breach of the negative covenant if the affirmative covenant is not capable of specific enforcement. *Long Beach Drug Co. v United Drug Co.*, *supra*. See also CC §3423; CCP §526(b)(5); *Motown Record Corp. v Brockert* (1984) 160 CA3d 123, 130, 207 CR 574; *Whipple Road Quarry Co. v L. C. Smith Co.* (1952) 114 CA2d 214, 216, 249 P2d 854.

An important consideration in deciding whether to seek an injunction is that a bond is normally required for a preliminary injunction. See CCP §529(a). Ordinarily, a preliminary injunction cannot take effect unless and until the plaintiff provides an undertaking that it will pay any damages that may be sustained by the defendant if the court finally determines that the plaintiff was not entitled to an injunction. *City of S. San Francisco v Cypress Lawn Cemetery Ass'n* (1992) 11 CA4th 916, 14 CR2d 323. The client should be advised of the bonding requirement at the very beginning of any case in which an injunction may be sought. For further information concerning bonds, see the Bond and Undertaking Law (CCP §§995.010-996.560).

NOTE: The Civil Code distinguishes between preliminary (temporary) and permanent injunctions. Civil Code §3421 provides that temporary injunctions are governed by the Code of Civil Procedure. See CCP §§525-533. Civil Code §3422 (quoted above) applies only to permanent injunctions. For the circumstances in which a court is or is

not authorized to grant a temporary injunction, see CCP §526.

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§11.3 B. Not Available to Enforce a Penalty or Forfeiture (CC §§3275, 3369)

Civil Code §3369 provides that "[n]either specific nor preventive relief can be granted to enforce a penalty or forfeiture in any case, nor to enforce a penal law, except in a case of nuisance or as otherwise provided by law." Another statute, CC §3275, also reflects the doctrine that law abhors a forfeiture, by providing relief from forfeiture even though the party seeking relief has breached the contract. Civil Code §3275 provides:

> Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful, or fraudulent breach of duty.

For a plaintiff to obtain relief under CC §3275 despite the plaintiff's breach of contract, the defendant must have been measurably enriched to an extent greater than the damages suffered by the defendant on account of the plaintiff's breach. *Lines v Marin Mun. Water Dist.* (1964) 228 CA2d 155, 39 CR 294. If it is possible for the court to reasonably interpret the agreement so as to avoid a forfeiture, the court is obliged to do so. *Universal Sales Corp. v California Press Mfg. Co.* (1942) 20 C2d 751, 128 P2d 665; *Horning v Ladd* (1958) 157 CA2d 806, 321 P2d 795.

Historically, CC §§3275 and 3369 have found particular application in cases involving part performance of installment land contracts or other installment loan payment arrangements. See, *e.g., Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170; *Scarbery v Bill Patch Land & Water Co.* (1960) 184 CA2d 87, 7 CR 408. In *MacFadden v Walker* (1971) 5 C3d 809, 97 CR 537, the California Supreme Court held that the buyer under an installment land sale contract was not precluded from obtaining specific performance, notwithstanding that time was of the essence under the contract and that the buyer had willfully failed to make installment payments when due. The court found that the contract was just and reasonable, the consideration was adequate, the buyer had paid over half of the purchase price before defaulting, and the value of the land adequately secured her obligation to pay the remainder. The court held that CC §§3275, 3294, and 3369, along with CC §§1670 and 1671, establish a policy that precludes any forfeiture having no reasonable relation to the damage caused by the buyer's breach, even in cases where the breach is willful. See also CC §3386.

NOTE: The rights and remedies of parties to installment purchase contracts involving personal property are now generally governed by other, more specific statutes, such as the Uniform Commercial Code and the Unruh Act (CC §§1801-1812.20) governing retail installment sales. See §6.39. The rule against forfeitures is discussed further in §10.41 in the context of liquidated damages clauses.

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C. Preventive Relief for Breach of Contract

§11.4 1. When Contract Is Specifically Enforceable (CC §3422; CCP §526(a))

If a contract is subject to specific performance (see CC §3423(e)) and either damages would not afford adequate relief or it would be extremely difficult to ascertain the amount of damages that would be adequate, an injunction may be granted to prevent a breach of contract. CC §3422. See also CCP §526(a)(4)-(5). A plaintiff is not required to wait until it suffers actual harm, but may seek preventive relief against a threatened infringement of its rights. *Southern Christian Leadership Conf. v Al Malaikah Auditorium Co.* (1991) 230 CA3d 207, 223, 281 CR 216. See also CCP §526(a)(1)-(3). In general, the function of an injunction is preventive rather than remedial, but an injunction may be granted with respect to prior acts if there is evidence that those acts will probably recur. *Fretz v Burke* (1967) 247 CA2d 741, 744, 55 CR 879 (action for partnership accounting). Damages may be considered an inadequate remedy if the plaintiff can show that a money judgment against the defendant would not be collectible. *Woodbine v Van Horn* (1946) 29 C2d 95, 173 P2d 17. Damages are generally always considered inadequate in actions to enforce contracts for the sale or lease of real property. *Wilkison v Wiederkehr* (2002) 101 CA4th 822, 830, 124 CR2d 631. See CC §3387, discussed in §11.10.

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§11.5 2. When Contract Is Not Specifically Enforceable (CC §3423(e); CCP §526(b))

Under both CC §3423(e) and CCP §526(b)(5), except for certain personal services contracts with "star" performers or athletes (see §11.6), an injunction cannot be granted to prevent the breach of a contract the performance of which cannot be specifically enforced. *Steinmeyer v Warner Consol. Corp.* (1974) 42 CA3d 515, 519, 116 CR 57; *Thayer Plymouth Ctr., Inc. v Chrysler Motors Corp.* (1967) 255 CA2d 300, 63 CR 148. The Civil Code specifies contracts for which the remedy of specific performance is generally not available, as follows (CC §3390(1)-(5)):

- Contracts to render personal services or to employ another in personal service (see §§11.17-11.21);
- Contracts for illegal acts (see §11.22);
- Contracts to obtain the consent of a spouse or other third person (see §11.23);
- Contracts, the terms of which are not sufficiently certain (see §§11.24-11.26).

In addition, by negative implication in CC §3422, specific performance is not available if damages are readily ascertainable and would afford adequate relief. See §11.29. See, *e.g., Pacific Decision Sciences Corp. v Superior Court* (2004) 121 CA4th 1100, 1110, 18 CR3d 104 (amount of plaintiff's claim was fixed or readily ascertainable; there was therefore no basis for preliminary injunction). Moreover, specific performance generally cannot be enforced against a contracting party (CC §3391; see §11.30):

- Who has not received adequate consideration for the contract (see §11.31);
- If it would be unjust or unreasonable to do so (see §11.32);
- If that party's assent was obtained by fraud or other unfair practices (see §11.33); or
- If that party's assent was given under the influence of mistake or surprise (see §11.34).

Finally, specific performance is generally not available:

- To a party who has not fully and fairly performed all conditions precedent to his or her performance (CC §3392; see §§11.35-11.37);
- To a real estate seller if the seller cannot give the buyer marketable title (CC §3394; see §11.38); or
- For contracts that prescribe a continuous succession of acts rather than a single transaction, because such continuing performance would require protracted supervision by the court (*Thayer Plymouth Ctr., Inc. v Chrysler Motors Corp.* (1967) 255 CA2d 300, 303, 63 CR 148; see §11.39).

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§11.6 3. Certain Personal Service Contracts (CC §3423(e); CCP §526(b))

As an exception to the general rule that an injunction will not be granted to prevent the breach of a contract for which specific performance is not available (see §11.5), both CC §3423(e) and CCP §526(b) expressly allow an injunction to issue to prevent the breach of personal services contracts that meet certain very specific requirements. The statutory requirements are as follows (CC §3423(e); CCP §526(b)):

- The contract must be in writing;
- The personal services must be "of a special, unique, unusual, extraordinary, or intellectual character, which gives it peculiar value, the loss of which cannot be reasonably or adequately compensated in damages in an action at law";
- The minimum compensation for the personal services required by the contract must be as follows:
- For contracts entered into on or before December 31, 1993, $6000 per year;
- For contracts entered into on or after January 1, 1994, (i) $9000 per year for the first year of the contract, $12,000 per year for the second year of the contract, and $15,000 per year for the third through seventh years of the contract; and (ii) in addition, after the third year of the contract, over and above the minimum amounts specified in clause (i), there shall have in fact been paid for the services, through and including the contract year during which injunctive relief is sought, $15,000 per year during the fourth and fifth years of the contract and $30,000 per year during the sixth and seventh years of the contract. If the contract does not meet the foregoing criteria, it will nevertheless qualify if the aggregate compensation actually received for the services is at least 10 times the applicable aggregate minimum amount specified in clauses (i) and (ii), through and including the contract year during which injunctive relief is sought. The amounts payable may be paid at any time before injunctive relief is sought.
- Compensation paid in any contract year over and above the minimums specified above will reduce the compensation otherwise required to be paid in subsequent contract years.

The exception in CC §3423(e) and CCP §526(b) is intended to enable enforcement of personal services contracts with performing artists and athletes of "star" quality. See generally *Motown Record Corp. v Brockert* (1984) 160 CA3d 123, 130, 207 CR 574. It has its genesis in the famous case of *Lumley v Wagner* (1852) 42 Eng Rep 687, in which an injunction was granted to prevent an opera singer who had agreed to sing at the plaintiff's theater for 3 months from performing anywhere else. The rationale for the exception is that the entrepreneur has contracted for the exclusive right to feature the star performer or athlete for a given period of time and has bargained with and compensated the star accordingly. *Lemat Corp. v Barry* (1969) 275 CA2d 671, 678, 80 CR 240. *Lemat* held that an injunction preventing a star athlete or performer from rendering services to anyone else may extend for the primary term of the contract and also for the period of any option to renew the contract, but cannot survive longer than that.

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III. SPECIFIC PERFORMANCE

A. When Available (CC §3384)

§11.7 1. Introduction

The remedial goal in an action for breach of contract is to put the nonbreaching party in the same position that it would have been in had the other party performed, thus fulfilling the nonbreaching party's expectancy interest in the contract and giving it the benefit of the bargain. See generally §10.3; CC §3300. Hence, the nonbreaching party's expectancy interest in a contract is protected most directly by a decree requiring the defaulting party in fact to perform the contract. Although specific performance best accomplishes this remedial goal in most instances, compensation in the form of damages may be the only practicable remedy in many situations where the passage of time or the intervention of other factors has made specific performance difficult or impossible. See generally chap 10. Specific performance may be considered whenever the subject matter of the contract is such that an action for damages would not adequately compensate the plaintiff for harm actually incurred from the breach. See §11.8.

NOTE: Specific performance in connection with real estate transactions is discussed at length in chapter 5 of California Real Property Remedies and Damages (2d ed Cal CEB 2002).

Civil Code §3384 provides broadly that "[e]xcept as otherwise provided in this article, the specific performance of an obligation may be compelled." Civil Code §§3386-3392, 3394, and 3395, discussed in §§11.8-11.38, set forth a series of rules governing the availability of specific performance as a remedy for breach of contract in California. In general, specific performance of a contract may be ordered whenever (*Blackburn v Charnley* (2004) 117 CA4th 758, 766, 11 CR3d 885):

- The terms of the contract are sufficiently definite and certain for enforcement (see §§11.24-11.26);
- There is adequate consideration (see §11.31);
- The requested performance is substantially similar to the contract terms;
- There is mutuality of remedy (see §11.9); and
- The plaintiff's legal remedy is not adequate (see §11.8, 11.29).

See also *Tamarind Lithography Workshop, Inc. v Sanders* (1983) 143 CA3d 571, 193 CR 409; *Porporato v Devincenzi* (1968) 261 CA2d 670, 674, 68 CR 210; *Henderson v Fisher* (1965) 236 CA2d 468, 46 CR 173. In addition, except in limited circumstances, the contract cannot involve personal services (see §§11.17-11.21); the contract cannot be illegal or impossible to perform (see §§11.22, 11.27); the requested performance cannot entail procuring the consent of, or an act by, a third party (see §11.23); the contract cannot be unjust or unreasonable (see §11.32); the defendant's assent to the contract cannot have been obtained by fraud, mistake, or other unfair practices (see §§11.33-11.34); the plaintiff must have performed its part of the bargain (see §§11.15, 11.35-11.37); and specific performance cannot require continuing supervision by the court (see §11.39).

Because it is an equitable remedy, specific performance will not be granted as a matter of absolute right. It is within the sound discretion of the court, and will only be given in accordance with established principles of equity and in reference to the facts of the particular case. *Maron v Howard* (1968) 258 CA2d 473, 488, 66 CR 70; *Pasqualetti v Galbraith* (1962) 200 CA2d 378, 19 CR 323. For the same reasons, it is flexible in nature. A decree of specific performance need not require performance that is identical to what was originally promised in the contract. It may be granted on whatever terms and conditions that justice requires, and may be crafted so as to best carry out the purposes for which the contract was made. The original performance required by the contract may be difficult to enforce, or it may have become impossible or unlawful. Enforcement of the original promise might operate as an unreasonable hardship. Nonetheless, the court may be able to achieve substantially the same result without undue difficulty, illegality, or hardship, and if so, the decree may be designed to best achieve that result. *Rogers v Davis* (1994) 28 CA4th 1215, 1221, 34 CR2d 716 (in place of specific performance of original contract for sale of real estate that had been foreclosed

on, court awarded plaintiffs a share of sales proceeds). See also *Lister v Sorge* (1968) 260 CA2d 333, 342, 67 CR 63 (court ordered payment of money and conveyance of promissory notes as substitute performance of original stock option agreement).

NOTE: Specific performance may be awarded in an arbitration proceeding in situations where it would not have been available had the dispute been litigated in court. The parties to an arbitration are free to determine the rules by which their dispute will be resolved, including the scope of available relief. *Advanced Micro Devices, Inc. v Intel Corp.* (1994) 9 C4th 362, 389, 36 CR2d 581.

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§11.8 2. Inadequacy of Legal Remedy

Although not mentioned in the Civil Code provisions concerning specific performance, a court will not grant specific performance if the plaintiff has an adequate legal remedy. "[A] proper exercise of the equitable jurisdiction will not give equitable relief in any case where the legal remedy is full and adequate and does complete justice. No principle of equitable jurisprudence is more firmly established than this." *Wilkison v Wiederkehr* (2002) 101 CA4th 822, 830, 124 CR2d 631. See also *Martin v County of Los Angeles* (1996) 51 CA4th 688, 696, 59 CR2d 303. If an ordinary action at law for breach of contract would give the injured party the very thing to which it is entitled based on the allegations in its complaint and would afford it full and adequate relief, specific performance will be denied. *Wilkison,* 101 CA4th at 833.

In determining the adequacy of a plaintiff's remedy at law, the question is not whether it has some remedy at law apart from the contract, but whether its remedy at law based on the contract itself, *i.e.,* for damages, is sufficient. If the plaintiff's expectancy interest in the contract can be protected by an award of damages, equity will not order specific performance. *Henderson v Fisher* (1965) 236 CA2d 468, 474, 46 CR 173.

In *Tamarind Lithography Workshop, Inc. v Sanders* (1983) 143 CA3d 571, 193 CR 409, a film producer sought damages and specific performance of the film owner's contractual obligation to give the producer screen credits. The court held that the trial court's damage award did not preclude additional relief of specific performance. The legal remedies available for harm resulting from future exhibitions of the film without the credits were inadequate as a matter of law, because an accurate assessment of damages would be difficult and require speculation and any future exhibitions might be deemed to be a continuous breach of contract, thereby creating the danger of numerous lawsuits. See also *Union Oil Co. v Greka Energy Corp.* (2008) 165 CA4th 129, 80 CR3d 738 (specific performance is generally appropriate remedy for breaches of oil field clean-up agreements because it is the most direct way to remedy breach and protect the environment).

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§11.9 3. Mutuality of Remedy (CC §3386)

Civil Code §3386 was amended in 1969 to eliminate the strict, historical requirement that specific performance could not be granted if the plaintiff had not performed (or could not be compelled to perform) all of its own obligations to the defendant under the contract. As amended, CC §3386 reads as follows:

> Notwithstanding that the agreed counterperformance is not or would not have been specifically enforceable, specific performance may be compelled if:
> (a) Specific performance would otherwise be an appropriate remedy; and
> (b) The agreed counterperformance has been substantially performed or its concurrent or future performance is assured or, if the court deems necessary, can be secured to the satisfaction of the court.

The 1969 amendment was intended to align the statute with then-developing case law to the effect that a defendant should not be required to perform without receiving the agreed counterperformance from the plaintiff. 9 Cal L Rev'n Comm'n Reports 201 (1969). Commenting on the way in which the historical doctrine of mutuality of remedy had evolved, the California Supreme Court in *Ellis v Mihelis* (1963) 60 C2d 206, 215, 32 CR 415, stated: "What equity exacts today as a condition of relief is the assurance that the decree, if rendered, will operate without injustice or oppression either to plaintiff or to defendant." Civil Code §3386 now gives the trial court flexibility to include terms in a decree of specific performance that adjust the equities between the parties in order to bring about substantial justice. The court can thereby ensure that the plaintiff's counterperformance will be forthcoming. In effect, mutuality of remedy is achieved by the plaintiff's act in submitting to the jurisdiction of the equity court. *Converse v Fong* (1984) 159 CA3d 86, 205 CR 242. See also *Bleecher v Conte* (1981) 29 C3d 345, 213 CR 852 (holding that buyers under land sale contract were not prevented from obtaining specific performance by existence of liquidated damage clause in contract).

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Source: Business Law/California Law of Contracts/11 Remedies: Injunctive and Declaratory Relief; Other Remedies/ §11.10 4. Contracts to Transfer Real Property (CC §§3387, 3395)

§11.10 4. Contracts to Transfer Real Property (CC §§3387, 3395)

Civil Code §3387 establishes a presumption that the legal remedy of damages will be inadequate in any action to enforce an agreement for the sale or lease of real property.

> It is to be presumed that the breach of an agreement to transfer real property cannot be adequately relieved by pecuniary compensation. In the case of a single-family dwelling which the party seeking performance intends to occupy, this presumption is conclusive. In all other cases, this presumption is a presumption affecting the burden of proof.

The presumption is based on the premise that each specific parcel of land is unique and therefore a breach of an agreement regarding land cannot be adequately compensated by money damages. See *Porporato v Devincenzi* (1968) 261 CA2d 670, 677, 68 CR 210. In *Real Estate Analytics, LLC v Vallas* (2008) 160 CA4th 463, 72 CR3d 835, the trial court refused to award the plaintiffs specific performance on a contract for sale of a parcel near the coast in Carlsbad, concluding money damages were adequate because the buyer purchased the property "solely as a commodity" to earn "money for their investors" and not because of the uniqueness of the property itself. The appellate court reversed, holding the defendants did not overcome the "strong statutory presumption" in §3387 that land is unique. The court concluded the land at issue was unique not only because of its physical attributes and location, but also because of its investment potential. See also *Wilkison v Wiederkehr* (2002) 101 CA4th 822, 830, 124 CR2d 631; *BD Inns v Pooley* (1990) 218 CA3d 289, 296, 266 CR 815.

Damages are also available for breach of real property sales contracts under CC §3307, in an amount equal to the excess, if any, of the amount that would have been due to the seller under the contract over the value of the property to the seller, plus any consequential damages subject to proof, and interest. The existence of CC §3307, however, does not mean that the nonbreaching party has an adequate remedy at law. Civil Code §3307 expands the remedies available for breach of a real property contract and does not preclude a decree of specific performance. *BD Inns v Pooley, supra.*

The right to obtain specific performance of a real estate sales contract extends to the seller as well as to the buyer. *Laske v Lampasona* (1948) 89 CA2d 284, 200 P2d 871. In either case, the plaintiff must show that he or she has performed or offered to perform all conditions precedent to the contract. CC §3392. See, *e.g., Realmuto v Gagnard* (2003) 110 CA4th 193, 204, 1 CR3d 569 (residential real estate seller was not entitled to specific performance because he failed to deliver required disclosure statement to buyers). The inadequacy of a real estate seller's remedy in damages has been explained by several factors: (1) The seller cannot get judgment for the full price because he or she still has the land; (2) the seller's actual damages will be difficult to prove because the land may have no established market value; (3) even if the seller can prove damages, the land may not be immediately resalable, therefore the lost sale carries an opportunity cost; and (4) before the seller obtains a judgment against the buyer, the existence of the buyer's contract adversely affects marketability of the property. See Restatement (Second) of Contracts §360, Comment e (1981).

The difference between a seller's remedy of damages and a seller's remedy of specific performance was explained in *BD Inns v Pooley* (1990) 218 CA3d 289, 298, 266 CR 815:

- If a real estate seller chooses damages for breach of contract, the seller gives up its interest in the unpaid purchase price and instead is awarded its equitable interest in the land plus damages equal to the difference between the value of the land on the date of breach and the contract price under CC §3307.
- In comparison, if the seller elects to seek specific performance of the contract, it must remain at all times ready to perform its own obligations. It gives up its equitable ownership and right to possession of the land and retains its interest in the purchase price under the contract. Because the goal of specific performance is to put the parties back in the position they would have been in had the contract been performed timely, the court may also award the seller interest on account of the delay in the buyer's performance of its obligation to pay. See §11.12.

The right to obtain specific performance also applies to a right of first refusal with respect to real property. See

Campbell v Alger (1999) 71 CA4th 200, 83 CR2d 696. Further, in *Ellison v Ventura Port Dist.* (1978) 80 CA3d 574, 145 CR 665, the court held that the right to obtain specific performance applied to the defendant port district's covenant in a condemnation settlement agreement to maintain a navigation and drainage channel, which was part of a larger transaction to sell land.

As a companion to CC §3387, CC §3395 provides that if specific performance is available to enforce an agreement concerning real property against a particular person, the agreement may likewise be enforced against any other person claiming under the defendant through a title created after the agreement, except a bona fide purchaser (or encumbrancer) for value.

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§11.11 5. Contracts to Transfer Personal Property

Specific performance of contracts for the sale of goods is available to a buyer against the seller under the Commercial Code "where the goods are unique or in other proper circumstances." Com C §2716(1). See §12.92. In the event of a breach by the buyer, the seller may recover the price "in a proper case." Com C §2703(e). See §§12.69-12.70. Similarly, "in a proper case," the lessee under a personal property lease may obtain specific performance of the lease against the lessor. Com C §§10508, 10521. See §§12.102, 12.110. In the event of a breach by the lessee, the lessor may recover the rent "in a proper case." Com C §§10523, 10529. See §12.112.

In light of the expansive definition of "goods" under the Commercial Code, which includes all movable personal property identified to the contract and excludes only money, investment securities, and choses in action (see Com C §2105), the remedial provisions of the Commercial Code will govern most actions for specific performance of contracts involving personal property. Under the Commercial Code, specific performance is not limited to goods that are specific or unique, but may be granted in other proper circumstances, including situations where the buyer is unable to "cover" by purchasing replacement goods. Comment 2 to Com C §2716.

For transactions involving personal property not subject to the Commercial Code, the court's jurisdiction to award specific performance depends on whether the nonbreaching party can be adequately compensated in damages. *Korabek v Weaver Aircraft Corp.* (1944) 65 CA2d 32, 149 P2d 876. The courts recognize that specific performance is available to enforce contracts to sell or convey unique items of personal property, such as shares of stock in closely held corporations, which are not publicly traded and have no established market value. *Capaldi v Levy* (1969) 1 CA3d 274, 281, 81 CR 629. See also *Steinmeyer v Warner Consol. Corp.* (1974) 42 CA3d 515, 519, 116 CR 57.

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§11.12 6. Incidental Damages

In general, specific performance and damages are separate remedies for breach of contract, and a plaintiff cannot obtain both specific performance and damages to redress the same breach, although the plaintiff can request alternate remedies in her or his complaint. See §§9.56-9.57. If necessary to fully vindicate a plaintiff's contractual rights, however, a plaintiff may be awarded compensation—sometimes referred to as "delay damages"—incidental to a decree of specific performance. Technically, such an award does not constitute damages at law for breach of contract. Because the time for actual performance of the contract has passed, the court relates the performance ordered back to that date, treating the parties as if the change in property ownership took place at that time. The buyer is entitled to rents and profits from the property running from the time when the contract should have been performed, and the seller is entitled to an offset for interest on the purchase price that the seller would have received if the contract had been performed. The procedure is equivalent to an accounting between the parties and is distinct from an assessment of damages. *Rogers v Davis* (1994) 28 CA4th 1215, 1220, 34 CR2d 716; *Hutton v Gliksberg* (1982) 128 CA3d 240, 248, 180 CR 141. See also *Ellis v Mihelis* (1963) 60 C2d 206, 219, 32 CR 415. The compensation awarded consists of adjustments for the lost use of the property or the purchase money during the period required by the plaintiff to pursue the specific performance remedy.

Following are some examples of incidental damages awarded in connection with a decree of specific performance:

- *Bravo v Buelow* (1985) 168 CA3d 208, 214 CR 65, allowed recovery of compensation for increased costs of home construction resulting from the seller's delay in conveying title.
- *Hutton v Gliksberg*, *supra,* allowed the buyers to recover the higher interest rate that they had to pay following the sellers' delay in conveying property, even though they would not be obligated to pay the higher rate after the property was resold, because a future sale would result in a lower purchase price on account of the higher rate.
- *Addiego v Hill* (1971) 17 CA3d 453, 460, 95 CR 151, limited the plaintiff-seller's recovery of interest on the purchase price of stock of a closely held corporation, to the increase in the proportionate net worth of the corporation attributable to the stock in question on account of the business transacted by the corporation during the pendency of the appeal.
- *Greenstone v Claretian Theological Seminary* (1959) 173 CA2d 21, 29, 343 P2d 161, allowed recovery of rents and profits lost during the time that the defendants wrongfully refused to convey the property.

A plaintiff who wishes both specific performance and delay damages must request both remedies in the initial proceeding for breach of contract. A decree of specific performance precludes a later action for monetary relief based on the same contract breach, even if the subsequent action seeks to recover for delay in performance caused by the litigation. A plaintiff cannot recover part of its relief in one action and part in another. *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 906, 123 CR2d 432.

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§11.13 7. Contracts Signed by One Party Only (CC §3388)

Civil Code §3388 provides that "[a] party who has signed a written contract may be compelled specifically to perform it, though the other party has not signed it, if the latter has performed, or offers to perform it on his part, and the case is otherwise proper for enforcing specific performance." This statute is consistent with the general rule that an unsigned written agreement may be enforceable if the parties orally agreed on its terms and manifested an intent to be bound. See generally §§4.39-4.41. Lack of a signature is significant only when it is shown that the contract was not intended to be binding unless and until all parties had signed it. If there is no showing that the contract was not intended to be effective until all parties signed, the parties who did sign will be bound. *Angell v Rowlands* (1978) 85 CA3d 536, 542, 149 CR 574 (defendant husband did not show that he only intended to be bound by contract for sale of residence owned by himself and his wife if all parties signed; contract was enforced although wife did not sign). In *Joseph E. Di Loreto, Inc. v O'Neill* (1991) 1 CA4th 149, 161, 1 CR2d 636, the court found that the defendant's failure to sign an employment contract was not legally significant. It could not be inferred from the lack of a signature that the defendant did not enter into the contract, considering the undisputed fact that he fully performed it.

The principle reflected in CC §3388 is similar to promissory estoppel. See §3.50. In *Hart v Erickson* (1944) 63 CA2d 719, 721, 147 P2d 414, the court held that when a buyer under an oral purchase agreement entered into possession of real property, paid all or part of the consideration, made valuable improvements, and performed all of his obligations under the contract, a court will decree specific performance by the seller under the doctrine of estoppel.

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§11.14 8. Contracts With Liquidated Damages Clauses (CC §3389)

Civil Code §3389 provides that a liquidated damages clause in a contract will not bar specific performance. It states that "[a] contract otherwise proper to be specifically enforced, may be thus enforced, though a penalty is imposed, or the damages are liquidated for its breach, and the party in default is willing to pay the same." In *Bleecher v Conte* (1981) 29 C3d 345, 213 CR 852, the court held that the buyers under a contract for the sale of land for condominium development were not prevented from obtaining specific performance by the fact that a liquidated damage clause in the contract stated that the seller waived that remedy if the buyers failed to perform their duties.

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§11.15 9. Plaintiff's Partial Performance Is Immaterial or Fully Compensable (CC §3392)

Civil Code §3392 states the general rule that a party cannot obtain specific performance unless he or she has performed all conditions precedent to the obligation of the other party sought to be enforced. See §11.35. Civil Code §3392 also contains an exception, however, for situations where the plaintiff's failure to perform "is only partial, and either entirely immaterial, or capable of being fully compensated, in which case specific performance may be compelled, upon full compensation being made for the default." In *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170, the California Supreme Court held that when the seller of land under an installment contract retains title only as security, and when the vendee defaults on one or more of the installments after having paid a substantial amount of the purchase price, the vendee retains an absolute right to redeem the property by paying the entire balance of the purchase price and any other amounts due. The court reversed a trial judge's conclusion that the granting of specific performance was discretionary in those circumstances. In contrast, the court in *Realmuto v Gagnard* (2003) 110 CA4th 193, 204, 1 CR3d 569, held that a seller's failure to provide a disclosure statement in a residential real estate sales transaction amounted to a failure of a condition precedent. It did not qualify as a "partial" failure to perform under the exception in CC §3392 and therefore prevented the seller from obtaining specific performance.

In *Williams Plumbing Co. v Sinsley* (1975) 53 CA3d 1027, 126 CR 345, a buyer made a deposit under an installment land sale contract, which provided that "time being of the essence of this contract," the deposit could be forfeited as liquidated damages on the buyer's default. The buyer was late making a payment into escrow, and before delivery of the buyer's letter notifying the seller of the payment, the seller refunded the deposit and purported to terminate the contract. The buyer brought an action for specific performance. The court of appeal found that buyer's failure had not been unlawful, grossly negligent, or intentional, and in spite of the "time of the essence" clause, the buyer's failure had not deprived him of the right to specific performance.

In *Piedmont Pub. Co. v Rogers* (1961) 193 CA2d 171, 14 CR 133, the court held that the plaintiff-buyer was entitled to specific performance of an option agreement for the defendants' stock, notwithstanding that the plaintiff's tender of the purchase price was insufficient. The plaintiff had acted in good faith; the deficiency in the price was the result of an accountants' mistake in construction of the formula in the agreement for valuing the stock; and the mistake was easily remedied.

NOTE: Another circumstance in which a plaintiff's part performance will not bar an action for specific performance is when the plaintiff has substantially performed but the plaintiff's full performance has been prevented by the action of the defendant. See, *e.g., Ninety Nine Invs., Ltd. v Overseas Courier Serv. (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1131, 6 CR3d 891; *Ambrose v Alioto* (1944) 65 CA2d 362, 369, 150 P2d 502.

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Source: Business Law/California Law of Contracts/11 Remedies: Injunctive and Declaratory Relief; Other Remedies/ B. When Specific Performance Is Not Available/ 1. Personal Service Contracts/§11.16 a. Contracts to Render Personal Services (CC §3390(1); Lab C §2855)

B. When Specific Performance Is Not Available

1. Personal Service Contracts

§11.16 a. Contracts to Render Personal Services (CC §3390(1); Lab C §2855)

Civil Code §3390 sets forth five types of obligations that cannot be specifically enforced. The first is an obligation to render personal services. CC §3390(1). The rule applies even though damages may be a wholly inadequate remedy for breach of a personal services contract. See §11.8. It applies not only to contracts involving continued employment but also to "contracts for the rendition of a performance that is of a distinctly personal and non-delegable character," such as "contracts of actors and artists, managers, sales agents, school-teachers, mechanics, cooks, and contracts for the furnishing of personal care and support." *Woolley v Embassy Suites, Inc.* (1991) 227 CA3d 1520, 1534, 278 CR 719 (citations omitted).

The statute is founded on the common law principle that recognizes the inherent difficulties courts would encounter in attempting to supervise the performance of uniquely personal endeavors. A basic reason why courts deny specific performance of personal services contracts is because "such an order would impose on the courts a difficult job of enforcement and of passing judgment upon the quality of performance." *Barndt v County of Los Angeles* (1989) 211 CA3d 397, 403, 259 CR 372. Another key reason is the Thirteenth Amendment. *Moss v Superior Court* (1998) 17 C4th 396, 413, 71 CR2d 215. As stated by the court in *Beverly Glen Music, Inc. v Warner Communications, Inc.* (1986) 178 CA3d 1142, 1144, 224 CR 260, "[a]n unwilling employee cannot be compelled to continue to provide services to his employer either by ordering specific performance of his contract, or by injunction. To do so runs afoul of the Thirteenth Amendment's prohibition against involuntary servitude." Enforcement of personal services contracts would involve (a) a need in some cases for lengthy and detailed supervision by the court to ensure proper execution of the decree, (b) difficulty in gauging whether the defendant had properly performed the services to the best of his or her ability, and (c) mandating the continuation of a personal association after a dispute had arisen and confidence and loyalty are gone. 25 Williston, Contracts §67-104 (4th ed 1990).

For example, in *Rautenberg v Westland* (1964) 227 CA2d 566, 572, 38 CR 797, the court denied specific performance of an agreement that obligated the parties "to perform acts requiring an exercise of personal judgment and a degree of cooperation in making the several enterprises successful." Similarly, in *Woolley v Embassy Suites, Inc., supra,* the court denied specific performance of hotel management contracts that required the exercise of special skill and judgment. The services required were wide-ranging and involved the performance of discretionary actions on a daily basis, including "hiring and firing of managerial personnel and hundreds of other employees, contracting for utility services, landscaping, maintenance and security, processing reservations, arranging for advertising and promotion, and filing legal actions on the owner's behalf to collect rent charges, cancel leases or dispossess guests." 227 CA3d at 1534. The court found that the contracts required "a series of complex and delicate business decisions and… mutual cooperation and trust, both of which have ceased to exist in the wake of rancorous litigation between the parties." 227 CA3d at 1534.

NOTE: Labor Code §2855 also addresses enforcement of personal services contracts. It provides in part that, with two limited exceptions,

> a contract to render personal service… may not be enforced against the employee beyond seven years from the commencement of service under it. Any contract, otherwise valid, to perform or render service of a special, unique, unusual, extraordinary, or intellectual character, which gives it peculiar value and the loss of which can not be reasonably or adequately compensated in damages in an action at law, may nevertheless be enforced against the person contracting to render the service, for a term not to exceed seven years from the commencement of service under it.

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§11.17 b. Contracts to Employ Another in Personal Service (CC §3390(2))

The second type of obligation that is not specifically enforceable under CC §3390 is an obligation to employ another in personal service. CC §3390(2). The basic difficulty with specific enforcement of a personal service contract against an employer is the absence of mutuality of remedy. See §11.9; *Henderson v Fisher* (1965) 236 CA2d 468, 46 CR 173. An employee's performance cannot be specifically enforced. Therefore, unless the employee has already substantially performed so that the action is more properly one at law for amounts owed under the contract or in quantum meruit for the value of services rendered, specific performance will be denied. See CC §3386(b). Further, some of the policy considerations against specific performance of a personal services contract against the employee (see §11.16) apply equally in an action against the employer, *e.g.,* the undesirability of compelling continuation of a personal association after a dispute between the parties has arisen.

In *Herman v County of Los Angeles* (2002) 98 CA4th 484, 119 CR2d 691, a former police officer with a transit authority sought a writ of mandate against the county to enforce an agreement between the county and the transit authority to meet and reach agreement on the placement of former transit authority police officers (including the plaintiff) who did not pass the county sheriff's review process after the authority abolished its police force and contracted with the county for police services. The court rejected the county's argument that the contract was unenforceable under CC §3390(2). The contract did not require the personal services of any particular person, but was analogous to a collective bargaining agreement, which is enforceable against a successor employer under Lab C §1127. See §11.18.

NOTE: If the employee has fully or substantially performed his or her obligations under an otherwise enforceable contract made in consideration of the employee's personal services, CC §3390(2) does not defeat the employee's right to receive the compensation or other specific benefits due to him or her under the contract. *Stone v Burke* (1952) 110 CA2d 748, 756, 224 P2d 51.

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§11.18 c. Collective Bargaining Agreements (Lab C §1126)

Collective bargaining agreements constitute an exception to the rules in CC §3390(1)-(2) against specific enforcement of personal services contracts. Labor Code §1126 provides that:

> Any collective bargaining agreement between an employer and a labor organization shall be enforceable at law or in equity, and a breach of such collective bargaining agreement by any party thereto shall be subject to the same remedies, including injunctive relief, as are available on other contracts in the courts of this State

See *Broadway-Hale Stores, Inc. v Retail Clerks Union Local Number 428, AFL-CIO* (1961) 55 C2d 754, 13 CR 97. Further, Lab C §1127 provides that, with certain exceptions, a collective bargaining agreement containing a successor clause is enforceable against a successor employer for a period of 3 years after the effective date of the agreement.

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§11.19 d. Special or Unique Services

Both CC §3423(e) and CCP §526(b) expressly allow an injunction to issue to prevent the breach of contracts for personal services of a special or unusual character that meet very specific statutory requirements. See §11.6.

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§11.20 e. Contracts to Make a Will: Quasi-Specific Performance

Contracts to make a will, *e.g.,* in exchange for personal services rendered to a decedent, may be valid under either Prob C §21700 (effective January 1, 2001) or former Prob C §150 (for contracts made before that date). Probate Code §21700 sets forth the exclusive ways in which the existence of a contract to make a will can be proven. See generally 3 California Decedent Estate Practice §§29.76-29.86 (2d ed Cal CEB 1987).

Although a contract to make a will can be valid, it cannot become subject to enforcement until after the promisor's death, because the promisor has his or her entire lifetime to comply with the agreement. Further, it cannot be enforced by specific performance. *Marriage of Edwards* (1995) 38 CA4th 456, 45 CR2d 138. See also *Wilkison v Wiederkehr* (2002) 101 CA4th 822, 828, 124 CR2d 631. In particular, if the intended beneficiary has an adequate remedy in the form of an action in damages against the estate for breach of contract or for compensation for the services rendered under the agreement, the court will not grant specific performance. *Wilkison v Wiederkehr, supra*; *Shive v Barrow* (1948) 88 CA2d 838, 843, 199 P2d 693. In certain circumstances, however, when the remedy at law is inadequate and the decedent has failed to make the promised disposition in his or her will, a court of equity may grant relief—called "quasi-specific performance" because it is equivalent to specific performance—by impressing a constructive trust on the property that the decedent had promised to leave to the intended beneficiary. There must be a valid agreement to make a will, the agreement must be fair and reasonable, it must be certain and definite, and it must be adequately supported by consideration. *Wilkison,* 101 CA4th at 831. See also *Brown v Superior Court* (1949) 34 C2d 559, 563, 212 P2d 878; *Marriage of Edwards* (1995) 38 CA4th 456, 45 CR2d 138; *Walton v Walton* (1995) 31 CA4th 277, 282, 36 CR2d 901. The cases in which quasi-specific performance is granted generally involve disputes over real estate. See, *e.g.,* cases cited in *Wilkison,* 101 CA4th at 837. The elements of a cause of action for quasi-specific performance are substantially the same as an action for specific performance. See §11.7; *Porporato v Devincenzi* (1968) 261 CA2d 670, 674, 68 CR 210.

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§11.21 f. *Marvin* Agreements

The remedy of "quasi-specific performance" may also be available for specific enforcement of a cohabitation agreement (a so-called "*Marvin*" agreement; see §§3.28, 3.41). *Byrne v Laura* (1997) 52 CA4th 1054, 60 CR2d 908 (causes of action for declaratory relief, specific performance, constructive trust, and injunctive relief were viable actions for enforcement of oral support agreements). In *Byrne,* the court noted that proof of the existence of a *Marvin* agreement for an interest in real property contrary to record title ownership must be made by clear and convincing evidence. 52 CA4th at 1073.

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§11.22 2. Inability Lawfully to Perform (CC §3390(3))

The third type of obligation that is not specifically enforceable under CC §3390 is "[a]n agreement to perform an act which the party has not power lawfully to perform when required to do." CC §3390(3). In general, courts will not enforce illegal contracts. See §§3.36-3.41. The "courts will not compel parties to perform contracts which have for their object the performance of acts against sound public policy either by decreeing specific performance or awarding damages for breach." *Stanley v Robert S. Odell & Co.* (1950) 97 CA2d 521, 531, 218 P2d 162. For example, under this rule, a provision in a strike settlement agreement in which the employer-county promised the striking public employees to restore fringe benefits for the period of the strike was held not enforceable because it contravened county civil service rules. *Social Workers Union Local 535 v County of Los Angeles* (1969) 270 CA2d 65, 75 CR 566.

Civil Code §3390(3) is also invoked to deny specific performance of real estate contracts against a seller who cannot convey good title to the property. For example, in *Crittenden v Hansen* (1943) 59 CA2d 56, 138 P2d 37, the defendant agreed to sell land to another but thereafter sold it to third parties. The court held that specific performance could not be had against the seller for he could not lawfully perform the agreement. See §11.38.

Specific performance will also be denied when the defendant's performance, although lawful, would be impossible. See §11.27.

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§11.23 3. Agreement to Procure Act or Consent of a Third Party (CC §3390(4))

The fourth type of obligation that is not specifically enforceable under CC §3390 is "[a]n agreement to procure the act or consent of the wife of the contracting party, or of any other third person." CC §3390(4). If the defendant's performance depends on the approval or consent of a person who is not a party to the contract and who is free to grant or withhold consent, specific performance will not be decreed if it does not appear that such approval or consent can be obtained or if it appears that such approval or consent has been withheld or refused. *Casady v Modern Metal Spinning & Mfg. Co.* (1961) 188 CA2d 728, 731, 10 CR 790.

Note that a contract in which the consent or other act of a third party is made a condition precedent to the obligations of one or both of the contracting parties is fully enforceable. See generally §§6.40-6.49. In *Bleecher v Conte* (1981) 29 C3d 345, 213 CR 852, the court held that CC §3390(4) did not bar specific performance of a land sales contract in which the city's approval of certain development plans was a condition precedent to completion of the agreement. Moreover, contracting parties can validly agree that one of them will use "best efforts" or "reasonable efforts" to obtain the consent or approval of a third party. See, *e.g., Stanford Ranch Inc. v Maryland Cas. Co.* (9th Cir 1996) 89 F3d 618, 625 (real estate purchase and sale agreement required seller to use its best efforts to obtain certain governmental approvals). It is likely, however, that such a "best efforts" clause would not be subject to specific enforcement. See *Poultry Producers of S. Cal., Inc. v Barlow* (1922) 189 C 278, 208 P 93 (agreement to use best efforts to resell eggs at best prices obtainable under market conditions involved degree of personal knowledge, judgment, and skill, and repose of confidence; hence, specific performance of agreement was denied).

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Source: Business Law/California Law of Contracts/11 Remedies: Injunctive and Declaratory Relief; Other Remedies/ 4. Agreements With Uncertain Terms (CC §3390(5))/§11.24 a. Requirement of Certainty

4. Agreements With Uncertain Terms (CC §3390(5))

§11.24 a. Requirement of Certainty

The fifth type of obligation listed as not specifically enforceable under CC §3390 is "[a]n agreement, the terms of which are not sufficiently certain to make the precise act which is to be done clearly ascertainable." CC §3390(5). In general, in determining whether the material terms and conditions of a contract are sufficiently certain to grant specific performance, the modern trend of the law is for the court to carry out the intentions of the parties by enforcing the contract, rather than holding the contract unenforceable on the grounds of uncertainty. "The defense of uncertainty has validity only when the uncertainty or incompleteness of the contract prevents the court from knowing what to enforce." *Blackburn v Charnley* (2004) 117 CA4th 758, 766, 11 CR3d 885. See also *Byrne v Laura* (1997) 52 CA4th 1054, 60 CR2d 908; *Okun v Morton* (1988) 203 CA3d 805, 250 CR 220.

The cases indicate a strong preference by the courts to enforce agreements when it is reasonably possible to do so. *Krantz v BT Visual Images L.L.C.* (2001) 89 CA4th 164, 175, 107 CR2d 209. See, *e.g., Ersa Grae Corp. v Fluor Corp.* (1991) 1 CA4th 613, 2 CR2d 288. If it is possible for the court to reach a just outcome, the court will enforce the contract even if the court is required to fill in some gaps in the process. "Under California law, a contract will be enforced if it is sufficiently definite … to ascertain the parties' obligations and to determine whether those obligations have been performed or breached." 1 CA4th at 623. See also *Okun,* 203 CA3d at 817. The courts "lean[] against the destruction of contracts because of uncertainty" and will "construe agreements as to carry into effect the reasonable intentions of the parties." *Patel v Liebermensch* (2008) 45 C4th 344, 349, 351, 86 CR3d 366 (although option contract for purchase of real estate did not specify length of escrow period, reasonable time implied under CC §1657). Some courts have suggested, however, that the requirement of certainty may be stricter in an action for specific performance than in an action for damages. *Byrne*, 52 CA4th at 1066 n3; *Larwin-Southern Cal., Inc. v JGB Inv. Co.* (1979) 101 CA3d 626, 636, 162 CR 52. But see *Hennefer v Butcher* (1986) 182 CA3d 492, 500 n4, 227 CR 318.

The certainty requirement may be satisfied by resorting to extrinsic evidence. See §11.25. See, *e.g., Blackburn v Charnley, supra* (extrinsic evidence cured any indefiniteness of land description in real estate contract; specific performance granted). For example, evidence of custom and standard industry practice may supply any incidental or immaterial omitted terms in a real estate transaction, such as matters relating to the opening of an escrow, furnishing deeds, title insurance policies, and prorating of taxes and other expenses. *Hutton v Gliksberg* (1982) 128 CA3d 240, 245, 180 CR 141. Evidence of custom and practice, however, cannot be used to create an agreement or to furnish material terms. *Roskamp Manley Assocs., Inc. v Davin Dev. & Inv. Corp.* (1986) 184 CA3d 513, 520, 229 CR 186; *White Point Co. v Herrington* (1968) 268 CA2d 458, 73 CR 885.

The certainty requirement may also be satisfied by implication of contract terms in certain circumstances. See §§5.23-5.24, 8.8; *House of Prayer: Renewal & Healing Ctr. v Evangelical Ass'n for India* (2003) 113 CA4th 48, 7 CR3d 24 (contract for sale of real estate is not unenforceable for failure to specify time of performance, because law implies reasonable time). See also *Patel v Liebermensch* (2008) 45 C4th 344, 86 CR3d 366.

As the court in *Hennefer v Butcher* (1986) 182 CA3d 492, 500, 227 CR 318, stated (citations and internal quotations omitted):

> Neither law nor equity requires that every term and condition of an agreement be set forth in the contract.… The usual and reasonable terms found in similar contracts can be looked to, unexpressed provisions of the contract may be inferred from the writing, external facts may be relied upon, and custom and usage may be resorted to in an effort to supply a deficiency if it does not alter or vary the terms of the agreement.… If the parties have concluded a transaction in which it appears that they intend to make a contract, the court should not frustrate their intention if it is possible to reach a fair and just result, even though this requires a choice among conflicting meanings and the filling of some gaps that the parties have left.

For further discussion of the principles of contract interpretation and resolving issues of uncertainty in contract language, see chap 5.

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§11.25 b. Extrinsic Evidence

Even if uncertainty in a written contract relates to "the precise act which is to be done" (see CC §3390(5)), extrinsic evidence may be admitted to determine what the parties intended. "It is only when the extrinsic evidence fails to remove the ambiguity that specific performance must be refused." *Okun v Morton* (1988) 203 CA3d 805, 819, 250 CR 220; *Crescenta Valley Moose Lodge v Bunt* (1970) 8 CA3d 682, 689, 87 CR 428.

In *Blackburn v Charnley* (2004) 117 CA4th 758, 11 CR3d 885, plaintiff-buyers sought specific performance of a real estate purchase contract that identified the subject land by lot number rather than a metes and bounds description. The court of appeal affirmed the trial court's decree of specific performance based on extrinsic evidence consisting of the tract map given to the plaintiffs at the time of contracting, together with standard features sheets, site plans, floor plans, and elevation plans describing the houses to be constructed. The defendant presented no evidence showing that the houses or lots were not what was intended to be described in those documents. The court of appeal noted the general rule that "[p]arol evidence that does not vary or contradict the written terms of the contract is admissible to explain the ambiguities or give meaning and content to words used, provided it does not vary or contradict the terms of the contract." 117 CA4th at 766. See §§5.33-5.42. The court held that the extrinsic evidence had been properly admitted and rendered the description of the lots sufficiently definite for enforcement.

In *Okun v Morton* (1988) 203 CA3d 805, 819, 250 CR 220, the court found that a contract between partners in a restaurant business for joint development of future business ventures on a "mutually agreeable basis" was not so unclear that specific performance should be denied. The contract provided for a 20-80 investment ratio for formation of the partnership and a 1-to-4 ratio for advances of additional funds, and the court found this was sufficient to determine the way in which future ventures were to be financed, owned, and operated. Both partners' conduct after execution of the contract and before the controversy arose was consistent with this interpretation.

Goodwest Rubber Corp. v Munoz (1985) 170 CA3d 919, 921, 216 CR 604, was an action for specific performance of an option to purchase real property, which specified the purchase price as "fair market value" at the time of exercise of the option. The court held that the price designation was certain and definite enough to support an action for specific performance. The court noted that "fair market value" was an established means of property valuation and was regularly determined by courts. The term did not require future agreement of the buyer and seller; it was a proper substitute for a specific purchase price.

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§11.26 c. Future Agreement of Parties

In *White Point Co. v Herrington* (1968) 268 CA2d 458, 73 CR 885, the parties to a real estate contract opened an escrow without having agreed on the precise amount of the down payment or the amount to be financed, the method of handling an issue concerning a water well, descriptions of the pipeline and other easements, and the terms of clauses relating to financing and security in the event of future development of the land. The court of appeal found that the trial court's decree of specific performance constituted an abuse of discretion because it in effect created a new contract for the parties. The agreement was not specifically enforceable because certain material provisions of the escrow instructions contemplated the future agreement of the parties. In *DVD Copy Control Ass'n v Kaleidescape, Inc.* (2009) 176 CA4th 697, 97 CR3d 856, however, the court held that specific performance was not precluded when a licensing agreement required the licensee to build its DVD system according to specifications that the licensor would later provide. For further discussion of the enforceability of so-called "agreements to agree," see §4.16.

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§11.27 5. When Performance Is Impossible

Impossibility. Although the defense of impossibility is not listed in CC §3390, it has been recognized that specific performance cannot be ordered if a defendant is absolutely unable to perform the obligation at issue. The defendant's incapacity must exist not only at the time the contract was entered into, but also at the time of the hearing, because specific performance will be ordered then if the act, although initially impossible, later becomes possible. *Stevens Group Fund IV v Sobrato Dev. Co.* (1991) 1 CA4th 886, 894, 2 CR2d 460. *Stevens Group* was an action for breach of a real estate sales contract commenced by the buyer after the sellers were unable to convey clear title to the property because the lienholder refused to accept prepayment of its loan. By the time of trial, however, the loan could have been prepaid and the lien removed. The court of appeal reversed the trial court's denial of specific performance, holding that the trial court should have considered the sellers' ability to perform at the time of the hearing. See also §11.38 on CC §3394 (when defendant lacks marketable title).

When performance excused. In general, if performance of a covenant has been excused, on the grounds of impossibility or otherwise (see CC §1511; §§8.28-8.41), specific performance of that covenant will be denied. See, *e.g., City of Vernon v City of Los Angeles* (1955) 45 C2d 710, 290 P2d 841 (contract for sewage disposal was excused as impracticable, therefore not capable of specific performance); *Dixon v Salvation Army* (1983) 142 CA3d 463, 191 CR 111 (property subject to real estate sale contract destroyed before closing without fault of either party; seller's performance was excused; specific performance with abatement of purchase price was not appropriate).

Substituted performance. *Lister v Sorge* (1968) 260 CA2d 333, 67 CR 63, was an action to reform a written option to purchase corporate stock and for specific performance of the contract as reformed. The corporation had been dissolved and liquidated after the option had been granted. The court of appeal held that general equitable principles supported the trial court's order for payment of money and conveyance of promissory notes received by the defendant as substituted performance of the option.

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§11.28 6. Uniform Vendor and Purchaser Risk Act (CC §1662)

The Uniform Vendor and Purchaser Risk Act, codified in California at CC §1662, controls when specific performance and other relief is available when all or a material part of real estate subject to a purchase and sale contract is destroyed or taken by eminent domain. It provides:

> Any contract hereafter made in this State for the purchase and sale of real property shall be interpreted as including an agreement that the parties shall have the following rights and duties, unless the contract expressly provides otherwise:
>
> (a) If, when neither the legal title nor the possession of the subject matter of the contract has been transferred, all or a material part thereof is destroyed without fault of the purchaser or is taken by eminent domain, the vendor cannot enforce the contract, and the purchaser is entitled to recover any portion of the price that he has paid;
>
> (b) If, when either the legal title or the possession of the subject matter of the contract has been transferred, all or any part thereof is destroyed without fault of the vendor or is taken by eminent domain, the purchaser is not thereby relieved from a duty to pay the price, nor is he entitled to recover any portion thereof that he has paid.

For cases in which the statute was applied, see *Dixon v Salvation Army* (1983) 142 CA3d 463, 191 CR 111; *Long v Keller* (1980) 104 CA3d 312, 163 CR 532.

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§11.29 7. When Damages Are Adequate

As discussed in §11.8, specific performance will be denied when the remedy at law for breach of contract, *i.e.,* damages, is adequate. If the law affords a full and adequate remedy in the way of damages as compensation for breach of contract (or for the services rendered under it) and the remedy does complete justice, a court will not grant specific performance. Equity will grant relief in the form of specific performance of a contract only in circumstances where the legal remedy of compensatory damages is not sufficient to do complete justice between the parties. *Wilkison v Wiederkehr* (2002) 101 CA4th 822, 830, 124 CR2d 631; *Shive v Barrow* (1948) 88 CA2d 838, 844, 199 P2d 693. See also *Porporato v Devincenzi* (1968) 261 CA2d 670, 674, 68 CR 210. Moreover, if the plaintiff's cause of action is one for which the legal remedy of damages is generally considered adequate, it does not become inadequate merely because the plaintiff has allowed the statute of limitations to run. *Wilkison,* 101 CA4th at 835.

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Source: Business Law/California Law of Contracts/11 Remedies: Injunctive and Declaratory Relief; Other Remedies/ §11.30 8. Parties Who Cannot Be Compelled to Perform (CC §3391)

§11.30 8. Parties Who Cannot Be Compelled to Perform (CC §3391)

Civil Code §3391 lists four circumstances in which specific performance cannot be enforced against a party to a contract, as follows:

- If that party has not received adequate consideration for the contract;
- If the consideration is not just and reasonable with respect to that party;
- If that party's assent was obtained by misrepresentation, concealment, circumvention, or unfair practices of any party to whom performance would become due under the contract, or by any promise of such party that has not been substantially fulfilled; and
- With one specified exception, if that party's assent was given under the influence of mistake, misapprehension, or surprise.

These circumstances are discussed in §§11.31-11.34. See also the requirement for mutuality of remedy under CC §3386, discussed in §11.9.

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§11.31 a. Inadequate Consideration (CC §3391(1))

The first circumstance listed in CC §3391 when specific performance will not be ordered against a party is if the party "has not received an adequate consideration for the contract." CC §3391(1). See *Petersen v Hartell* (1985) 40 C3d 102, 109, 219 CR 170. A defense based on inadequate consideration must be considered in light of all the facts and circumstances surrounding the contract, the purpose of the contract, and the relationship of the parties, and the time for measuring the adequacy of consideration is as of the time when the contract was made. 40 C3d at 110; *Berkeley Lawn Bowling Club v City of Berkeley* (1974) 42 CA3d 280, 290, 116 CR 762; *Polinsky v Vaughan* (1968) 268 CA2d 183, 194, 73 CR 764. The phrase "adequate consideration" as used in CC §3391(1) with reference to a transfer of property does not mean the highest price obtainable, but rather a price that is fair and reasonable under all the circumstances when the contract was formed, without regard to later events. *Henderson v Fisher* (1965) 236 CA2d 468, 474, 46 CR 173. In addition to the value of the property, the court may consider factors such as friendship, love, affection, and mutual regard between the parties. *Porporato v Devincenzi* (1968) 261 CA2d 670, 675, 68 CR 210; *Ornbaum v Main* (1961) 198 CA2d 92, 17 CR 631.

The issue is always a question of fact for determination by the trial court, taking into account all the facts and circumstances of the particular case. *Chalmers v Raras* (1962) 200 CA2d 682, 689, 19 CR 531. In *Cubic Corp. v Marty* (1986) 185 CA3d 438, 229 CR 828, the court of appeal affirmed the trial court's decree of specific performance of an invention agreement by an employer against a former employee, who asserted that there was insufficient consideration for the agreement. The agreement was a condition of the employee's employment; his employment therefore constituted adequate consideration for the agreement, and the agreement was specifically enforceable against him. The scope of his employment encompassed design work, and he was given a substantial raise in salary and a promotion as a partial consequence of his invention.

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§11.32 b. Unjust or Unreasonable Contracts (CC §3391(2))

The second circumstance listed in CC §3391 when specific performance will not be ordered against a party is "[i]f [the contract] is not, as to him, just and reasonable." CC §3391(2). See *MacFadden v Walker* (1971) 5 C3d 809, 815, 97 CR 537; *Saika v Gold* (1996) 49 CA4th 1074, 1081, 56 CR2d 922 (clause in arbitration agreement providing for trial de novo was inequitable and therefore unenforceable; net effect of clause was to render arbitration an illusory remedy). See also Restatement (Second) of Contracts §364 (1981). "[S]pecific performance will always be refused when a contract itself is unfair, one-sided, unconscionable, or affected by any other such inequitable feature, and when specific enforcement would be oppressive upon the defendant, or would prevent the enjoyment of his own rights, or would in any other manner work injustice." *Jacklich v Baer* (1943) 57 CA2d 684, 693, 135 P2d 179. The requirement that the contract be just and reasonable with respect to the defendant often also implicates the requirement that the defendant have received adequate consideration. See, *e.g., Re v Wells Fargo Bank* (1969) 269 CA2d 783, 787, 75 CR 367 (consideration for lease constituted consideration for option; specific performance affirmed). See also §11.31. Like the defense of inadequate consideration, a defense based on the assertion that the contract is not just and reasonable must be considered in light of all of the facts and circumstances, including the purpose of the contract, and the parties' relationship. Further, it must be determined as of the time of formation of the contract. *Hastings v Matlock* (1985) 171 CA3d 826, 839, 217 CR 856; *Berkeley Lawn Bowling Club v City of Berkeley* (1974) 42 CA3d 280, 290, 116 CR 762.

NOTE: A claim that a contract is unfair or unjust may not be asserted in an action for damages for breach of contract. It may be raised as a defense only in an action for specific performance. It may only be asserted as a defense and only by the person with respect to whom the contract is alleged to be unjust and unreasonable. *Yackey v Pacific Dev. Co.* (1979) 99 CA3d 776, 783, 160 CR 430.

If the plaintiff is not entitled to specific performance because the contract is unfair or unjust to the defendant, the plaintiff may nonetheless be entitled to restitution or damages. *Eldridge v Burns* (1978) 76 CA3d 396, 427, 142 CR 845.

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§11.33 c. Misrepresentation, Concealment, or Unfair Practices (CC §3391(3))

The third circumstance listed in CC §3391 when specific performance will not be ordered against a party is "[i]f [the defendant's] assent was obtained by the misrepresentation, concealment, circumvention, or unfair practices of any party to whom performance would become due under the contract, or by any promise of such party which has not been substantially fulfilled." CC §3391(3). See *Cornblith v Valentine* (1930) 211 C 243, 294 P 1065; *Davy v Ogier* (1948) 87 CA2d 835, 198 P2d 92 (buyer who was aware of existence of unrecorded lease was not entitled to specific performance of contract to convey merchantable title, and was required to accept title subject to lease); *Milton Kauffman, Inc. v Smith* (1947) 82 CA2d 302, 186 P2d 11 (purchaser who had obtained contract from seller through misrepresentations was not entitled to specific performance). In general, if it appears that the plaintiff's conduct in obtaining or performing an agreement has been unconscionable, inequitable, or characterized by bad faith, specific performance will be denied. *Boas v Bank of America* (1942) 51 CA2d 592, 125 P2d 620. See also Restatement (Second) of Contracts §364 (1981).

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§11.34 d. Mistake, Misapprehension, Surprise (CC §3391(4))

The fourth circumstance listed in CC §3391 when specific performance will not be ordered against a party is "[i]f [the defendant's] assent was given under the influence of mistake, misapprehension, or surprise, except that where the contract provides for compensation in case of mistake, a mistake within the scope of such provision may be compensated for, and the contract specifically enforced in other respects, if proper to be so enforced." CC §3391(4). For example, a court will not order specific performance of a real estate purchase contract when there is a mutual mistake in the description of the land. *Cavalieri v Hess* (1928) 205 C 703, 272 P 295.

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9. Lack of Full Performance by Plaintiff (CC §3392)

§11.35 a. General Rule

Civil Code §3392 provides that:

> Specific performance cannot be enforced in favor of a party who has not fully and fairly performed all the conditions precedent on his part to the obligation of the other party, except where his failure to perform is only partial, and either entirely immaterial, or capable of being fully compensated, in which case specific performance may be compelled, upon full compensation being made for the default.

As a general rule, a plaintiff cannot obtain specific performance unless he or she has performed, or offered to perform, all of the conditions precedent required by the contract terms to be performed by him or her. *Realmuto v Gagnard* (2003) 110 CA4th 193, 204, 1 CR3d 569 (real estate seller not entitled to specific performance because seller failed to provide disclosure statement to buyer). *Stanchfield v Hamer Toyota, Inc.* (1995) 37 CA4th 1495, 44 CR2d 565 (buyer not entitled to specific performance of stock purchase agreement when buyer lacked both personal assets and ability to obtain financing necessary to close transaction). The plaintiff must establish either his or her own full performance or a valid excuse for nonperformance. Further, the plaintiff must show that he or she was ready, willing, and able to perform not only at the time the contract was entered into, but also throughout the prosecution of the action for specific performance. *Ninety Nine Invs., Ltd. v Overseas Courier Serv. (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1126, 6 CR3d 891; *Gaggero v Yura* (2003) 108 CA4th 884, 890, 134 CR2d 313.

In *Ninety Nine Invs.,* the court held that a real estate seller's failure to comply with its escrow obligations prevented the escrows from closing and the loans from funding on the closing date. Under CC §1511(1) (see §§8.28-8.29), the buyer's obligation to perform by the closing date was excused because it was prevented or delayed by the seller's conduct. The buyer was therefore entitled to specific performance.

NOTE: If the plaintiff has only partly failed to perform, and the failure is either immaterial or capable of being fully compensated, specific performance may be ordered. See §11.15.

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§11.36 b. Time for Performance

As discussed in §§8.8-8.10, a contractual obligation must be performed at the time specified in the contract or, if no time is specified, within a reasonable time. See CC §1657; *Patel v Liebermensch* (2008) 45 C4th 344, 86 CR3d 366 (when option contract for purchase of real estate did not specify length of escrow period, reasonable time is implied under CC §1657). Time may be an important factor in determining whether a plaintiff seeking specific performance has performed his or her own obligations. For example, in *Galdjie v Darwish* (2003) 113 CA4th 1331, 7 CR3d 178, the court found that the sellers had waived a "time of the essence" clause in a real property sales contract and continued to deal with the buyer. Therefore, the buyer's failure to close the transaction on the original date specified in the contract did not prevent the buyer from obtaining specific performance. Similarly, in *Williams Plumbing Co. v Sinsley* (1975) 53 CA3d 1027, 126 CR 345, a real estate contract required payment in three installments, and time was stated to be of the essence. Before the second installment was due, the buyer proposed to obtain a loan and pay off the entire remaining balance later in the month. The court found that the seller had tacitly approved the proposal. The day after the second installment was due, however, the seller threatened to cancel the contract and keep the first installment. The buyer paid the second installment immediately and filed an action for specific performance. The court found that the seller had waived the due date and the buyer was entitled to specific performance.

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§11.37 c. Relief From Forfeiture

As discussed in §11.3, under CC §3275, even if a plaintiff has not fully performed all of its obligations under a contract, the plaintiff may nonetheless obtain specific performance or other relief from the defendant if the plaintiff would otherwise incur a forfeiture and can compensate the defendant for the plaintiff's breach, provided that the plaintiff's conduct was not fraudulent, willful, or grossly negligent. See, *e.g., MacFadden v Walker* (1971) 5 C3d 809, 97 CR 537 (specific performance granted to buyer under installment land sale contract, despite failure to make payments when due; buyer had paid over half the total price, and land value was adequate security for seller); *Williams Plumbing Co. v Sinsley* (1975) 53 CA3d 1027, 126 CR 345 (plaintiff's failure was not unlawful, grossly negligent, or intentional; plaintiff therefore entitled to specific performance).

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§11.38 10. Seller's Inability to Convey Marketable Title (CC §3394)

Civil Code §3394 provides that "[a]n agreement for the sale of property cannot be specifically enforced in favor of a seller who cannot give to the buyer a title free from reasonable doubt." In general, if a seller has no title or interest in the property that he or she has contracted to convey, the buyer has no right to specific performance of the contract, although the buyer may have other remedies against the seller. A court of equity will not compel the seller to obtain title. If, however, the seller has an equitable interest in the property, *e.g.,* as the beneficiary of a trust, and has the right to call for legal title, the buyer can obtain specific performance. *Walgren v Dolan* (1990) 226 CA3d 572, 576, 276 CR 554 (specific performance available to buyers under real estate sale agreement; seller held beneficial interest in property and had power under trust terms to require conveyance of legal title by trustee); *Friedrich v Roland* (1950) 95 CA2d 543, 550, 213 P2d 423.

If a seller has some, but not the entire, legal title to real property under contract, at the buyer's option, the seller may be compelled to perform to the extent of his or her interest, even if the deficiency in the seller's interest is significant. *Milkes v Smith* (1949) 91 CA2d 79, 204 P2d 419. In *Milkes,* the seller was able to convey only an undivided one-half interest, but the court ruled that the buyer was entitled to specific performance to the extent of that interest, together with an abatement of the purchase price on account of the seller's inability to convey the complete title.

In like manner, if a seller did not have title to the property at the time the contract was made or the transaction was scheduled to close, but acquires it later on, specific performance may be granted. *Stevens Group Fund IV v Sobrato Dev. Co.* (1991) 1 CA4th 886, 2 CR2d 460 (seller's inability to convey title free and clear at time of sale because note secured by deed of trust was not prepayable was not proper ground for denying buyer's request for specific performance, when seller could convey title free and clear at time of trial).

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§11.39 11. Continuous Supervision

Specific performance will not be granted to enforce a contract that requires a continuing series of actions over a period of time and requires constant personal supervision and oversight by the court. A court will order specific performance only if the subject matter of the decree is capable of being expressed in a single court order that is immediately enforceable. The performance to be enforced must be capable of being consummated in one transaction. *Long Beach Drug Co. v United Drug Co.* (1939) 13 C2d 158, 171, 88 P2d 698; *Thayer Plymouth Ctr., Inc. v Chrysler Motors Corp.* (1967) 255 CA2d 300, 63 CR 148; *Nadell & Co. v Grasso* (1959) 175 CA2d 420, 346 P2d 505.

In *Thayer Plymouth Ctr.,* the court refused to enter a permanent injunction to prohibit the defendant-manufacturer from breaching its contract with the plaintiff-automobile dealer, because the effect of the injunction would be to specifically enforce the dealership agreement requiring the manufacturer to sell its products to the dealer over an indefinite period of time. The court held that such a decree would impose on the court the impossible task of supervising continuous performance by the parties, and under such circumstances, equitable relief should be denied and the dealer left in a position where it could assert its legal rights to damages under the contract. 255 CA2d at 304.

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IV. DECLARATORY RELIEF

§11.40 A. Availability in Contract Disputes (CCP §1060)

In California, declaratory relief is available to a party in interest under a written instrument (excluding a will or trust) or a contract "in cases of actual controversy relating to the legal rights and duties of the respective parties." CCP §1060. An action for a declaratory judgment offers a party in interest a quick, efficient means of resolving a disputed contractual issue, and therefore promotes judicial economy. *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 897, 123 CR2d 432. An interested party may "bring an original action or cross-complaint in the superior court for a declaration of his or her rights and duties in the premises, including a determination of any question of construction or validity arising under the instrument or contract." CCP §1060. For example, "questions relating to the formation of a contract, its validity, its construction and effect, excuses for nonperformance, and termination are proper subjects for declaratory relief." *Caira v Offner* (2005) 126 CA4th 12, 24, 24 CR3d 233. See also *Southern Cal. Edison Co. v Superior Court* (1995) 37 CA4th 839, 846, 44 CR2d 227 (contract interpretation is proper subject of declaratory relief). But see *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 647, 88 CR3d 859 (declaratory relief not "necessary or proper" when it would not affect parties' future conduct with regard to contract).

Declaratory relief is forward-looking. It "operates prospectively, and not merely for the redress of past wrongs. It serves to set controversies at rest before they lead to repudiation of obligations, invasion of rights or commission of wrongs; in short, the remedy is to be used in the interests of preventive justice.... [Its] purpose is to liquidate doubts with respect to uncertainties or controversies which might otherwise result in subsequent litigation." *Baxter Healthcare Corp. v Denton* (2004) 120 CA4th 333, 360, 15 CR3d 430.

A declaration of the parties' rights or duties under the contract may be sought and granted either alone or with other relief, may be either affirmative or negative in form and effect, and will have the force of a final judgment. The important practical characteristic of the remedy is that the declaration may be obtained before the occurrence of any breach of the obligation with respect to which the declaration is sought. CCP §1060. Unlike the coercive remedies of damages, specific performance, or an injunction—in which a party is ordered by the court to do or not to do something, a declaratory judgment merely declares the legal relationship of the parties. It may be brought either to establish rights after a dispute has arisen or as a prophylactic measure before a breach occurs. *Mycogen Corp.,* 28 C4th at 898.

Both oral and written contracts are eligible for declaratory relief. *Columbia Pictures Corp. v DeToth* (1945) 26 C2d 753, 161 P2d 217; *Byrne v Laura* (1997) 52 CA4th 1054, 60 CR2d 908. The fact that the contract is for personal services does not make the contract an improper subject for declaratory relief nor make the action subject to the other rules governing specific performance. *Bertero v National Gen. Corp.* (1967) 254 CA2d 126, 62 CR 714.

NOTE: Actions for declaratory relief concerning professional liability insurance policies covering health care providers are subject to special rules. See CCP §1062.5.

For a comprehensive discussion of declaratory relief, including required forms, see California Civil Procedure Before Trial, chap 35 (4th ed Cal CEB 2004).

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§11.41 B. Equitable Remedy

An action for declaratory relief is equitable. The court's powers in a declaratory judgment action are as broad and extensive as those exercisable by the court in any equitable proceeding. *Caira v Offner* (2005) 126 CA4th 12, 24, 24 CR3d 233. Further, the court can retain jurisdiction to grant additional relief as may be necessary. See *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 901, 123 CR2d 432; *Westerholm v 20th Century Ins. Co.* (1976) 58 CA3d 628, 632 n1, 130 CR 164.

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§11.42 C. Requirement of Actual Controversy (CCP §1060)

Code of Civil Procedure §1060 requires that there be an "actual controversy" in order for declaratory relief to be granted. This requirement has been construed to refer to a controversy that "admits of definitive and conclusive relief by judgment within the field of judicial administration, as distinguished from an advisory opinion upon a particular or hypothetical state of facts. The judgment must decree, not suggest, what the parties may or may not do." *Selby Realty Co. v City of San Buenaventura* (1973) 10 C3d 110, 117, 109 CR 799; *Baxter Healthcare Corp. v Denton* (2004) 120 CA4th 333, 360, 15 CR3d 430; *BKHN, Inc. v Department of Health Servs.* (1992) 3 CA4th 301, 308, 4 CR2d 188.

The requirement of an actual controversy is also referred to as "ripeness." A request for a declaratory judgment must be founded on an actual dispute between the parties, and must not be made simply to obtain a judicial determination of a point of law. The ripeness doctrine is intended to prevent the court from issuing purely advisory opinions. It is founded on a "recognition that judicial decisionmaking is best conducted in the context of an actual set of facts so that the issues will be framed with sufficient definiteness to enable the court to make a decree finally disposing of the controversy." *City of Santa Monica v Stewart* (2005) 126 CA4th 43, 63, 24 CR3d 72 (citations omitted). Before a controversy will be considered "ripe" for adjudication, it "must be definite and concrete, touching the legal relations of parties having adverse legal interests.... It must be a real and substantial controversy admitting of specific relief through a decree of a conclusive character, as distinguished from an opinion advising what the law would be upon a hypothetical state of facts." *Alameda County Land Use Ass'n v City of Hayward* (1995) 38 CA4th 1716, 1722, 45 CR2d 752.

In *City of Santa Monica v Stewart,* 126 CA4th at 64, the court of appeal set forth a two-part test for determining ripeness: "(1) whether the dispute is sufficiently concrete so that declaratory relief is appropriate; and (2) whether the parties will suffer hardship if judicial consideration is withheld." Under the first part of the test, a court will "decline to adjudicate a dispute if 'the abstract posture of [the] proceeding makes it difficult to evaluate … the issues … if the court is asked to speculate on the resolution of hypothetical situations … or if the case presents a 'contrived inquiry'." Under the second part, a court will "not intervene merely to settle a difference of opinion; there must be an imminent and significant hardship inherent in further delay." 126 CA4th at 64 (citations omitted).

Although an actual controversy relating to legal rights and duties of the respective parties under the contract must exist, a plaintiff need not establish its right to a favorable judgment to be entitled to declaratory relief. *Lockheed Martin Corp. v Continental Ins. Co.* (2005) 134 CA4th 187, 221, 35 CR3d 799; *Ludgate Ins. Co. v Lockheed Martin Corp.* (2000) 82 CA4th 592, 606, 98 CR2d 277 (although exhaustion of underlying insurance policy limits is necessary to entitle insured to recover under excess insurance policy, it is not necessary for purposes of establishing existence of actual controversy for purposes of declaratory relief action). See also *Otay Land Co. v Royal Indemn. Co.* (2008) 169 CA4th 556, 86 CR3d 408 (plaintiff was premature in claiming actual controversy existed relating to current or future rights under insurance policy when plaintiff's interests were contingent on its prevailing against defendant's insureds in separate federal environmental action).

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§11.43 D. Requirement of Urgency (CCP §1061)

Code of Civil Procedure §1061 provides that the court may refuse to grant declaratory relief "in any case where its declaration or determination is not necessary or proper at the time under all the circumstances." If resolution of a controversy over future remedies would have little practical effect on the parties' behavior, the court may deny declaratory relief because it "is not necessary or proper at the time." *Meyer v Sprint Spectrum LP* (2009) 45 C4th 634, 647, 88 CR3d 859. In *Meyer*, the plaintiffs sued Sprint, alleging its arbitration agreement was unconscionable under the Consumers Legal Remedies Act, but they did not allege that the agreement had been enforced against them or otherwise damaged them. They also did "not with any particularity allege[] that the resolution of the declaratory relief action concerning contractual remedies would, at this point, have any practical consequences." 45 C4th at 648. Thus, the court held that the trial court did not abuse its discretion in sustaining a demurrer to the plaintiffs' declaratory relief action.

When a case is properly before the trial court, however, and the complaint is legally sufficient and sets forth facts and circumstances showing that declaratory relief is appropriate, the court may not refuse to assume jurisdiction. *Aicco, Inc. v Insurance Co. of N. Am.* (2001) 90 CA4th 579, 590, 109 CR2d 359. A complaint requesting declaratory relief is legally sufficient if it sets forth facts indicating the existence of an actual controversy concerning the legal rights and obligations of the parties under a written document and asks the court to adjudicate the controversy. *Aicco, Inc. v Insurance Co. of N. Am., supra.* The court may not refuse the action if the alternative remedy of a suit for breach is not as speedy and adequate or as well suited to the plaintiff's needs as declaratory relief, *e.g.,* if the parties' relationship will continue in the future or if a declaratory judgment will avoid a multiplicity of suits. *Warren v Kaiser Found. Health Plan, Inc.* (1975) 47 CA3d 678, 683, 121 CR 19. The purpose of declaratory relief is to allow the parties to obtain a prompt adjudication of their rights and obligations without a dispute over the damages suffered. *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 898, 123 CR2d 432.

NOTE: To advance the purpose of providing a rapid means of dispute resolution, declaratory relief actions are given a special priority on the court calendar. See CCP §1062.3; *Mycogen Corp.,* 28 C4th at 898.

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§11.44 E. Cumulative Nature of Remedy (CCP §1062)

Code of Civil Procedure §1060 states that a party "may ask for a declaration of rights or duties,… whether or not further relief is or could be claimed at the time." Further, CCP §1062 provides expressly that declaratory relief is cumulative, and "shall not be construed as restricting any remedy, provision or otherwise, provided by law for the benefit of any party to such action." The availability of another remedy does not automatically preclude the granting of declaratory relief. As the California Supreme Court in *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 897, 123 CR2d 432, explained, although declaratory judgments are issue preclusive for purposes of res judicata (see §11.45), they are not necessarily claim-preclusive. See also *Baxter Healthcare Corp. v Denton* (2004) 120 CA4th 333, 15 CR3d 430. "[I]t is only where an alternative remedy offers more effective relief, or is as well suited to the plaintiff's needs as is declaratory relief, that the court is justified in refusing a declaration because of the availability of another remedy." 120 CA4th at 364. The court in *Bertero v National Gen. Corp.* (1967) 254 CA2d 126, 136, 62 CR 714 (citations omitted) explained the cumulative nature of the remedy as follows:

> [T]he court may make a binding declaration of rights whether or not other relief *is or could be* claimed at the time,… the mere fact that the contract has already been breached and a cause of action therefor (one of the traditional remedies) has accrued, does not necessarily deprive the court of the power to grant declaratory relief under the law. Neither the fact that a party has another remedy nor that a breach has occurred prior to the commencement of his action compels the court to deny relief. Ordinarily, the alternative remedy, such as damages, injunctive relief and the like would be more harsh, and if he chooses the milder remedy, declaratory relief, the court is not required for that reason to compel him to seek a more stringent one.

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§11.45 F. Res Judicata Effect

Res judicata refers to the preclusive effect of a final judgment on the merits. The doctrine of res judicata (claim preclusion) prevents relitigation of the same claim or cause of action in a subsequent lawsuit between the same parties or parties in privity with them. The related doctrine of collateral estoppel (issue preclusion) prevents relitigation of issues that have been argued and decided in a prior proceeding. By operation of the doctrine of res judicata, if a plaintiff prevails in a lawsuit, the plaintiff's cause of action is merged into the final judgment and may not be asserted in a subsequent lawsuit. Similarly, if the defendant prevails, the final judgment serves as a bar to further litigation of the same cause of action. *Mycogen Corp. v Monsanto Co.* (2002) 28 C4th 888, 896, 123 CR2d 432.

A declaratory judgment is binding regarding the matters declared, but generally does not operate as a merger or bar in a suit for additional relief based on the same facts. The reason is that CCP §§1060 and 1062 expressly provide that the remedy is cumulative. See §11.44. Code of Civil Procedure §1062 states that no declaratory judgment "shall preclude any party from obtaining additional relief based upon the same facts." Accordingly, the merger doctrine is generally not applicable. *Aerojet-General Corp. v American Excess Ins. Co.* (2002) 97 CA4th 387, 402, 117 CR2d 427.

In *Mycogen Corp.,* however, the California Supreme Court clarified that a declaratory judgment represents an exception to the bar of res judicata only if a plaintiff's initial action seeks *purely* declaratory relief. If the plaintiff seeks and receives both declaratory and coercive relief such as damages or specific performance in its initial suit, res judicata prevents the plaintiff from obtaining additional relief based on the same cause of action. In *Mycogen,* the licensee of technology to produce genetically altered plant seeds brought an action against the licensor for damages for breach of contract after having obtained a declaratory judgment and specific performance in a prior suit. The court held that the licensee's second action was barred by res judicata. The court noted that to hold otherwise would encourage plaintiffs to split their causes of action. Once a party has obtained some form of coercive relief, "the basis for applying the declaratory judgment exception evaporates, and ordinary rules of claim preclusion must apply." 28 C4th at 901 (citations omitted).

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V. RESCISSION (CC §§1688-1695.17)

§11.46 A. General Rules (CC §§1688, 1689, 1690-1693)

The generally applicable Civil Code provisions governing the remedy of rescission are found in CC §§1688-1689 and 1690-1693, and are discussed in §§11.47-11.58. Interspersed among these general Civil Code provisions are a number of statutes granting rescission or cancellation rights under particular types of contracts. See §11.58.

NOTE: Rescission in the context of real estate transactions is discussed at length in chapter 1 of California Real Property Remedies and Damages (2d ed Cal CEB 2002).

Rescission operates to extinguish the contract between parties. CC §1688; *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 960, 23 CR3d 233. It necessarily involves a repudiation of the contract. *People ex rel Kennedy v Beaumont Inv., Ltd.* (2003) 111 CA4th 102, 133, 3 CR3d 429. A contract that has been rightfully rescinded ceases to exist. If an action to rescind is successful, the contract is ended forever and its covenants cannot thereafter be made the basis of an action for damages caused by a breach of its covenants. Rescission terminates all further liability of the parties under the contract, and also restores them to their respective positions as they existed when the contract was made, by requiring each party to restore any consideration received from the other party. See *Larsen v Johannes* (1970) 7 CA3d 491, 501, 86 CR 744.

As the remedy of rescission now exists under California law, it operates extra-judicially, but either party may seek relief in court based on the rescission—either to recover money or other property or obtain other relief as may be appropriate, or to assert rescission as a defense or cross-claim. CC §1692. The statutes that created an action for judicial rescission were repealed in 1961, in order to provide a single, simplified procedure to be followed in all situations where rescissionary relief is desired. *Runyan v Pacific Air Indus., Inc.* (1970) 2 C3d 304, 313, 85 CR 138; *Resure, Inc. v Superior Court* (1996) 42 CA4th 156, 49 CR2d 354. Therefore, rescission does not require judicial action in order to be effective. If a party to a contract is entitled to rescission under CC §1689, that party may rescind the contract by following the extra-judicial procedures in CC §1691. Rescission involves judicial action only if necessary to enforce the rescission against the other party, and then only as provided in CC §1692. See generally *Runyan v Pacific Air Indus., Inc.*, *supra*.

A party who attempts to rescind a contract, but does not do so effectively, does not thereby lose his or her right to bring a lawsuit for damages based on the continued existence of the contract. The party may request rescission or damages as an alternative based on the contract if rescission cannot be obtained. The plaintiff need not make an election of remedies during the course of the trial. *Walters v Marler* (1978) 83 CA3d 1, 16, 147 CR 655. See also *Denevi v LGCC, LLC* (2004) 121 CA4th 1211, 1221, 18 CR3d 276. For further discussion of the status of the doctrine of election of remedies in California, see §§9.56-9.57.

Except to the extent provided under statutes regulating particular types of contracts (see §11.58), the grounds for rescission are limited to those specified in CC §1689. See §§11.49-11.52.

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§11.47 B. As Distinct From Restitution

Rescission is a remedy distinct from restitution, although rescission is often coupled with restitution in accordance with CC §§1691(b) and 1692. *People ex rel Kennedy v Beaumont Inv., Ltd.* (2003) 111 CA4th 102, 133, 3 CR3d 429; *Gardiner Solder Co. v SupAlloy Corp.* (1991) 232 CA3d 1537, 1544, 284 CR 206. Restitution is an equitable remedy with roots in the common law, designed to prevent unjust enrichment. It does not depend on the prior existence of a contract between the parties. *People ex rel Kennedy v Beaumont Inv., Ltd.*, *supra*. It may be granted independently, whenever one person has unjustly enriched himself or herself at the expense of another. A party who has been unjustly enriched is required to make restitution of property or benefits received or taken, if it would be just and equitable and if restitution would involve no direct or indirect violation of law or frustration of public policy. *Gardiner Solder Co.,* 232 CA3d at 1542. See also *First Nationwide Sav. v Perry* (1992) 11 CA4th 1657, 15 CR2d 173 (restitution case). Restitution as a remedy in quasi-contract for unjust enrichment is discussed in §§11.66-11.73.

As discussed in §11.56, rescission requires restoration of any benefits received under the contract (see CC §1691(b)), and restitution of benefits may be ordered in any court action to enforce a rescission under CC §1692. See *People ex rel Kennedy,* 111 CA4th at 133.

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§11.48 C. Who May Rescind

Both CC §1689 (grounds for rescission) and CC §1691 (how to effect a rescission) specify that rescission is available to "a party to a contract." Thus, without an assignment of the rights of one of the parties, a third party beneficiary cannot rescind a contract. *Schauer v Mandarin Gems of Cal., Inc.* (2005) 125 CA4th 949, 959, 23 CR3d 233. In *Schauer,* the court was careful to distinguish rescission rights from the right of a third party beneficiary to "enforce" the contract under CC §1559. See §§7.61-7.68. The court stated that "[t]he interest of the third party beneficiary is as the intended recipient of the *benefits* of the contract, and a direct right to those benefits, *i.e.,* specific performance, or damages in lieu thereof, will protect the beneficiary's interests." 125 CA4th at 959.

Civil Code §1559 provides that the third party beneficiary may enforce the contract at any time before the contract is rescinded. Conversely, the primary parties to a third party creditor beneficiary contract may rescind it at any time before the beneficiary commences an action for enforcement. *R.J. Cardinal Co. v Ritchie* (1963) 218 CA2d 124, 32 CR 545. See also *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1486, 77 CR2d 479, in which the court stated that rescission of third party beneficiary contracts is governed by the same principles as are applicable to rescission of contracts generally.

A party who is in default in performance of a dependent or concurrent obligation, or whose default is so related to the other party's breach that the first party's default affects the other party's performance or duty to perform, may not rescind the contract unilaterally on account of the other party's breach. "One party cannot violate the contract himself, and then seek a rescission on the ground that the other party has followed his example." *Nelson v Spence* (1960) 182 CA2d 493, 499, 6 CR 312. If, however, the rescinding party's default has no relation to the other party's obligation in respect of which the rescission is asserted, it will not bar rescission. *Integrated, Inc. v Alec Fergusson Elec. Contractors* (1967) 250 CA2d 287, 298, 58 CR 503. See also *Nelson v Spence, supra.*

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D. Grounds for Rescission

§11.49 1. Mutual Consent (CC §1689(a))

Civil Code §1689 specifies the grounds on which a contract may be rescinded. The first is with consent of all parties. CC §1689(a). Rescission by mutual consent can be done at any stage of the parties' performance. *Griffin v Beresa* (1956) 143 CA2d 299, 32 CR 545. It requires an intent to rescind on the part of both parties. *Pennel v Pond Union Sch. Dist.* (1973) 29 CA3d 832, 105 CR 817.

Consent to rescind need not be in writing, even if the contract being rescinded was or was required to be in writing. *Sass v Hank* (1951) 108 CA2d 207, 211, 238 P2d 652; *Grant v Aerodraulics Co.* (1949) 91 CA2d 68, 204 P2d 683. Moreover, it is not necessary for the parties to state either in writing or orally that the contract is rescinded. Rescission can be accomplished if the parties' intent to abandon the contract can be ascertained from their acts or conduct. *C. Norman Peterson Co. v Container Corp.* (1985) 172 CA3d 628, 218 CR 592; *Pennel v Pond Union Sch. Dist., supra*. Mutual rescission is sufficient consideration for the act by each party bound by the original agreement. *Schertzinger v Williams* (1961) 198 CA2d 242, 246, 17 CR 719; *Sass v Hank, supra*.

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§11.50 2. Unilateral Rescission (CC §1689(b))

Civil Code §1689(b) permits unilateral rescission in the following seven categories of cases:

- If consent of the rescinding party was given by mistake, or obtained by duress, menace, fraud, or undue influence exercised by the nonrescinding party (CC §1689(b)(1));
- If there is a partial or total failure of consideration through the fault of the nonrescinding party (CC §1689(b)(2));
- If the consideration becomes entirely void from any cause (CC §1689(b)(3));
- If the consideration owing to the rescinding party fails in a material respect from any cause before it is given (CC §1689(b)(4));
- If the contract is unlawful for reasons not apparent on its face and the parties are not equally at fault (CC §1689(b)(5));
- If the public interest will be prejudiced by allowing the contract to continue (CC §1689(b)(6)); or
- Under the circumstances specified in any other statute providing for rescission, including, *e.g.,* CC §§39 (contracts by persons of unsound mind made before a judicial determination of incapacity), 1533 (rescission of novation by creditor), 1566 (rescission of consent not freely given), 1930 (rescission by lessor), 2314 (rescission of agency ratification), specified Insurance Code provisions, or any other statute (CC §1689(b)(7); see §11.58).

An asserted rescission may be justified by proving that there was adequate cause at the time of the rescission, even though it did not become known to the rescinding party until later. *Wilson v Lewis* (1980) 106 CA3d 802, 809, 165 CR 396.

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§11.51 3. Mistake or Fraud (CC §§1689(b)(1), 1690)

A party who has been induced by mistake or fraud to enter into a contract may have the contract set aside and obtain restitution of the benefits lost to him or her in the transaction. CC §1689(b)(1); *Merced County Mut. Fire Ins. Co. v State* (1991) 233 CA3d 765, 771, 284 CR 680. Even if the contract includes a stipulation that errors in description shall not void the contract nor give rise to a right of compensation, the right of rescission for fraud or for mistake continues to exist if a mistake concerns a matter "essential to the inducement of the contract" and not "capable of exact and entire compensation." CC §1690.

A unilateral factual mistake by one party to a contract may afford a basis for rescission in some circumstances. *Donovan v RRL Corp.* (2001) 26 C4th 261, 278, 109 CR2d 807. If the plaintiff does not cause, and has no reason to know of, the defendant's unilateral mistake of fact, the defendant must show the following in order to obtain rescission of the contract: (1) that the defendant made a mistake regarding a basic assumption on which the defendant entered into the contract; (2) that the mistake has a material effect on the agreed exchange of performances that is adverse to the defendant; (3) that the defendant does not bear the risk of the mistake; and (4) that the effect of the mistake is such that enforcement of the contract would be unconscionable. 26 C4th at 282. See §3.33 for further discussion of the *Donovan* case. See also *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1332, 96 CR3d 813; *Grenall v United of Omaha Life Ins. Co.* (2008) 165 CA4th 188, 80 CR3d 609 (annuity could not be rescinded based on decedent's unilateral mistaken belief when she entered into contract that she was in good health and had reasonable life expectancy, because she bore risk of mistake); *Stewart v Preston Pipeline, Inc.* (2005) 134 CA4th 1565, 1588, 36 CR3d 901. For a general discussion of mistake as a factor that may defeat a party's consent, see §§3.32-3.34. Undue influence is discussed in §§3.21-3.31.

A party who has been defrauded has the right to rescind a contract, even without proof of damages, if the party can establish that the promises that induced that party's reliance were fraudulent and have been breached. "The rule derives from the basic principle that a contracting party has a right to what it contracted for, and so has the right 'to rescind where he obtain[ed] something substantially different from that which he [is] led to expect.'" *Engalla v Permanente Med. Group, Inc.* (1997) 15 C4th 951, 979, 64 CR2d 843 (citations omitted). See also *Denevi v LGCC, LLC* (2004) 121 CA4th 1211, 1220, 18 CR3d 276. For a general discussion of fraud as a factor that may defeat a party's consent, see §§3.11-3.20.

Although the general rule is that rescission is available to a party to a contract whose consent was given by fraud, rescission will be denied and the plaintiff left to other remedies if the rights of third parties have intervened and circumstances have changed to such an extent that rescission could not be ordered without injury to those parties and their rights. Rescission is not available if the rights of third parties would be prejudiced. *Gill v Rich* (2005) 128 CA4th 1254, 1265, 28 CR3d 52.

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§11.52 4. Failure of Consideration (CC §1689(b)(2)-(4))

Failure of consideration, as grounds for rescission listed in CC §1689(b)(2)-(4), was explained in *Taliaferro v Davis* (1963) 216 CA2d 398, 410, 31 CR 164, as "the failure to execute a promise, the performance of which has been exchanged for performance by the other party" (citations omitted). In any executory contract, the parties' reciprocal obligations constitute the consideration for the contract. See generally §§3.40-3.50. "[A] failure to perform constitutes a failure of consideration—either partial or total, as the case may be—within the meaning of section 1689 of the Civil Code." 216 CA2d at 411. See also *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1332, 96 CR3d 813. The contract remains in effect, however, until the contract is rescinded or terminated. Unlike fraud or mistake, which usually rests on facts existing at the time the contract was made, a failure of consideration is based on a fact or contingency that occurs after the making of the contract. Failure of consideration authorizes rescission of the contract, and also constitutes a defense to an action for breach of a bilateral contract. If the consideration fails in whole or in part through one party's fault, the other party may invoke such failure as a basis for rescinding or terminating the contract, provided that the first party's failure or refusal to perform constitutes a material breach. *Taliaferro v Davis*, 216 CA2d at 412.

Eidsmore v RBB, Inc. (1994) 25 CA4th 189, 30 CR2d 357, was an action for rescission of a contract to purchase an expensive foreign automobile. The court of appeal affirmed the trial court's finding that rescission was not warranted on the grounds of failure of consideration. The contract did not specify a delivery date; therefore, a reasonable time was allowed for performance. The plaintiff had made a nonrefundable down payment, which gave him the right to the first automobile of a particular model once it was received by the defendant dealer. The court found that the 6-month period between execution of the contract and arrival of the first automobile was reasonable, given the limited production and distribution of the automobile.

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§11.53 E. Must Involve Entire Contract

As a general rule, a party entitled to rescind a contract must rescind the entire contract, and may not retain some rights under it but repudiate the remainder of the contract's provisions. The underlying theory is that retention of only the benefits of the contract would amount to unjust enrichment and would bind the parties to a contract that they did not contemplate or bargain for. *Simmons v California Inst. of Technol.* (1949) 34 C2d 264, 275, 209 P2d 581; *IMO Dev. Corp. v Dow Corning Corp.* (1982) 135 CA3d 451, 185 CR 341; *Yeng Sue Chow v Levi Strauss & Co.* (1975) 49 CA3d 315, 326, 122 CR 816. See also *Gill v Rich* (2005) 128 CA4th 1254, 1265, 28 CR3d 52 (physicians could not accept benefits of interindemnity trust alternative to malpractice insurance for 3 years and then rescind when assessments were increased).

If the contract is severable or divisible, however, total rescission is not required. *IMO Dev. Corp. v Dow Corning Corp.*, *supra*; *Yeng Sue Chow,* 49 CA3d at 326. In general, the test for whether a contract is severable or divisible is as follows: "if the consideration is single, the contract is entire, but if the consideration is apportioned, the contract may be regarded as severable.... And a contract may be severable as to some of its terms, or for certain purposes, but indivisible as to other terms, or for other purposes." *Simmons,* 34 C2d at 275. If, however, it was the parties' intention to regard the agreement as an entire contract, and the parties would not have entered into the contract except with a clear understanding that the entire contract should be performed, then the contract is not severable or divisible. *IMO Dev. Corp.,* 135 CA3d at 458; *Yeng Sue Chow,* 49 CA3d at 326. See *Habitat Trust for Wildlife, Inc. v City of Rancho Cucamonga* (2009) 175 CA4th 1306, 1344, 96 CR3d 813 (entire contract was rescinded and thus extinguished; as result, contract's savings clause was of no effect).

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§11.54 F. Procedure for Rescission (CC §1691)

Civil Code §1691 sets for the procedures for effecting rescission of a contract. It provides as follows:

> Subject to Section 1693 [see §11.55], to effect a rescission a party to the contract must, 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:
> (a) Give notice of rescission to the party as to whom he rescinds; and
> (b) Restore to the other party everything of value which he has received from him under the contract or offer to restore the same upon condition that the other party do likewise, unless the latter is unable or positively refuses to do so.
> When notice of rescission has not otherwise been given or an offer to restore the benefits received under the contract has not otherwise been made, the service of a pleading in an action or proceeding that seeks relief based on rescission shall be deemed to be such notice or offer or both.

In *Myerchin v Family Benefits, Inc.* (2008) 162 CA4th 1526, 76 CR3d 816, the plaintiff attempted to rescind a settlement agreement after accepting and spending the settlement funds. The court refused to allow the plaintiff to do so, noting the plaintiff had not given notice of rescission or returned the settlement funds. The court rejected the plaintiff's argument that his amended answer to the cross-complaint seeking enforcement of the settlement agreement satisfied the final paragraph of §1691. In *LA Sound USA, Inc. v St. Paul Fire & Marine Ins. Co.* (2007) 156 CA4th 1259, 67 CR3d 917, an action for breach of the duty to defend, the defendant insurer alleged that material misrepresentations in the insurance application rendered the policy "voidable, and/or subject to reformation or rescission." 156 CA4th at 1267. The court held the insurer's pleadings were sufficient to satisfy its obligation to provide notice and restore consideration under §1691.

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§11.55 1. Notice of Rescission (CC §§1691(a), 1693)

As provided in CC §1691, notice of rescission must be given promptly after the party wishing to rescind discovers the facts on which rescission is based. If a party chooses to rescind, the party must do so promptly after discovery of the breach. "He may not wait to see whether the contract turns out to be profitable or unprofitable, good or bad." *B. C. Richter Contracting Co. v Continental Cas. Co.* (1964) 230 CA2d 491, 500, 41 CR 98. Promptness is a condition of rescission under the statutes, and a failure to take action may be held to constitute a waiver of the right to rescind. *Cutter Labs., Inc. v Twining* (1963) 221 CA2d 302, 317, 34 CR 317.

Yet CC §1693 provides that in an action where relief based on rescission is claimed, a delay in giving notice of rescission should not result in a denial of rescission unless the other party has been substantially prejudiced by the delay. Indeed, there may be situations in which the party seeking rescission must continue to perform the contract and delay notice of rescission for practical considerations. See, *e.g., Uniwill L.P. v Los Angeles* (2004) 124 CA4th 537, 21 CR3d 464 (developer properly alleged rescission for economic duress when city demanded that developer grant easement as condition of approval of final tract map; tentative tract map had been approved, and developer had begun construction, incurring substantial costs each day, and thus had no choice but to accede to demand and delay action for rescission).

The notice of rescission should clearly show intention to rescind, but need not designate grounds therefor; statement of certain grounds does not preclude relying on other grounds. *Wilson v Lewis* (1980) 106 CA3d 802, 809, 165 CR 396.

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§11.56 2. Restoration of Consideration (CC §§1691(b), 1693)

Further as provided in CC §1691, promptly after a party wishing to rescind discovers the facts on which rescission is based, that party must restore everything of value received under the contract (or else offer to restore it on condition that the other party do the same), unless the other party is unable or expressly refuses to do so. See generally *Star Pac. Invs., Inc. v Oro Hills Ranch, Inc.* (1981) 121 CA3d 447, 176 CR 546; *Gantner v Johnson* (1969) 274 CA2d 869, 79 CR 381. The purpose of this requirement is to restore the status quo, the position that the parties occupied right before the contract was made, in order to avoid unjust enrichment. See *B. J. Metcalf Gen. Contractor, Inc. v Earl Erne, Inc.* (1963) 212 CA2d 689, 28 CR 382; *Kreisa v Stoddard* (1954) 127 CA2d 627, 274 P2d 164. Of course, if nothing of value has been received under the contract, this requirement is inapplicable. *Modoc Mineral & Oil Co. v Cal-Vada Drilling & Exploration Co.* (1965) 236 CA2d 868, 46 CR 508.

Civil Code §1693 provides that in an action in which relief based on rescission is claimed, a delay in restoring or tendering restoration of benefits before judgment should not result in a denial of rescission unless the other party has been substantially prejudiced by the delay, although the court may make a tender of restoration a condition of its judgment. In *Myerchin v Family Benefits, Inc.* (2008) 162 CA4th 1526, 76 CR3d 816, the court found the defendants were substantially prejudiced by the plaintiff's delay in restoring funds that the defendants had given up to effect a settlement.

In cases involving fraud, the restoration requirement may not be rigidly enforced if it is possible for the court to achieve substantial justice by adjusting the equities between the parties. See CC §1692. The fact that it is not possible to reproduce the status quo exactly will not necessarily prevent a defrauded party from rescinding the contract. See *McCoy v West* (1977) 70 CA3d 295, 138 CR 660; *Lobdell v Miller* (1952) 114 CA2d 328, 250 P2d 357.

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§11.57 G. Relief Based on Rescission (CC §1692)

Civil Code §1692 (added to the Civil Code in 1961) allows a party who has rescinded a contract to bring an action "to recover any money or thing owing to him by any other party to the contract as a consequence of such rescission or for any other relief to which he may be entitled under the circumstances." It also allows a party to assert rescission as a defense or cross-claim. In effect, CC §1692 gives a rescinding party the right to enforce the rescission in court if the other party to the contract refuses to treat the contract as having been rescinded. Note that an action under CC §1692 is not an action to rescind the contract, *i.e.,* a judicial rescission, but rather an action "based upon" a party's extrajudicial rescission. See §11.47. If the court determines that the contract has not been rescinded, CC §1692 also provides that the court may grant any party to the action any other relief to which it may be entitled under the circumstances. See *Runyan v Pacific Air Indus., Inc.* (1970) 2 C3d 304, 313, 85 CR 138. Whether or not a party in an action based on a rescission under CC §1692 is entitled to a jury trial will be determined by the nature of the relief requested. *Nmsbpcsldhb v County of Fresno* (2007) 152 CA4th 954, 61 CR3d 425 (no right to jury trial in rescission action where plaintiff land seller sought money from buyer, not return of land).

Civil Code §1692 grants the court wide latitude in crafting relief based on rescission. It provides in part that "[i]f in an action or proceeding a party seeks relief based upon rescission, the court may require the party to whom such relief is granted to make any compensation to the other which justice may require and may otherwise in its judgment adjust the equities between the parties." Civil Code §1692 further provides in part that the plaintiff in an action based on rescission may seek damages and restitution of any benefits conferred by the plaintiff on the other party, as well as any consequential damages to which the plaintiff may be entitled, although double recovery is not permitted:

> A claim for damages is not inconsistent with a claim for relief based upon rescission. The aggrieved party shall be awarded complete relief, including restitution of benefits, if any, conferred by him as a result of the transaction and any consequential damages to which he is entitled; but such relief shall not include duplicate or inconsistent items of recovery.

For example, in *Jahn v Brickey* (1985) 168 CA3d 399, 214 CR 119, the court ruled that simply canceling the transaction would not make the plaintiff whole. There was also the issue of consequential damages. The plaintiff was entitled to consequential damages in the form of rents and profits during the period that the defendant retained ownership of the property, as well as the real estate commission paid by the plaintiff. Consequential damages were also allowed in *Leaf v Phil Rauch, Inc.* (1975) 47 CA3d 371, 120 CR 749, and *Kass v Weber* (1968) 261 CA2d 417, 67 CR 876. In *Hedging Concepts, Inc. v First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1422, 49 CR2d 191, however, the court cautioned that the authority granted in CC §1692 for a court to "adjust the equities" between the parties does not allow the court to restructure the agreed terms of the parties' contract.

Runyan v Pacific Air Indus., Inc. (1970) 2 C3d 304, 85 CR 138, was an action for rescission of a franchise contract and damages. The California Supreme Court affirmed the trial court's judgment, which adjusted the equities and restored the parties to their former positions as far as it was possible. In addition to awarding the plaintiff the amount he paid for the franchise and certain expenses, the court allowed him lost income for the period between execution and rescission of the franchise agreement. The court found that the plaintiff relied on the contract to his detriment by giving up his former employment, and the defendant received benefit from the plaintiff's services. The court deducted from the total amount of consequential damages the gross income received by the plaintiff from his franchise activities.

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§11.58 H. Statutory Rescission Rights for Particular Types of Contracts

In addition to the general rules governing rescission in CC §§1688-1689 and 1690-1693, a number of other Civil Code provisions grant rescission or cancellation rights for contracts utilized in particular types of businesses in California. As discussed in §6.38, many, although not all, of these statutes involve consumer transactions. Most of these statutes require contracts to include particular terms and disclosures. Attorneys faced with contracts for these types of businesses should review the applicable statutes carefully for specific requirements, including cancellation rights. A nonexclusive list of the statutes that include rescission or cancellation rights follows. See also §6.38.

Uniform Vendor and Purchaser Risk Act (CC §1662). Although the Uniform Vendor and Purchaser Risk Act (see §11.28) does not set forth an express right of rescission or cancellation, in *Dixon v Salvation Army* (1983) 142 CA3d 463, 191 CR 111, the court ordered rescission of a real property purchase and sale contract when a material portion of the subject property was destroyed by fire before the seller transferred legal title and possession of the premises. The court refused to grant the buyer specific performance of the contract with an abatement of the purchase price, stating that it was more appropriate to place the parties in their original positions, free to make a new bargain.

Endless chain schemes (CC §1689.2). An "endless chain" refers to a pyramid marketing scheme, and is defined in the Penal Code as "any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant." Pen C §327. Civil Code §1689.2 gives any participant in an endless chain scheme (as so defined) an unrestricted right to rescind the contract and recover any consideration paid (less amounts received under the scheme). See *Bounds v Figurettes, Inc.* (1982) 135 CA3d 1, 185 CR 480.

Dental services contracts (CC §1689.3). Civil Code §1689.3 gives any patient who contracts with a dental office or plan for dental services a right to rescind the contract, exercisable up until midnight of the third business day after the date on which the contract or plan was signed. If the dental office has provided services to the patient, the office is entitled to compensation for those services.

Home solicitation contracts (CC §§1689.5-1689.13). Civil Code §1689.5 defines "home solicitation contract" as any contract or offer for "the sale, lease or rental of goods or services or both, made at other than appropriate trade premises" in an amount of $25 or more. The definition encompasses telephone sales. *People v Toomey* (1984) 157 CA3d 1, 203 CR 642. The terms "goods" and "services" are specially defined in CC §1689.5(c)-(d), and generally refer to consumer goods and services, with certain exceptions. Civil Code §1689.6(a) grants a buyer the right to cancel the contract or offer until midnight of the third business day after the day on which the buyer signed the contract or offer, by giving written notice of cancellation to the seller. If the contract is one for a "personal emergency response unit" (as defined in CC §1689.6(g)) or if the contract is one for repair or restoration of residential premises damaged by a disaster, the buyer has up until midnight of the seventh business day after the signing date to cancel. CC §1689.6(b)-(c). If the contract does not include certain disclosures required by the statute, the buyer's right to cancel extends for an indefinite period, until the disclosures are added. *Beley v Municipal Court* (1979) 100 CA3d 5, 8, 160 CR 508. There are exceptions for certain contracts regulated by the Business and Professions Code. See CC §1689.6(a)-(b).

With certain exceptions, within 10 days after the buyer cancels the contract, the seller must tender to the buyer any payments made by the buyer under the contract, in cash or in kind. CC §1689.10. If any goods have been delivered to the buyer under the contract, the buyer must take reasonable care of those goods and return them to the seller on the terms provided in the statute. CC §§1689.10(c), 1689.11(a)-(b). If any services have been rendered before cancellation of the contract, the seller is not entitled to any compensation for those services. If the property has been altered, the seller must restore the property to substantially the same condition as it was before the services were rendered. CC §1689.11(c).

Exceptions are provided for certain contracts for emergency repairs or services (CC §1689.13) and for contracts for goods that have become fixtures before cancellation, if the property has been sold or encumbered to a bona fide purchaser or encumbrancer (CC §1689.9). Any purported waiver of the provisions of CC §§1689.5-1689.11 is void and

unenforceable. CC §1689.12.

See generally *Handyman Connection of Sacramento, Inc. v Sands* (2004) 123 CA4th 867, 20 CR3d 727; *Louis Luskin & Sons v Samovitz* (1985) 166 CA3d 533, 212 CR 612; *Williams v Kapilow & Son* (1980) 105 CA3d 156, 164 CR 176.

Seminar sales solicitation contracts (CC §§1689.20-1689.24). "Seminar sales solicitation contracts" are defined in CC §1689.24(a) as any contract or offer "for the sale, lease, or rental of goods or services or both, made using selling techniques in a seminar" for $25 or more. The terms "goods" and "services" are specially defined in CC §1689.24(b)-(c). The terms generally refer to consumer goods and services, with certain exceptions. Civil Code §1689.20 grants a buyer a right to cancel the contract or offer until midnight of the third business day after the day on which the buyer signed the contract or offer, by giving written notice of cancellation to the seller. CC §1689.20(a). The seller must refund amounts paid within 10 days of notice of cancellation. CC §1689.22. Other statutory provisions regarding seminar sales solicitation contracts are similar to the provisions governing home solicitation contracts described above.

Dating service contracts (CC §§1694-1694.4). Civil Code §1694.1 grants a buyer a right to cancel a dating service contract or offer (as defined in CC §1694) until midnight of the third business day after the day on which the buyer signed the contract or offer, by giving written notice of cancellation to the seller in compliance with the statute. If the dating service contract does not comply with statutory requirements, the buyer has an unrestricted right to cancel the contract at any time. CC §1694.2(e). The seller must refund amounts paid within 10 days of notice of cancellation. CC §1694.1(e). The law provides for the apportionment and recovery, in appropriate circumstances, of fees paid for services. CC §§1694.3-1694.4. The buyer may also recover treble damages and reasonable attorney fees if the buyer has been injured by a violation of the statutory requirements. CC §1694.4(c). For further discussion of dating service contracts, see *Duffens v Valenti* (2008) 161 CA4th 434, 74 CR3d 311.

Weight loss contracts (CC §§1694.5-1694.9). Civil Code §1694.6 grants a buyer a right to cancel a weight loss contract or offer (as defined in CC §1694.5) until midnight of the third business day after the day on which the buyer signed the contract or offer, by giving written notice of cancellation to the seller in compliance with the statute. If the weight loss contract does not comply with statutory requirements, the buyer has an unrestricted right to cancel the contract at any time. CC §1694.7(e). Other statutory provisions regarding weight loss contracts are similar to the provisions governing dating service contracts described above.

Home equity sales contracts (CC §§1695-1695.17). Civil Code §1695.4 provides that, in addition to any other rescission right, a seller of the equity of a home in foreclosure is entitled to cancel the contract with the equity purchaser until midnight of the fifth business day after the day on which the seller signed the contract, by giving written notice of cancellation to the purchaser. CC §1695.4. A transaction in which an equity purchaser has taken "unconscionable advantage" of the seller in a residential real estate foreclosure may be rescinded within 2 years after the conveyance of the subject property was recorded. CC §§1695.13, 1695.14(a). There are specific exceptions to the definition of "equity purchaser" in CC §1695.1(a). Note that the statute applies to anyone who purchases a residence subject to an outstanding notice of default, regardless of whether the homeowner initiates the negotiations or the purchaser routinely engages in such transactions. *Segura v McBride* (1992) 5 CA4th 1028, 1031, 7 CR2d 436.

The equity purchaser is restricted from taking certain actions, including (among other things), paying the equity seller any consideration or accepting a deed from the seller, during the time period allowed for the seller to cancel. CC §1695.6. Civil and criminal penalties are provided for certain violations. Among other things, the seller may recover treble damages and reasonable attorney fees and costs. See CC §§1695.7-1695.8. An equity purchaser is also liable to the seller for any damages resulting from statements or actions of the purchaser's representative. CC §1695.15. Any purported waiver of the statutes regulating home equity sales contracts is void. CC §1695.10.

See generally *Boquilon v Beckwith* (1996) 49 CA4th 1697, 57 CR2d 503; *Segura v McBride*, *supra*.

NOTE: In *Schweitzer v Westminster Invs. Inc.* (2007) 157 CA4th 1195, 69 CR3d 472, the court held that CC §1695.17, which imposes bonding and disclosure requirements on representatives of home equity purchasers, was void for vagueness but that this provision was severable from the other provisions of the Home Equity Sales Contracts Act (CC §§1695-1695.17).

The "Lemon Law" (CC §§1790-1795.8). The Song-Beverly Consumer Warranty Act (CC §§1790-1795.7), popularly known as the "Lemon Law," is discussed generally in §6.24. The Act gives consumers protection against nonconforming or defective products, including motor vehicles. If a manufacturer or its representatives cannot service or

repair a consumer product in conformity with applicable warranties after a reasonable number of attempts, the manufacturer must either replace the goods or make restitution to the buyer in the amount of the purchase price paid, less an amount directly attributable to the buyer's use of the product before discovery of the nonconformity. See CC §§1793.2, 1793.3; *Oregel v American Isuzu Motors, Inc.* (2001) 90 CA4th 1094, 109 CR2d 583; *Lundy v Ford Motor Co.* (2001) 87 CA4th 472, 475, 104 CR2d 545. The buyer may also have an action for damages and other legal and equitable relief, and in addition may exercise buyer's remedies provided in Division 2 of the Commercial Code. See CC §1794; Com C §§2711-2715.

Technically, the statutory remedy of a buyer of consumer goods under the Act to compel the manufacturer to reimburse the purchase price or replace the goods is distinct from rescission. The Act provides different and more extensive remedies to a consumer. Thus, an action founded solely on the Act is not subject to the common law and Commercial Code rules concerning rescission. *Jiagbogu v Mercedes-Benz USA* (2004) 118 CA4th 1235, 1238, 13 CR3d 679.

Karnette Rental-Purchase Act (CC §§1812.620-1812.649). The Karnette Rental-Purchase Act generally applies to any rental-purchase agreement between a lessor and a consumer for personal property to be used for personal, family, or household purposes. See CC §1812.622(d). Rental-purchase agreements are subject to the rules governing home solicitation contracts (see above) if made at other than appropriate trade premises. CC §1812.628(a). Consumers who have not taken possession of the rental property have an unrestricted right to cancel the agreement without penalty or obligation. CC §1812.628(b). Lessors have an obligation to repair or replace any property subject to the agreement that is not in good working order. CC §1812.633. Consumers who suffer damages as a result of violations of the Act may recover actual and exemplary damages, reasonable attorney fees, and equitable relief as the court may deem proper. CC §1812.636.

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VI. CANCELLATION

§11.59 A. Extrajudicial Cancellation (CC §§1699-1701)

Civil Code §§1699-1701 address extrajudicial cancellation of a written contract. Civil Code §1699 provides that "[t]he destruction or cancellation of a written contract, or of the signature of the parties liable thereon, with intent to extinguish the obligation thereof, extinguishes it as to all the parties consenting to the act." See*, e.g., Pico Citizens Bank v Tafco, Inc.* (1962) 201 CA2d 131, 19 CR 905. Civil Code §1700 provides that "[t]he intentional destruction, cancellation, or material alteration of a written contract, by a party entitled to any benefit under it, or with his consent, extinguishes all the executory obligations of the contract in his favor, against parties who do not consent to the act." See, *e.g.*, *Montgomery v Bank of America* (1948) 85 CA2d 559, 193 P2d 475 (description in deed was altered by escrow agent without grantors' knowledge or consent; deed therefore void). Civil Code §1701 clarifies that CC §1700 is not applicable in situations where a contract has been executed in counterpart copies and one copy of a contract is altered or destroyed, but other copies remain in existence.

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§11.60 B. Judicial Cancellation (CC §§3412-3414)

Judicial cancellation of a contract is governed by CC §§3412-3414. As an equitable remedy, cancellation is distinct from, and broader in scope than, rescission. *Boyd v Lancaster* (1942) 56 CA2d 103, 110, 132 P2d 214. Civil Code §3412 sets forth the grounds for cancellation as follows:

> A written instrument, in respect to which there is a reasonable apprehension that if left outstanding it may cause serious injury to a person against whom it is void or voidable, may, upon his application, be so adjudged, and ordered to be delivered up or canceled.

With reference to cancellation of a written contract under CC §3412, the term "cancellation" has been defined to mean "to abrogate so much of it as remains unperformed. It differs from 'rescission,' which means to restore the parties to their former position. The one refers to the state of things at the time of the cancellation; the other to the state of things existing when the contract was made." *Fireman's Fund Am. Ins. Co. v Escobedo* (1978) 80 CA3d 610, 619, 145 CR 785 (citations omitted). In insurance cases, the courts distinguish rescission, as a remedy that may be effective retroactively to the time of the making of the contract, from cancellation as a remedy that terminates the contract only prospectively. *Escobedo v Estate of Snider* (1997) 14 C4th 1214, 1225, 60 CR2d 722; *Imperial Cas. & Indem. Co. v Sogomonian* (1988) 198 CA3d 169, 182, 243 CR 639.

The term "injury" as used in CC §3412 is not limited to financial loss, and may consist of an adverse effect or prejudice to one's position. *Turner v Turner* (1959) 167 CA2d 636, 334 P2d 1011. Civil Code §3413 provides that an instrument that is invalid on its face is not to be considered capable of causing injury within the meaning of CC §3412.

Cancellation is the remedy typically sought when fraud, duress, undue influence, or mental incapacity is present and has defeated mutual consent of the parties. See, *e.g., Gross v Needham* (1960) 184 CA2d 446, 7 CR 664 (duress); *Sullivan v Dunnigan* (1959) 171 CA2d 662, 341 P2d 404 (fraud); *Webb v Saunders* (1949) 89 CA2d 732, 201 P2d 816 (mental incapacity); *Reiss v Reiss* (1941) 45 CA2d 740, 114 P2d 718 (undue influence). See generally §§2.24-2.28, 3.8-3.30. It is also used to correct mistakes in real estate transactions. See, *e.g., Duley v Westinghouse Elec. Corp.* (1979) 97 CA3d 430, 158 CR 668 (cancellation of reconveyance of deed of trust, which had been recorded mistakenly by escrow agent).

In *Sullivan v Dunnigan, supra,* the plaintiff was an elderly woman with cataracts, who signed a deed for certain property owned jointly by herself and her son and daughter-in-law at her son's request without receiving any consideration. The son told the plaintiff that the purpose of the deed was to get his name off the property, but the deed conveyed the plaintiff's interest to the son and daughter-in-law, reserving a life estate in the plaintiff. The evidence showed that the plaintiff never had any intention of parting with title to her interest. The court therefore held that the action was properly one for cancellation of the deed, not for rescission. *Sullivan v Dunnigan*, *supra*.

Partial cancellation is allowed under CC §3414, which provides "[w]here an instrument is evidence of different rights or obligations, it may be canceled in part, and allowed to stand for the residue." This rule is similar to the rule that allows partial rescission of a contract if it is severable or divisible. See §11.53.

In contrast with the procedural requirements for rescission discussed in §§11.54-11.56, there is no requirement that a plaintiff seeking judicial cancellation of an instrument give formal notice or formally offer to restore benefits received (*Smith v Willliams* (1961) 55 C2d 617, 12 CR 665), although the court may order the plaintiff to return any benefits received in order to avoid unjust enrichment. In general, an action for judicial cancellation must be brought within the 4-year statute of limitations of CCP §343. If fraud or mistake is involved, the applicable statute is CCP §338(a), which allows only 3 years. Actions involving title to or possession of land are subject to the applicable real estate statute of limitation, CCP §§318-319 or §328. *Robertson v Superior Court* (2001) 90 CA4th 1319, 109 CR2d 650.

NOTE: Cancellation in the context of real estate transactions is discussed at length in California Real Property Remedies and Damages, chap 6 (2d ed Cal CEB 2002).

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§11.61 VII. ABANDONMENT

In general, abandonment of a contract occurs by mutual consent of the parties, and can occur at any stage of the parties' performance. If abandonment has occurred, each party is released from any further obligations under the contract. Abandonment is a matter of the parties' intent. The fact of abandonment may be established by the parties' words or may be implied from their conduct. *Honda v Reed* (1958) 156 CA2d 536, 319 P2d 72; *Evans v Rancho Royale Hotel Co.* (1952) 114 CA2d 503, 250 P2d 283. Abandonment is equivalent to a mutual waiver of the parties' contractual rights. See §5.88.

Abandonment has a special meaning in the context of construction contracts. If a property owner imposes on the construction contractor such an excessive number of changes that the scope of the work under the original contract has been altered, the court may properly find an abandonment of contract. *Sehulster Tunnels/Pre-Con v Traylor Bros., Inc./Obayashi Corp.* (2003) 111 CA4th 1328, 1344 n12, 4 CR3d 655. In general, abandonment of a construction contract can occur when the scope of work requested or undertaken greatly exceeds what was originally called for in the contract. It "requires a finding that *both* parties intended to disregard the contract, and abandonment may be implied from the acts of the parties." *C. Norman Peterson Co. v Container Corp.* (1985) 172 CA3d 628, 643, 218 CR 592. See generally *Amelco Elec. v City of Thousand Oaks* (2002) 27 C4th 228, 115 CR2d 900. The abandonment theory does not apply as against public entities, because it is fundamentally inconsistent with competitive bidding procedures required by statute for public works contracts. *Sehulster Tunnels/Pre-Con,* 111 CA4th at 1343.

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VIII. REFORMATION

§11.62 A. Generally (CC §§3399, 3402)

The equitable remedy of reformation of contracts is referred to as "revision" in the Civil Code, and is subject to CC §§3399-3402. Civil Code §3399 provides for reformation (revision) as follows:

> When, through fraud or a mutual mistake of the parties, or a mistake of one party, which the other at the time knew or suspected, a written contract does not truly express the intention of the parties, it may be revised, on the application of a party aggrieved, so as to express that intention, so far as it can be done without prejudice to rights acquired by third persons, in good faith and for value.

The remedy is equitable in nature and is not restricted to the exact situations stated in CC §3399. *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 388, 131 CR2d 859. See also *Schools Excess Liab. Fund v Westchester Fire Ins. Co.* (2004) 117 CA4th 1275, 1284 n12, 12 CR3d 626. Reformation is commonly sought in cases involving a mistake in a written contract or instrument, but mistake is not the "essence" of reformation. "The essential purpose of reformation is to reflect the intent of the parties." *Jones,* 107 CA4th at 389. As stated by the California Supreme Court in *Bailard v Marden* (1951) 36 C2d 703, 708, 227 P2d 10:

> To obtain the benefit of this statute, it is necessary that the parties shall have had a complete mutual understanding of all the essential terms of their bargain; if no agreement was reached, there would be no standard to which the writing could be reformed.... [Inasmuch] as the relief sought in reforming a written instrument is to make it conform to the real agreement or intention of the parties, a definite intention or agreement on which the minds of the parties had met must have pre-existed the instrument in question.

Although a court may reform an agreement as provided in CC §§3399-3402, and in doing so may add, subtract, or transpose words, the court is not allowed to create a new agreement for the parties under a theory of reformation. It may only reform the agreement "to conform with the mutual understanding of the parties at the time they entered into it, if such an understanding exists." *Hess v Ford Motor Co.* (2002) 27 C4th 516, 524, 117 CR2d 220; *Ike v Doolittle* (1998) 61 CA4th 51, 70 CR2d 887. Moreover, a court may not cure an illegal contract provision by reformation. If the illegality cannot be removed by severance or restriction, the court must void the entire agreement. *Abramson v Juniper Networks, Inc.* (2004) 115 CA4th 638, 660, 9 CR3d 422.

NOTE: Reformation in the context of real estate transactions is discussed at length in chapter 2 of California Real Property Remedies and Damages (2d ed Cal CEB 2002).

Reformation is quite distinct from rescission. Reformation assumes that the parties made a valid agreement but that, by mutual mistake, the written contract fails to express the parties' actual intent. It contemplates that the parties will continue their contractual relationship on the basis that they originally intended. Rescission, however, operates to undo the parties' relationship, and means that both parties are released from their respective obligations as if the contract had never been made. *Douglass v Dahm* (1950) 101 CA2d 125, 128, 224 P2d 914.

The right to obtain reformation of a contract is not restricted to the original parties to the transaction. A "party aggrieved" within CC §3399 need not be one of the original parties, but may include anyone who has suffered prejudice or pecuniary loss. *Shupe v Nelson* (1967) 254 CA2d 693, 698, 62 CR 352; *Watson v Collins* (1962) 204 CA2d 27, 32, 21 CR 832. In *Shupe,* the court reformed a deed to include access rights for the benefit of subsequent grantees when their predecessors-in-title were aware of the need for access but had failed to include access rights in the original deed.

Civil Code §3402 provides that "[a] contract may be first revised and then specifically enforced." Reformation is one of several remedies that may be available for a single wrong. When a plaintiff's action is based on nonperformance of an intended agreement and there are grounds for reformation, the plaintiff may also request specific performance, damages, and possibly other remedies in addition to reformation. *Landis v Superior Court* (1965) 232 CA2d 548, 555, 42 CR 893. If specific performance cannot be decreed through no fault of the plaintiff, the court may grant monetary

relief as an alternative provided that the monetary relief is strictly incidental to the equitable relief of reformation. *Tomas v Vaughn* (1944) 63 CA2d 188, 192, 146 P2d 499.

NOTE: A contract that has been fully executed cannot be reformed if the aggrieved party, with knowledge of the facts, has accepted performance in accordance with the terms of the contract as written. *Venress Farms, Inc. v Sydenstricker* (1970) 11 CA3d 943, 950, 90 CR 251.

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§11.63 B. Presumption of Intent; Principles of Revision (CC §§3400-3401)

Civil Code §§3400-3401 set forth guidelines for the court in reforming a contract. Civil Code §3400 states that "[f]or the purpose of revising a contract, it must be presumed that all the parties thereto intended to make an equitable and conscientious agreement." See *La Mancha Dev. Corp. v Sheegog* (1978) 78 CA3d 9, 17, 144 CR 59. Further, CC §3401 provides that "[i]n revising a written instrument, the court may inquire what the instrument was intended to mean, and what were intended to be its legal consequences, and is not confined to the inquiry what the language of the instrument was intended to be."

When a court is considering reformation of an instrument, it is essential for the court to conduct an inquiry to ascertain the parties' true intention. *First Am. Title Ins. & Trust Co. v Cook* (1970) 12 CA3d 592, 598, 90 CR 645. See CC §1636, discussed in §5.5. A court cannot reform a written contract to make it conform with the parties' intentions unless the court can first determine what their intentions were. See *Bailard v Marden* (1951) 36 C2d 703, 708, 227 P2d 10. A written instrument is presumed to express the parties' true intent in the first instance, unless there is clear and convincing evidence to the contrary. See CC §1639, discussed in §5.7. This is especially true if the instrument was drafted by an attorney representing the party seeking to reform its terms. *Moore v Vandermast, Inc.* (1941) 19 C2d 94, 98, 119 P2d 129. See CC §1654, discussed in §5.22. In general, reformation of a document that is unambiguous on its face must be supported by clear and convincing evidence. *Shupe v Nelson* (1967) 254 CA2d 693, 62 CR 352; *Gardner v Mobil Oil Co.* (1963) 217 CA2d 220, 31 CR 731.

In determining whether reformation should be ordered, a court may (and usually must) consider parol or extrinsic evidence. Parol evidence is normally the only way a court can determine the true intentions of the parties and whether or not their written agreement accurately reflects their intentions. *Hess v Ford Motor Co.* (2002) 27 C4th 516, 117 CR2d 220. The parol evidence rule is discussed in §§5.33-5.43. The rule as set forth in the Code of Civil Procedure includes an express exception allowing admission of parol evidence in cases involving "mistake or imperfection" of a written document. See CCP §1856(e).

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§11.64 C. Reformation for Mistake

Mistake as a factor that may defeat mutual consent and nullify a contract is discussed generally in §§3.32-3.34. In a classic case for reformation of a contract, the contract has been formed, but a provision of the written contract contradicts the terms to which the parties actually agreed as a result of a mistake such as a drafting error. The court in such a case has the power to correct the error by deleting the mistaken language and inserting other appropriate language if there is evidence of the actual agreement of the parties. *PG&E v Superior Court* (1993) 15 CA4th 576, 593, 19 CR2d 295.

To constitute grounds for reformation, a mistake must be either (1) a mutual mistake or (2) a unilateral mistake that the other party knew of or suspected at the time the contract was made. CC §3399. A unilateral mistake is generally not sufficient grounds for reformation unless the mistake was known or suspected by the other party and as a result, the writing does not express the parties' intent. *La Mancha Dev. Corp. v Sheegog* (1978) 78 CA3d 9, 16, 144 CR 59. See also *Stare v Tate* (1971) 21 CA3d 432, 98 CR 264 (allowing reformation of property settlement agreement based on wife's unilateral mistake, known to husband). The court in *La Mancha* held that the other party's knowledge of the mistake must be actual knowledge. Constructive notice of a unilateral mistake is not a sufficient basis for reformation. *La Mancha Dev. Corp.,* 78 CA3d at 17.

What if the party seeking to reform the contract is negligent? In *Harris v Rudin, Richman & Appel* (2002) 95 CA4th 1332, 116 CR2d 552, the court referred to CC §§1577-1578 (discussed in §§3.33-3.34) in making a distinction between mistakes of fact and mistakes of law. The court held that freedom from negligence is not a requirement for rescission based on a mistake of law. "Freedom from negligence is only required for rescission based on a mistake of fact." 95 CA4th at 1341. See also *Mercury v Pearson* (2008) 169 CA4th 1064, 1074, 87 CR3d 310 (reformation not available when language of insurance policy was clear and policy contained notice "DO NOT SIGN THIS AGREEMENT UNTIL YOU READ AND UNDERSTAND IT"). Citing CC §1577, the court in *Mercury* held that "reformation is not available for a mistake of fact that is caused by the neglect of a legal duty." 169 CA4th at 1074. Even so, the courts will allow reformation if the plaintiff's failure or negligence occurs as a result of false representations or fraud of the other party, "unless plaintiff's conduct, in the light of his intelligence and information, is preposterous or irrational." *Van Meter v Bent Constr. Co.* (1956) 46 C2d 588, 595, 297 P2d 644. To bar rescission, the plaintiff must be guilty of gross negligence. "[T]he negligent failure of a party to know or discover facts as to which both parties are under a mistake does not preclude rescission or reformation because of the mistake." 46 C2d at 594; *Harris v Rudin, Richman & Appel*, 95 CA4th at 1342. See also *Lister v Sorge* (1968) 260 CA2d 333, 67 CR 63.

In *Jones v First Am. Title Ins. Co.* (2003) 107 CA4th 381, 131 CR2d 859, the court ordered reformation of a deed of trust to reflect a trustee substitution in order to validate a nonjudicial foreclosure sale after the fact. The court of appeal found that the parties had entered into a complex series of agreements that included the bank's right to foreclose if the borrowers did not perform. One of the documents was deficient, so reformation was necessary to carry out the parties' intent. At the time of foreclosure, all parties believed that the documents were sufficient. The mutual mistake concerned only the identity of the person who was to perform a ministerial act. There was no evidence that the borrowers were prejudiced by the successor trustee's conduct of the foreclosure sale.

First Am. Title Ins. & Trust Co. v Cook (1970) 12 CA3d 592, 90 CR 645, illustrates reformation of a promissory note to remove a usurious interest provision. In that case, the lender and borrower negotiated a loan providing for interest at the maximum legal rate and containing a penalty for late payment. The escrow agent inadvertently used a note form with a compound default interest provision that made the note usurious. Neither the borrower nor the lender discovered the mistake until after default. The court of appeal held that there was sufficient evidence to support the finding that all parties intended the note to bear interest not exceeding the maximum legal rate and that the compound interest clause was included as a result of mutual mistake. Reformation of the note was therefore proper.

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Source: Business Law/California Law of Contracts/11 Remedies: Injunctive and Declaratory Relief; Other Remedies/ §11.65 IX. LOST OR DESTROYED DOCUMENTS (CC §3415)

§11.65 IX. LOST OR DESTROYED DOCUMENTS (CC §3415)

If a written contract has been lost or destroyed, CC §3415 gives any interested person a right of action to have the document reissued. Civil Code §3415(a) provides:

> An action may be maintained by any person interested in any private document or instrument in writing, which has been lost or destroyed, to prove or establish the document or instrument or to compel the issuance, execution and acknowledgment of a duplicate of the document or instrument.

If the document or instrument is a negotiable instrument, the court is required to order its owner to furnish an indemnity bond. See CC §3415(b).

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X. QUASI-CONTRACT, RESTITUTION

§11.66 A. What Is Quasi-Contract?

Contracts can be either "express," "implied in fact," or "implied in law." Implied-in-law contracts are also commonly referred to as quasi-contracts. An express contract is one, the terms of which are stated in words, either orally or in writing. CC §1620. An implied-in-fact contract is one, the existence and terms of which are manifested by conduct. CC §1621. See §4.34. The distinction between express and implied-in-fact contracts relates only to the manner in which the parties have manifested their assent; both types are based on the parties' expressed or apparent intention. *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 1134, 4 CR3d 583; *McGough v University of San Francisco* (1989) 214 CA3d 1577, 1584, 263 CR 404. Both express and implied-in-fact contracts require a meeting of the minds—a consensual agreement. The principal difference between the two is the manner of proof of establishing their existence. *Friedman v Friedman* (1993) 20 CA4th 876, 887, 24 CR2d 892. For further discussion of implied-in-fact contracts, see §4.34.

Implied-in-law contracts (quasi-contracts) are quite different from express or implied-in-fact contracts. Quasi-contracts are not based on mutual promises or a mutual intention to undertake certain performances; hence, they are not true contracts. They are obligations created by law, without regard to the parties' intent, for reasons of justice. *McBride v Boughton* (2004) 123 CA4th 379, 388, 20 CR3d 115; *McGough,* 214 CA3d at 1584.

Quasi-contract, unjust enrichment, and restitution are interrelated aspects of the same legal principle. Quasi-contract is a legal theory that provides a right of restitution as a remedy for unjust enrichment. If one obtains a benefit that he or she is not, in justice, entitled to retain, he or she is unjustly enriched. The contract implied in law, or quasi-contract, is an obligation created by law, regardless of the parties' intentions, designed to restore the aggrieved party to his or her former position by requiring the party who has been unjustly enriched to return the property taken or its equivalent in money. *Ghirardo v Antonioli* (1996) 14 C4th 39, 51, 57 CR2d 687; *McBride,* 123 CA4th at 388; *California Med. Ass'n v Aetna U.S. Healthcare of Cal., Inc.* (2001) 94 CA4th 151, 172 n23, 114 CR2d 109. Quasi-contract is essentially another way of describing the basis for the equitable remedy of restitution to prevent unjust enrichment. See *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 1136, 4 CR3d 583.

As a general rule, a public entity cannot be held liable on a theory of quasi-contract or contract implied-in-law, because such a theory is based on considerations of restitution or quantum meruit that are outweighed by the need to limit and protect a public entity's contractual obligations. *Pasadena Live, LLC v City of Pasadena* (2004) 114 CA4th 1089, 1094, 8 CR3d 233; *Los Angeles Equestrian Ctr., Inc. v City of Los Angeles* (1993) 17 CA4th 432, 449, 21 CR2d 313.

A cause of action seeking restitution based on quasi-contract may be framed as quantum meruit, money had and received, or another one of the common counts. See generally §11.71-11.73.

NOTE: An action for restitution based on quasi-contract is an action at law, even though equitable principles are applicable in the decision process. Therefore, a plaintiff seeking restitution is entitled to a trial by jury. *Lectrodryer v SeoulBank* (2000) 77 CA4th 723, 728, 91 CR2d 881.

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§11.67 B. Effect of Express Contract

It is well settled that an action based on quasi-contract will not lie if there exists a valid express contract between the parties covering the same subject matter. *Shvarts v Budget Group, Inc.* (2000) 81 CA4th 1153, 97 CR2d 722; *Lance Camper Mfg. Corp. v Republic Indem. Co.* (1996) 44 CA4th 194, 203, 51 CR2d 622. In *Hedging Concepts, Inc. v First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1419, 49 CR2d 191, a financial consultant sought recovery of fees under a quantum meruit theory (see §11.72), but the court denied relief because the parties had an express contract concerning the consultant's right to payment, yet the consultant had not met the contractual conditions for payment. The court explained that quasi-contractual recovery is founded on the theory that a contract to pay for services rendered is implied by law for reasons of justice, but there is no equitable basis for implying such an obligation if the parties have an express agreement regarding compensation. A quantum meruit or quasi-contract analysis would supply missing contractual terms in furtherance of equity, but contractual terms regarding a particular subject are not missing if the parties have agreed on express terms regarding that subject. Quasi-contract will not supply "missing" terms that are not missing. If "the parties have freely, fairly and voluntarily bargained for certain benefits in exchange for undertaking certain obligations, it would be inequitable to imply a different liability." *Hedging Concepts, Inc.,* 41 CA4th at 1419 (citations omitted).

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§11.68 C. Benefit or Enrichment

The phrase "unjust enrichment" is used to characterize the effect or result of a failure to make restitution of or for benefits or property received under circumstances that give rise to a legal or equitable obligation to account therefor. *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 1136, 4 CR3d 583. See also *McBride v Boughton* (2004) 123 CA4th 379, 387, 20 CR3d 115. If a person is unjustly enriched at the expense of another, he or she may be required to make restitution to the other. Someone is enriched if he or she receives a benefit at another's expense. "The term 'benefit' denotes any form of advantage." *Ghirardo v Antonioli* (1996) 14 C4th 39, 51, 57 CR2d 687; *McBride,* 123 CA4th at 389; *First Nationwide Sav. v Perry* (1992) 11 CA4th 1657, 1662, 15 CR2d 173. A benefit may be conferred not only when a person adds to the property of another, but also when a person saves another from loss or expense. *Ghirardo,* 14 C4th at 51; *Dunkin v Boskey* (2000) 82 CA4th 171, 98 CR2d 44. Moreover, it is not necessary that money be paid directly to the recipient by the party seeking restitution. *County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 1278, 90 CR2d 41.

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§11.69 D. Benefit or Enrichment Must Be Unjust

The mere fact that one person benefits another is not sufficient, by itself, to require the other person to make restitution. It is well established that even if the other person has received a benefit from the first, the other person is not required to make restitution unless the circumstances are such that, as between them, it would be unjust for the other retain the benefit. *Ghirardo v Antonioli* (1996) 14 C4th 39, 51, 57 CR2d 687; *McBride v Boughton* (2004) 123 CA4th 379, 389, 20 CR3d 115; *California Med. Ass'n v Aetna U.S. Healthcare of Cal., Inc.* (2001) 94 CA4th 151, 172, 114 CR2d 109. See also *Doe v Wal-Mart Stores, Inc.* (9th Cir 2009) 572 F3d 677, 684. Following are some of the circumstances identified in case law when restitution is not available:

- A person who voluntarily pays the debts of another person without an express agreement generally has no right to recover the money paid, either from the debtor or the creditor. *Marriage of Smith & Maescher* (1993) 21 CA4th 100, 26 CR2d 133; *Thompson v Thompson* (1963) 218 CA2d 804, 32 CR 808.
- A person who officiously confers a benefit on another is not entitled to restitution. *Stein v Simpson* (1951) 37 C2d 79, 86, 230 P2d 816.
- A person whose wrongful conduct confers a benefit on another does not thereby "unjustly" enrich the other person and cannot seek restitution from the other. 37 C2d at 86.
- Restitution will be denied if application of the doctrine would involve a violation or frustration of the law or opposition to public policy. *McBride,* 123 CA4th at 389 (boyfriend supported child later proved not to be his biological offspring; restitution based on unjust enrichment denied to protect enforcement of parental obligations to support their children and children's interest in stability of their family relationships).
- A person whose mistake confers a benefit on another has no right to restitution from the other if the other person does not know about the mistake, has no reason to suspect it, and also relies on it to his or her detriment. *Ghirardo v Antonioli* (1996) 14 C4th 39, 51, 57 CR2d 687. In this circumstance, policy considerations dictate that the person making the mistake should bear the risk of error. *First Nationwide Sav. v Perry* (1992) 11 CA4th 1657, 1663, 15 CR2d 173.
- A bona fide purchaser for value without notice is generally not required to make restitution. 11 CA4th at 1663. Similarly, a person in the position of an innocent transferee or beneficiary who is protected by statute or common law may not be required to make restitution, particularly if he or she has changed position after the transaction and it is impossible or impractical to restore his or her original position. *McBride,* 123 CA4th at 389; *First Nationwide Savs.,* 11 CA4th at 1663. In contrast, a transferee with knowledge of the circumstances giving rise to the unjust enrichment claim may be obligated to make restitution. 11 CA4th at 1663.
- A person who has benefited from driving a hard bargain with another may not be required to make restitution to the other because of the desirability, as a matter of legal policy, of allowing a party to retain the benefit of his or her bargain. *First Nationwide Savs.,* 11 CA4th at 1663.

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§11.70 E. Restitution as Remedy for Unjust Enrichment

Restitution—a right to restoration or reimbursement—is a remedy that may be available in several different situations. It may be awarded in lieu of the traditional measure of contract damages to parties who had an express contract that was obtained by fraud, mistake, or unconscionability, or is otherwise ineffective or unenforceable. *McBride v Boughton* (2004) 123 CA4th 379, 388, 20 CR3d 115. It is also may be provided to redress statutory violations. For example, the California Unfair Competition Law (Bus & Prof C §§17200-17209) specifically provides for restitution of money or property acquired by unfair competition. See Bus & Prof C §17203; *Bradstreet v Wong* (2008) 161 CA4th 1440, 75 CR3d 253 (order to pay unpaid wages, a restitutionary remedy authorized by Unfair Competition Law, is improper against officers of corporation who did not personally obtain benefit of employees' services and did not misappropriate corporate funds that would have been used to pay unpaid wages); *Madrid v Perot Sys. Corp.* (2005) 130 CA4th 440, 453, 30 CR3d 210. But see *Troyk v Farmers Group, Inc.* (2009) 171 CA4th 1305, 1338, 90 CR3d 589 (if defendant insurance exchange and subsidiaries of attorney-in-fact were acting as single enterprise, defendant could be liable under Bus & P C §17203 for restitution of service charges paid in violation of Ins C §381, even though defendant did not directly receive service charges).

Finally, restitution may be awarded based on quasi-contract to avoid unjust enrichment of someone who has obtained a benefit from another through fraud, duress, conversion, or similar conduct. A right of restitution runs against the person who has been unjustly enriched and in favor of the person who has suffered loss thereby. *Blue Ridge Ins. Co. v Jacobsen* (2001) 25 C4th 489, 501, 106 CR2d 535; *Buss v Superior Court* (1997) 16 C4th 35, 50, 65 CR2d 366; *McBride v Boughton* (2004) 123 CA4th 379, 388, 20 CR3d 115. As stated by the court in *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 1136, 4 CR3d 583 (citations omitted):

> It is a general principle, underlying various legal doctrines and remedies, that one person should not be permitted unjustly to enrich himself at the expense of another, but should be required to make restitution of or for property or benefits received, retained, or appropriated, where it is just and equitable that such restitution be made, and where such action involves no violation or frustration of law or opposition to public policy, either directly or indirectly.

See also *Goehring v Chapman Univ.* (2004) 121 CA4th 353, 384, 17 CR3d 39 (citations omitted).

At common law, a plaintiff seeking restitution on account of a loss, *e.g.,* from another's fraud, was deemed to have "waived the tort and sued in assumpsit," *i.e.,* to be seeking restitution based on a theory of quasi-contract rather than tort damages. See *Murrish v Industrial Indem. Co.* (1986) 178 CA3d 1206, 1209, 224 CR 308 (election to waive tort and sue in assumpsit is a fiction that broadens remedies available to plaintiff, but does not create a contract where none existed). In these cases, restitution will be ordered when appropriate, based on a contract implied by law (quasi-contract) without regard to the parties' intent, to avoid unjust enrichment. *McBride,* 123 CA4th at 388. See, *e.g., Cassinos v Union Oil Co.* (1993) 14 CA4th 1770, 1787, 18 CR2d 574 (waiver of tort of trespass and suit on contract implied in law, which obligated wrongful occupant of real property to pay owner reasonable value of use thereof during period of occupancy).

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F. Common Counts

§11.71 1. Generally

The common counts have their roots in the common law writ of assumpsit, which existed before the introduction of code pleading in California. See generally *Interstate Group Adm'rs, Inc. v Cravens, Dargan & Co.* (1985) 174 CA3d 700, 707 n2, 220 CR 250; 4 Witkin, California Procedure, *Pleading* §553 (5th ed 2008). The writ of assumpsit (which in Latin refers to an undertaking or an obligation) usually involved a duty to pay money. See *Walton v Walton* (1995) 31 CA4th 277, 290, 36 CR2d 901. A common count is technically not a specific cause of action, but rather a simplified form of pleading used to allege the existence of one or more forms of indebtedness, including one arising from a duty to make restitution. *McBride v Boughton* (2004) 123 CA4th 379, 395, 20 CR3d 115. The common counts are abbreviated statements of commonly occurring reasons for a defendant to be indebted to the plaintiff. Corbin, Corbin on Contracts §1.18 (rev ed 1993). They include quantum meruit, quantum valebant, money had and received, money lent, money paid, goods sold and delivered, and open account. Quantum meruit is discussed in §11.72; money had and received is discussed in §11.73. Further discussion of the common counts is beyond the scope of this title. See generally 4 Witkin, California Procedure, *Pleading* §§553-570 (5th ed 2008); Corbin, Corbin on Contracts §1.18 (rev ed 1993).

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§11.72 2. Quantum Meruit

Quantum meruit is a common count or common law cause of action that may be available to a plaintiff who rendered services to another with some expectation or understanding that he or she would be compensated for doing so. It is based on the quasi-contractual principle that the law will imply a promise to pay for services performed under circumstances indicating that the services were not performed gratuitously. *Huskinson & Brown v Wolf* (2004) 32 C4th 453, 458, 9 CR3d 693. It refers to an obligation created by law without regard to the parties' intentions. It is appropriate in situations where a party should be held accountable to another on the ground that otherwise one party would be unjustly enriched and the other would unjustly suffer a loss. *California Emergency Physicians Med. Group v PacifiCare of Cal.* (2003) 111 CA4th 1127, 4 CR3d 583; *Hedging Concepts, Inc. v First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1419, 49 CR2d 191. A party need not prove the existence of a contract to recover in quantum meruit. *Huskinson & Brown,* 32 C4th at 458. Quantum meruit will often lie when services have been rendered under a contract that is unenforceable, either because it is not in writing or for other reasons. See *Iverson, Yoakum, Papiano & Hatch v Berwald* (1999) 76 CA4th 990, 996, 90 CR2d 665.

To recover on a quantum meruit claim for the reasonable value of services rendered to the defendant, the plaintiff must establish that (1) in performing the services, the plaintiff was acting in accordance with an express or implied request from the defendant, and (2) the services rendered were intended to, and in fact did, benefit the defendant. *Ochs v PacifiCare of Cal.* (2004) 115 CA4th 782, 794, 9 CR3d 734; *Day v Alta Bates Med. Ctr.* (2002) 98 CA4th 243, 248, 119 CR2d 606. Under the first leg of the test, there must have been either an express or implicit request for the services. The recipient of the services performed must have either requested them or acquiesced in them. If the services were rendered by the plaintiff to a third party, there must have been a specific request for the services by the defendant. 98 CA4th at 249. The second leg of the test, that the services must have benefited the defendant, is also integral to recovery. "The theory of quasi-contractual recovery is that one party has accepted and retained a benefit with full appreciation of the facts, under circumstances making it inequitable for him to retain the benefit without payment of its reasonable value." 98 CA4th at 249 (citations omitted); *Maglica v Maglica* (1998) 66 CA4th 442, 78 CR2d 101.

The measure of recovery in quantum meruit is "the reasonable value of the services rendered *provided* they were of direct benefit to the defendant." *Day,* 98 CA4th at 249, citing *Palmer v Gregg* (1967) 65 C2d 657, 661, 56 CR 97 (emphasis in original). As the court in *Maglica* emphasized: "The legal test for recovery in quantum meruit is not the value of the benefit, but value of the services (assuming, of course, that the services were beneficial to the recipient in the first place)." *Maglica,* 66 CA4th at 446. For purposes of quantum meruit recovery, the court may consider the price that the parties agreed on in determining the reasonable value of the services rendered. *Watson v Wood Dimension, Inc.* (1989) 209 CA3d 1359, 1365, 257 CR 816. However, the contract price and the reasonable value of the services rendered are two different things; at times, the reasonable value of the services exceeds the contract price. *Maglica*, 66 CA4th at 450.

NOTE: Recovery in quantum meruit is not appropriate if it would frustrate the law or public policy. *Ochs,* 115 CA4th at 794; *Dinosaur Dev., Inc. v White* (1989) 216 CA3d 1310, 1315, 265 CR 525. For example, in *Castillo v Barrera* (2007) 146 CA4th 1317, 53 CR3d 494, the court refused to allow recovery in quantum meruit on an unenforceable oral contract because to do so would subvert the purpose of the laws and regulations governing boxing.

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§11.73 3. Money Had and Received

Money had and received ("by the defendant for the use of the plaintiff") is a common count or common law cause of action that may be available to a plaintiff who has paid money to the defendant under a contract that is void or unenforceable or if money was obtained by the defendant from the plaintiff through fraud, undue influence, or mistake of fact. *Supervalu, Inc. v Wexford Underwriting Managers, Inc.* (2009) 175 CA4th 64, 78, 96 CR3d 316; *Schultz v Harney* (1994) 27 CA4th 1611, 1623, 33 CR2d 276; *City Bank of San Diego v Ramage* (1968) 266 CA2d 570, 585, 72 CR 273. The essential elements of a cause of action for money or goods had and received are (1) a statement of indebtedness of the defendant in a certain sum, (2) the consideration made by the plaintiff, and (3) nonpayment of the debt. *First Interstate Bank v State* (1987) 197 CA3d 627, 635, 243 CR 8.

Like an action for quantum meruit, no contract is necessary to support an action for money had and received other than the contract implied at law when a party receives money from another but has no right to retain it. See *Supervalu Inc. v Wexford,* 175 CA4th at 79. In these circumstances, the law implies a promise to return the money. The action is based on the principle that "the defendant has money which, in equity and good conscience, he ought to pay to the plaintiffs." *Stratton v Hanning* (1956) 139 CA2d 723, 727, 294 P2d 66. If there is an express contract, however, and the contract is affirmed by the plaintiff, an action for money had and received is not available. *City Bank of San Diego v Ramage* (1968) 266 CA2d 570, 587, 72 CR 273. See also *Jalali v Root* (2003) 109 CA4th 1768, 1 CR3d 689 (no contract implied in law until express contract is avoided). Moreover, if the plaintiff has received benefits in return for the money given to the defendant, but cannot return them, an action for money had an received will not lie. *Jalali v Root, supra*. But see *Supervalu Inc. v Wexford, supra* (parties' contractual relationship did not preclude restitution; defendant insurer was entitled to restitution of amounts mistakenly paid to plaintiff under policy).

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12

Remedies: Commercial Code

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I. PRELITIGATION REMEDIES FOR BREACH OF CONTRACTS FOR THE SALE OF GOODS

A. General Considerations

§12.1 1. Remedies Cumulative

In general, Commercial Code remedies are cumulative and combinations of prelitigation remedies are usually available. See Official Comment 1 to UCC §2-703; Com C §§2711, 2721. Remedies for breach of any obligation or promise, either collateral or ancillary to a contract for sale, are not impaired by the remedies provided by the Commercial Code. Com C §2701. One notable exception occurs in the area of reclamation. When the seller successfully reclaims the goods from an insolvent buyer, the Commercial Code expressly provides that successful exercise of the remedy of reclamation is the exclusive remedy of the seller. Com C §2702(3). See §§12.11-12.14.

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.2 2. Supplementary Principles of Law Applicable (Com C §1103(b))

§12.2 2. Supplementary Principles of Law Applicable (Com C §1103(b))

Unless expressly displaced or preempted by the Commercial Code, other sources of law supplement the Commercial Code in regard to the transactions to which it applies. Com C §1103(b). In addition, remedies for material misrepresentation or fraud include all remedies available under Division 2 of the Commercial Code for nonfraudulent breach. Com C §2721.

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§12.3 B. Seller's Remedies

The remedies provided to sellers by Division 2 of the Commercial Code for breach of a buyer's obligations under a contract for the sale of goods are set out in Com C §§2702-2710. See §§12.4-12.24.

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§12.4 1. Refusing Delivery Except for Cash on Buyer's Insolvency (Com C §2702(1))

If the seller discovers that the buyer is insolvent, the seller may refuse delivery unless payment is received in cash on delivery. See Com C §2702(1). A buyer is considered "insolvent" if the buyer has ceased to pay its debts in the ordinary course of business, cannot pay debts as they become due, or is insolvent within the meaning of the federal bankruptcy law. Com C §1201(23). See 11 USC §101(32)(A). If the entity is a partnership, the Bankruptcy Code's definition also takes into account the positive net worth of the individual general partners. See 11 USC §101(32)(B).

As a practical matter, the difficulty of assessing the buyer's solvency limits the usefulness of this remedy. The Commercial Code defines "discover" as "knowledge" as opposed to "reason to know." Com C §1202(c) (former Com C §1201(25)). The seller must therefore have actual knowledge of the buyer's insolvency as defined. Otherwise, the seller risks breaching the agreement if it refuses to deliver unless it is paid in cash. The best approach for a seller who reasonably suspects that the buyer is insolvent is to demand assurances of performance. See §8.58; Com C §2609(1). If the buyer does not provide adequate assurance within 30 days after the seller's demand, the seller may treat the contract as having been repudiated (Com C §2609(4)) and avail itself of the remedies described in Com C §2610.

The seller's refusal to deliver the goods unless cash payment is received should prompt the buyer to either tender payment or disclose that payment cannot be made to the seller. If the buyer is unable to pay for and claim the goods, other remedies such as suing the buyer for the contract price may be worthless to the seller because the buyer is insolvent.

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2. Withholding Delivery (Com C §2703)

§12.5 a. Grounds

An aggrieved seller still in possession or control of goods sold or contracted to be sold may withhold their delivery. This remedy is authorized when:

- The buyer wrongfully rejects or revokes acceptance of the goods. A buyer rarely rejects or revokes acceptance of the goods before delivery, but if this occurs, the seller may withhold delivery. Com C §2703.
- The buyer fails to make a payment when due on or before delivery. Such a failure of payment may include dishonor of a check on due presentment, nonacceptance of a draft, or failure to furnish an agreed letter of credit. Official Comment 3 to UCC §2-703.
- The agreed means or manner of payment fails because of domestic or foreign government regulation. The seller must accept payment, however, if the buyer provides a means or manner of payment that is "commercially a substantial equivalent." Com C §2614(2).
- The buyer repudiates the contract in whole or in part. If the buyer repudiates the whole contract, the seller may withhold delivery of all goods in its possession or control. Repudiation of only one installment of a contract may or may not justify the seller's treating the breach as a breach of the whole contract. The test is whether the value of the whole contract is "substantially impaired" by the one installment. See Com C §2612. If the repudiation does not qualify as a breach of the whole contract, the seller may withhold delivery of the installment that was repudiated but must deliver future installments. Official Comment 6 to UCC §2-612.
- There are reasonable grounds for insecurity with respect to the buyer's performance. If the seller justifiably demands assurance of performance, the seller may, if commercially reasonable, suspend performance until the assurance has been received. Com C §2609(1). In most cases, suspension of performance would include withholding delivery. See Official Comment 2 to UCC §2-609.
- The buyer fails to cooperate seasonably to enable the seller to perform. An action is taken "seasonably" when it is taken at or within the time agreed, or if no time is agreed, at or within a reasonable time. Com C §1205(b) (former Com C §1204(3)). The buyer's failure to cooperate seasonably so as to enable the seller to perform will excuse the resulting delay in the seller's performance and permit the seller to withhold delivery of the goods. Com C §2311(3)(a).

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§12.6 b. Effect

The right to withhold delivery may be exercised without being considered a breach of the seller's obligation to tender delivery of the goods. The seller must be certain that the buyer has committed a breach (see Com C §2703) before delivery is withheld. If the seller wrongfully withholds (*e.g.,* the seller mistakenly believes that the buyer repudiated the contract), the seller's action will be a breach and the buyer will be entitled to damages.

Although withholding delivery gives the seller substantial leverage, this step is usually taken while the seller prepares to exercise some further remedy because the withholding does not fulfill the seller's contract obligations. Unless the buyer cures the default, the seller has a choice of additional remedies, which include stopping delivery by any bailee, canceling the contract, reselling the goods in its possession and recovering damages, and recovering the contract price of the goods. Com C §2703.

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3. Stopping Delivery (Com C §2705)

§12.7 a. Grounds and Effect

The seller may stop delivery of any shipment of goods destined for the buyer, regardless of its size or whether it is in the possession of the shipping carrier or certain other bailees, if the seller discovers that the buyer is insolvent, or the agreed means or manner of payment fails because of domestic or foreign government regulation. Com C §2705(1). See also Com C §§2614(2), 2702(1). This remedy is different from the remedy of withholding delivery (see §§12.5-12.6) because the goods are no longer in the seller's possession. Regardless of the buyer's status as solvent or insolvent, the seller may also stop delivery of carload, truckload, planeload, or larger shipments if the buyer fails to make a payment due before delivery or if for another reason the seller has a right to withhold or reclaim the goods. Com C §2705(1); Official Comment 1 to UCC §2-705.

The right to stop delivery on discovery of the buyer's insolvency extends the seller's control over the goods to situations in which the seller has already released and shipped the goods. The seller's position after stopping delivery in transit is the same as it would have been had the seller held the goods and refused to deliver them, or delivered the goods only on receipt of cash from the buyer. See Official Comments 1, 6 to UCC §2-705.

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§12.8 b. Limits on Right to Stop Delivery (Com C §2705(2))

The seller's right to stop delivery ends when any one of the following occurs:

- The buyer or a purchaser from the buyer receives the goods. Com C §2705(2)(a); Official Comment 2 to UCC §2-705. The Commercial Code defines "receipt" of goods as "taking physical possession of them." Com C §2103(1)(c). Consequently, the right to stop goods in transit may continue after delivery to the carrier and until the buyer is in physical or constructive possession of the goods.
- A bailee of the goods (except a carrier) acknowledges to the buyer that it holds the goods for the buyer. Com C §2705(2)(b)-(c). The Commercial Code defines "bailee" as "the person who by a warehouse receipt, bill of lading or other document of title acknowledges possession of goods and contracts to deliver them." Com C §7102(a)(1).
- A carrier acting as a warehouseman acknowledges to the buyer that it holds the goods for the buyer. Once a carrier stores the goods in its warehouse, the acknowledgment that the goods are being held for the buyer signifies that the carrier is now acting "as warehouseman" and that delivery to the buyer has occurred. A separate contract by the carrier is required to establish the carrier "as a warehouseman [warehouse]." Official Comment 3 to former UCC §2-705 (Official Comment 3 to UCC §2-705 (2003)).
- A carrier reships the goods at the buyer's instructions. "Reshipment" for this purpose occurs when a carrier ships goods to another destination or purchaser at the *buyer's* instruction. Com C §2705(2)(c).
- A negotiable document of title covering the goods is negotiated to the buyer. A document of title is equivalent to receipt of the goods. Com C §2705(2)(d).

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§12.9 c. Procedure for Stopping Delivery (Com C §2705(3))

The seller must notify the carrier or other bailee regarding the stoppage so that the carrier or bailee, with reasonable diligence, can stop or prevent delivery of the goods. Com C §2705(3)(a). The carrier or bailee must comply with the notification when it is properly given by the seller. Com C §2705(3)(b). The carrier must hold the goods at the direction of the seller if the carrier receives a stop notification that it must obey or elects to obey. The seller is liable to the carrier for any losses, charges, or damages that the carrier incurs in following the seller's directions, whether or not the carrier was obligated to follow them. Com C §§2705(3)(b), 7504(d); Official Comment 4 to UCC §7-504; Official Comment 5 to UCC §2-705.

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§12.10 d. Buyer's Forfeiture of Its Deposit (Com C §2718)

The Commercial Code permits the limited forfeiture of a buyer's deposit or prepayment. After a seller has justifiably withheld delivery because of a buyer's breach, the buyer may be compelled to forfeit 20 percent of the total value of its performance under the contract or $500, whichever is smaller. Com C §2718(2)(b). The buyer's right to restitution, however, is subject to setoff if the seller has a right to damages. The 20-percent forfeiture may be modified by a provision in the sales contract for liquidated damages, provided that it conforms to the restrictions of Com C §2718(1), which requires compliance with CC §1671. See §§10.39-10.45. The forfeiture provisions of Com C §2718 apply whether the prepayment is to be applied on the price or is merely intended as security for performance. See Com C §2718(4); Official Comment 2 to former UCC §2-718.

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4. Reclamation of Goods

§12.11 a. Grounds and Effect (Com C §2702(2))

If it is too late for the seller to withhold delivery or stop the goods in transit because the buyer has already received them, the seller may be able to reclaim the goods if the following conditions are met (Com C §2702(2)):

- The goods must have been received while the buyer was insolvent. An "insolvent" buyer is one that has ceased to pay its debts in the ordinary course of business (other than as a result of a bona fide dispute), cannot pay its debts as they become due, or is insolvent within the meaning of the federal bankruptcy law. Com C §1201(b)(23).
- The seller must make demand for the goods within 10 days after the buyer receives them. This requirement applies only to credit sellers. A cash seller that accepts a check in payment that is later dishonored has a reasonable time to reclaim on discovering that the check has been dishonored. See *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729.
- Until the buyer files a bankruptcy case, a reclamation demand may be written or oral. The demand should specifically refer to the seller's right of reclamation. See *Montello Oil Corp. Cities Serv. Co. v Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)* (3d Cir 1984) 740 F2d 220 (seller's complaint seeking attachment, injunction, and other relief did not constitute demand because it did not mention reclamation).
- Once the buyer has filed for relief under the Bankruptcy Code, a seller seeking reclamation under Com C §2702 must comply with the requirements of 11 USC §546(c). The demand must be in writing, and must be made within 45 days after the buyer receives the goods, or, if the 45-day period ends after the bankruptcy case was filed, 20 days after the filing date. See 11 USC §546(c)(1). Reclamation demands are not subject to the automatic stay. 11 USC §362(b)(3).

In effect, reclamation extends the seller's power over the goods to situations in which the goods have already been delivered. Although bankruptcy debtors rarely return goods subject to a demand for reclamation, the seller's demand should be sufficient to change the seller's claim against the debtor from a general unsecured claim to a priority administrative claim for the value of the goods, if the goods were received by the debtor within 20 days before the date of the bankruptcy filing. See 11 USC §§503(b)(9), 546(c)(2).

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§12.12 b. Ten-Day Limitation and Exception (Com C §2702(2))

Normally, the seller must demand the goods within 10 days after the buyer has received them. Com C §2702(2). "Receipt" means taking actual physical possession, not delivery to a carrier or mere passage of title. Com C §2103(1)(c). A seller's reclamation right extends to the goods in the debtor's possession at the time notice of the demand was received. *In re Flagstaff Foodservice Corp.* (Bankr SD NY 1986) 56 BR 910. If the buyer has misrepresented its solvency in writing to the seller within 3 months before delivery of the goods, the 10-day limitation does not apply. Com C §2702(2). Tendering a check that is subsequently dishonored may constitute a written misrepresentation of solvency for purposes of Com C §2702(2). See *Amoco Pipeline Co. v Admiral Crude Oil Corp.* (10th Cir 1974) 490 F2d 114.

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§12.13 c. Other Limitations

A seller that successfully reclaims its goods may *not* invoke any other remedies, including contract damages. Com C §2702(3). See Official Comment 3 to UCC §2-702. Because of the harshness of this rule, courts have construed the limitation narrowly to permit other remedies, including non-Code remedies in certain cases, such as claim and delivery actions under CCP §§511.010-516.050. Before exercising a right of reclamation, a seller should be advised that doing so may constitute an election and waiver of other remedies.

The right to reclaim is also narrowed somewhat by the following limitations:

- Only "sellers" may reclaim. A person who is not a seller, even if that person is "a person in the position of a seller" (see Com C §2707(1)), does not qualify for the right to reclaim goods under Com C §2702.
- The seller cannot ordinarily reclaim the proceeds of goods. *U.S. Billiards Co. v Greenberger (In re Bensar Co.)* (Bankr SD Ohio 1984) 36 BR 699. If the seller retained a security interest in the goods under Division 9, however, the seller might be entitled to the proceeds on a priority basis. See Com C §9315(a)(2).
- Goods processed into other products most likely cannot be reclaimed, because they are no longer identifiable. *Party Packing Corp. v Rosenberg (In re Landy Beef Co.)* (Bankr D Mass 1983) 30 BR 19. But see *Eighty-Eight Oil Co. v Charter Crude Oil Co. (In re Charter Co.)* (Bankr MD Fla 1985) 54 BR 91 (crude oil commingled in pipeline with other parties' oil subject to reclamation).

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§12.14 d. Rights of Third Parties

An unpaid seller's right of reclamation may be limited by the rights of certain third parties, including a buyer in the ordinary course of business (Com C §2702(3); *English v Ford* (1971) 17 CA3d 1038, 95 CR 501) and a secured creditor with a perfected security interest in the buyer's inventory and after-acquired property (Com C §2702). Unlike a good faith purchaser or secured party, however, a judgment creditor does not have rights sufficient to defeat a reclaiming seller. *Citizens Bank v Taggart* (1983) 143 CA3d 318, 191 CR 729. Moreover, the rights of a trustee in bankruptcy or debtor in possession should be inferior to the rights of a reclaiming seller if the seller complies with 11 USC §546(c).

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5. Identifying Goods to the Contract (Com C §2704)

§12.15 a. Grounds and Effect

Identifying existing goods as goods to which the sales contract refers affects the rights and remedies of both the seller and the buyer. See Com C §2501. Identifying the goods after the buyer's default enables the seller to resell them and hold the buyer liable for damages determined by the resale. See Official Comment 1 to UCC §2-704. If the seller cannot resell the goods, or if the circumstances reasonably indicate that any effort to resell would be unavailing, the seller can hold the buyer liable for the contract price. Com C §2709(1)(b).

The seller can identify goods to the contract in response to the buyer's wrongful rejection or revocation or acceptance, failure to make a payment due on or before delivery, or repudiation of all or part of the contract. Com C §§2703-2704. In an installment contract, the power to identify may extend to all or only part of the goods, depending on whether the breach is of the whole contract. Com C §§2612, 2703.

Identification is usually pursued as a seller's remedy (Com C §2704), but it is also a necessary prerequisite to a buyer's recovery of goods from an insolvent seller (Com C §2502) and to a buyer's exercise of the right of replevin (Com C §2716). See §§12.31, 12.88; *Diesel Performance, Inc. v G. Paoletti Co. (In re G. Paoletti, Inc.)* (Bankr ND Cal 1997) 205 BR 251.

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§12.16 b. What Constitutes Identification? (Com C §2501(1))

Unless the contract explicitly provides for a distinct means of identification, identification occurs when the contract is made if the goods are already in existence then (Com C §2501(1)(a)), or else, if the goods are not yet in existence when the contract is made, when the goods are shipped, marked, or otherwise designated by the seller as goods to which the contract refers (Com C §2501(1)(b)). Special rules apply if the goods are unborn animals or future crops. See Com C §2501(1)(c).

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§12.17 c. Unfinished Goods

A seller who must react to a buyer's breach or repudiation when the goods are not yet finished faces a dilemma. Finishing the goods increases the seller's investment in them. Completion also enhances the value of the goods and may be the only opportunity for making them salable for anything other than scrap. The Commercial Code gives the seller a variety of choices, placing the risk of a reasonable error on the buyer in breach:

- The seller can simply resell those unfinished goods that "have demonstrably been intended for the particular contract." Com C §2704(1)(b). If the seller does sell the goods in an unfinished state, the costs of manufacture that the seller saves are deducted from its damages. Com C §2706(1).
- The seller may instead choose to finish the goods, if it does so "in the exercise of reasonable commercial judgment for the purposes of avoiding loss and of effective realization." Com C §2704(2). Even if the seller is wrong and finishing the goods results in greater damages, the buyer can avoid liability for the increased costs only if it shows that the seller's judgment was unreasonable. Official Comment 2 to UCC §2-704. The reasonableness of the seller's judgment is tested in light of facts apparent to the seller at the time it learned of the buyer's breach. Official Comment 2 to UCC §2-704.
- The seller may cease manufacture and resell the unfinished goods for scrap or "proceed in any other reasonable manner." Com C §2704(2).
- A seller that cannot resell the unfinished goods at a reasonable price may sue for the price. See Com C §2709(1)(b).

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.18 d. Seller's Security Interest (Com C §2505(1))

§12.18 d. Seller's Security Interest (Com C §2505(1))

If identified goods are shipped under a negotiable bill of lading, the seller reserves a security interest in the goods. The buyer must receive and surrender the bill before it can obtain possession. Thus, the buyer must pay the seller first. Com C §2505(1)(a). The seller's security interest is restricted to securing payment or performance by the buyer. Official Comment 1 to UCC §2-505.

If identified goods are shipped under a nonnegotiable bill of lading naming the seller as consignee, the seller reserves possession of the goods as security and they will not be delivered until the seller so directs. Com C §2505(1)(b). If the buyer is named as consignee, however, the seller has no security interest even though it retains the bill of lading. Com C §2505(1)(b).

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6. Reselling Goods (Com C §2706)

§12.19 a. Grounds, Purpose, Good Faith Standard

The seller may resell the goods when the buyer (1) repudiates the agreement in whole or in part, (2) fails to make a payment due on or before delivery, (3) wrongfully rejects the goods, or (4) wrongfully revokes its prior acceptance. Com C §§2703, 2706. In an installment contract, the right to resell applies only to those goods directly affected by the buyer's breach. The right to resell applies to all the goods covered by the contract only if the breach is of the whole contract. Com C §2612.

A seller that follows the detailed rules of Com C §2706 in reselling the goods will fix its damages, removing from future litigation the issue of market price, which is the basis for measuring damages in the absence of an authorized resale. Com C §2708. See, *e.g., KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286. But see *Allied Canners & Packers, Inc. v Victor Packing Co.* (1984) 162 CA3d 905, 209 CR 60 (if market price less cover price would over-compensate the plaintiff, limit damages to actual loss). Resale is particularly useful if a market price for the goods is difficult to establish because of fluctuations or lack of any demand for the goods.

Although Com C §2706 places some specific restrictions on the manner of resale, "good faith" and "commercial reasonableness" are the standards by which a resale is evaluated. See Com C §2706(1). Failure to observe those standards can mean the difference between substantial recovery and no recovery. Good faith is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Com C §1201(20) (former Com C §1201(19)). To the aggrieved seller, therefore, a good faith resale is one that accords with reasonable commercial standards of fair dealing and is objectively honest. See *Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 249 CR 872 (§2706 resales must merely be conducted in commercially reasonable manner and in good faith; resales to seller's affiliates are not per se unreasonable). Good faith and commercial reasonableness are questions of fact that pertain to the difference between the resale price of the goods and the contract price, as well as "every aspect of the sale including the method, manner, time, place and terms." Com C §2706(2); *Coast Trading Co. v Cudahy Co.* (9th Cir 1979) 592 F2d 1074.

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§12.20 b. Public or Private Resale?

In many instances, sellers may choose between a private and a public sale. The detailed rules for both types of sales are set forth in Com C §2706. The sale must be public if the buyer wishes to buy the goods. Com C §2706(4)(d). The sale also must be public if the goods were purchased primarily for personal, family, or household purposes under a "retail installment sales contract" (see CC §1802.1-1802.6) and the seller has repossessed them. CC §§1812.2-1812.5. The sales agreement may indicate both the type of sale that the seller should use and the manner in which it should be conducted. In addition, Official Comment 4 to former UCC §2-706 (Official Comment 5 to UCC §2-706 (2003)) directs that "[i]n choosing between a public and private sale, the character of the goods must be considered and relevant trade practices and usage must be observed." Failure to comply with Com C §2706 prevents recovery of resale or "cover" damages.

In general, the requirement that the resale must be conducted in good faith and in a commercially reasonable manner (see §12.19) may obligate the seller to choose the type of resale that is most likely to bring the highest price. If the seller acts in a manner that prevents a resale at a fair price (*e.g.,* advertises an incorrect date, location, or price, or fails to set a fair minimum price), the sale may not be commercially reasonable. Public or private sales to affiliates are not prohibited by the Commercial Code if they are otherwise conducted in good faith and in a commercially reasonable manner. *Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 249 CR 872.

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§12.21 c. Private Sale Procedures (Com C §2706(3))

The buyer is given a measure of protection against possible abuse by the seller of the private sale procedure under Com C §2706(3). That section requires the seller to give the buyer reasonable notification of its intention to resell. The amount of advance notice, however, depends on the urgency of the matter. Notice of the time and place of a sale that must be conducted immediately is not required when the goods are perishable or threaten to decline speedily in value. Official Comment 8 to UCC §2-706. In addition to the requirement that the notice indicate that the seller intends to sell the goods, the only other formal requirement is that the resale be "reasonably identified as referring to the broken contract." Com C §2706(2).

The timing of a private sale depends on the nature of the goods and market and the acts of the buyer. A falling market (possibly the true reason for a buyer's repudiation) or the perishability of the goods dictates the need for a prompt resale. A buyer that repudiated because of claimed deficiencies in the goods may demand a postrejection inspection that will prevent the seller from proceeding with the sale immediately. Official Comment 5 to UCC §2-706.

Almost any sale arrangement is permitted under Com C §2706(1). A sale may be conducted by direct negotiations with prospective purchasers or through brokers. If a broker is employed, the charges incurred constitute incidental damages that the seller can collect under Com C §§2706(1) and 2710. The goods may be sold in lots at any place on any terms, and the seller may make almost any other arrangements, provided the seller acts in a commercially reasonable manner and gives proper notice. Com C §2706. A sale may be on credit rather than cash terms.

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§12.22 d. Public Sale Procedures (Com C §2706(4))

The simplicity and cost-effectiveness of a private sale are compelling, but one of the main reasons public sales are performed is to maximize the seller's opportunity to establish a commercially reasonable sale, particularly with regard to price. The rules governing public sales are as follows:

- With a limited exception, only identified goods may be sold. Com C §2706(4)(a). The seller also has a right either to cease or to complete manufacture of the goods under certain circumstances. See Com C §2704(2).
- The sale must be conducted "at a usual place or market for public sale if one is reasonably available." Com C §2706(4)(b); Official Comment 9 to former UCC §2-706 (Official Comment 8 to UCC §2-706 (2003)). This requirement is easy to comply with if established auction markets exist. Some markets conduct public sales at regularly scheduled intervals. In other markets or with unusual goods, the seller may be required to seek out a type of public sale likely to attract buyers interested in the goods. See Official Comment 9 to UCC §2-706 (Official Comment 8 to UCC §2-706 (2003)). The goods may be so unusual that a public sale may be commercially unreasonable. See Official Comment 4 to former UCC §2-706 (Official Comment 5 to former UCC §2-706). The more unusual the goods, the more widely the seller should advertise their sale. Sometimes trade journals are the only commercially reasonable advertising medium.
- The seller must give the buyer reasonable notice of the time and place of resale (unless the goods are perishable or threaten to decline speedily in value). Com C §2706(4)(b); Official Comment 8 to UCC §2-706. The seller should advise the buyer immediately, even informally, of a public resale to demonstrate fairness and to preclude a challenge over the reasonableness of the notice. Formal notice may be given after the informal notice.
- The goods must be within the view of those attending the sale, or the notification of sale must state the location of the goods and provide for reasonable inspection. Com C §2706(4)(c); Official Comment 9 to former UCC §2-706 (Official Comment 8 to UCC §2-706 (2003)).
- The seller may buy the goods. Com C §2706(4)(d). In the context of an auction sale, the seller must indicate to other bidders that it may participate in the bidding or the buyer may exercise the option to avoid the sale or take the goods at the price of the last good faith bid. Com C §2328(4). It is not clear whether this requirement applies to nonauction sales under Com C §2706(4)(d).
- Failure of the seller to comply with the statutory requirements for a resale does not impair the rights of a good faith purchaser. Com C §2706(5).
- If the seller can resell the goods at a profit, the seller is not accountable to the buyer for that profit. Com C §2706(6); Official Comment 11 to former UCC §2-706 (Official Comment 10 to UCC §2-706 (2003)). A person in the position of a seller or a buyer with a security interest who resells the goods, however, must account for proceeds in excess of its security interest. Com C §2706(6).

If the goods were originally purchased primarily for personal, family, or household purposes under a "retail installment sales contract" (see CC §1802.6) and thereafter repossessed by the seller, special sale procedures are prescribed by statute. See CC §§1812.2-1812.5.

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7. Canceling the Contract (Com C §2703(f))

§12.23 a. Grounds and Effect

Commercial Code §2703(f) allows a seller to cancel the contract in whole or part if the buyer wrongfully rejects or revokes acceptance, fails to make a payment due on or before delivery, or repudiates a part or the whole of the contract. The seller's right to cancel may be broadened by contractual provisions. Com C §2719(1)(a). The Commercial Code generally favors the cumulation of remedies as opposed to an election of remedies. Once a party's rights have accrued, they should not be impaired lightly. Therefore, unless the cancellation of a contract expressly states that it is "without reservation of rights," the cancellation will not constitute a renunciation of the canceling party's rights. Official Comment to UCC §2-720. Unless the intention is clear, expressions of cancellation or rescission of the contract will not be construed as a renunciation or discharge of any claim in damages for an antecedent breach. Com C §2720. Breaches of installment contracts permit the seller to cancel the entire contract only when they substantially impair the value of the whole contract. See Com C §2612(3).

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§12.24 b. Limitation on Right to Cancel

Insolvency is not a specified ground for cancellation, although the buyer's insolvency may give the seller specific rights, *e.g.,* the right to refuse delivery except for cash. See Com C §2702. A buyer's insolvency would, however, give the seller reasonable grounds for demanding adequate assurance of performance. Com C §2609. If the buyer fails to give that assurance, the seller may treat the failure as a repudiation and cancel the contract. Com C §2609(4). See §12.23.

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C. Buyer's Remedies

§12.25 1. Selection of Responses (Com C §2711)

An aggrieved buyer's general prelitigation approach should be to (1) reject and return nonconforming goods to the seller, (2) reasonably dispose of any nonconforming goods in its possession, or (3) procure the type of goods contracted for, or a reasonable substitute, from another seller. See Com C §2711. The buyer should consider litigation remedies (see §§12.62-12.81) if prelitigation remedies do not make the buyer whole under the circumstances.

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§12.26 2. Buyer's Identification of Goods to the Contract (Com C §§2501-2502)

A buyer of goods obtains a special property interest that is an insurable interest in goods when those goods are identified to the contract, *i.e.,* identified as the goods to which the contract refers, even if the goods that are identified are nonconforming and the buyer has the option to return or reject them. Com C §2501(1). "Identification to the contract" can take place at any time and in any manner to which the parties expressly agree, and is a prerequisite for the buyer to obtain the rights provided in Com C §2502. See Com C §2502. If the parties do not have an explicit agreement on the subject, identification occurs when the contract is made if the goods are already in existence then (Com C §2501(1)(a)), or, if the goods are not yet in existence when the contract is made, when the goods are shipped, marked, or otherwise designated by the seller as goods to which the contract refers (Com C §2501(1)(b)). Special rules apply if the goods are unborn animals or future crops. See Com C §2501(1)(c).

There is no requirement that the goods in question be in a finished state or be fully processed by the seller in order to be identified to the contract. Official Comment 4 to UCC §2-501. With respect to fungible goods, such as grain or oil in storage, the official comments state that "[t]he mere making of the contract with reference to an undivided share in an identified fungible bulk is enough… to effect an identification if there is no explicit agreement otherwise." Official Comment 5 to UCC §2-501.

Notwithstanding the buyer's acquisition of an insurable interest in the goods at the time of identification to the contract, the seller retains an insurable interest in the goods as long as the seller retains title or a security interest in the goods. If the goods are identified to the contract by the seller alone, until the buyer defaults or becomes insolvent, and until the seller notifies the buyer that the identification is final, the seller may substitute other goods for those previously identified and the newly identified goods are then considered those that are identified to the contract. Com C §2501(2).

The insurable interest and other provisions of §2501 do not preempt or impair any other insurable interest recognized under applicable law. Com C §2501(3). Substantially similar provisions govern insurable interests in goods that are leased. Com C §§10217-10218.

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§12.27 3. Buyer Remedies for Seller Defaults (Com C §§2711-2717)

The remedies provided to buyers by Division 2 of the Commercial Code for breach of a seller's obligations under a contract for the sale of goods are set out in Com C §§2711-2717. The buyer's remedies are triggered by actions by the seller that constitute a breach or a default:

- **The seller repudiates or fails to deliver.** Typically the buyer's first decision is to cover (*i.e.,* purchase substitute goods; see §12.40) if possible. The buyer may or may not want to cancel. If the buyer owes the seller money under the contract, the buyer will probably want to deduct damages from the price. See §12.47.
- **The seller delivers conforming goods in a nonconforming manner.** If the goods are late or there is a shortage or overage, the buyer may take advantage of the so-called "perfect tender" rule. See §12.30. The buyer may reject the goods or, if there is a shortage or latent nonconformity, revoke acceptance of the goods received. See §§12.29-12.39. If the buyer rejects or revokes acceptance, the seller may cover, cancel the contract, and deduct its damages from any part of the price due. If and when the goods arrive, the buyer has an enforceable security interest in the goods. See §§12.44-12.45. The buyer may have duties that require preservation and safekeeping when the buyer is in possession of nonaccepted goods.
- **The seller delivers nonconforming goods or breaches a warranty.** If the buyer discovers a nonconformity before accepting the goods, the buyer may reject them. See §§12.29-12.35. If the nonconformity is not discovered until after the buyer accepts the goods, the buyer may be able to revoke the acceptance under limited circumstances. Com C §§2607-2608. See §§12.36-12.39. To obtain proper goods, the buyer can cover, cancel the contract, deduct its damages from amounts owed on the price, and enforce its security interest by selling the goods. If the goods are nonconforming only in part, the buyer may accept the goods that are in conformance and exercise its remedies for the balance of the goods.
- **The seller becomes insolvent.** A seller's insolvency is of greatest importance to a buyer when the buyer has partially or fully paid for goods that are still in the possession or control of the seller. In limited circumstances, the buyer can claim the goods. See §12.46. Alternatively, the buyer may cancel the contract and cover by buying the goods elsewhere. See §§12.40-12.42. The importance of cover as a method of fixing damages is diminished if there are limited assets in an insolvent seller's estate.
- **The seller commits fraud.** The seller's misrepresentation or fraud entitles the buyer to both common law and Commercial Code remedies. See Com C §2721. Consequently, the measure of damages stated in CC §3343 for fraud cases may be liberalized by Com C §2721. Cal Comment to Com C §2721.

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§12.28 4. Notice to Seller (Com C §2607(3)(A))

To preserve its right to a remedy for breach of contract after goods are accepted, the buyer must notify the seller of a breach within a reasonable time after the date that the buyer discovered or should have discovered the breach. Com C §2607(3)(A). The notice requirement is intended to give the seller an opportunity "to repair the defective item, reduce damages, and avoid defective products in the future." *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 135, 87 CR3d 5. Whether reasonable notice has been given is determined based on all the circumstances. *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 62 CR2d 701 (plaintiff failed to give defendants reasonable notice when, although arguably not aware of specifics, plaintiff knew sinks were defective for 3 years before giving notice to two defendants and for 5 years before giving notice to the third). See also *Cardinal Health*, *supra* (notice of breach of warranty to original manufacturer was not reasonable notice to its successor; there was no evidence of any connection between them when notice was given).

The notification need not state all of the buyer's potential objections. It need only inform the seller that the transaction is claimed to involve a breach, and thus open the way for settlement through negotiation. Official Comment 4 to UCC §2-607. The purpose of notice of an alleged breach of warranty is to protect the seller from stale claims; notice is therefore also required if the claims sound in tort rather than in contract.

If a buyer who resells goods is sued for breach of warranty, patent or trademark infringement, or any other obligation for which the buyer's supplier may be liable to the buyer (*e.g.,* in a suit by the ultimate purchaser for breach of the warranty of merchantability or through an indemnity agreement), special rules concerning defense of the litigation apply. See Com C §2607(5)).

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5. Remedies Available

§12.29 a. Rejecting Goods (Com C §2601)

If the buyer discovers before acceptance that either the goods or their tender by the seller are nonconforming, the buyer will typically want to reject them. See Com C §2601. Rejection does not limit the remedies that are available to the buyer for the seller's breach of the contract. Although the buyer may accept a nonconforming tender and still exercise appropriate remedies, rejection is generally to the buyer's advantage.

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§12.30 (1) Perfect Tender Rule (Com C §2601)

The buyer has the right to reject whenever the goods or their tender of delivery fails *in any respect* to conform to the contract. Com C §2601. The so-called perfect tender rule is a matter of some controversy because of the perceived potential for abuse by the buyer. See Lawrence, *The Prematurely Reported Demise of the Perfect Tender Rule*, 35 U Kan L Rev 557 (1987). One image frequently invoked is a buyer who rejects goods because of a trivial nonconformity in order to take advantage of a rapid falling market price. Such a rejection, however, may be in bad faith. See *Neumiller Farms v Cornett* (Ala 1979) 368 So2d 272.

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§12.31 (2) Limitations

The buyer's right of rejection is limited by the following considerations:

Wrongful versus ineffective rejection. There is a distinct difference between a wrongful rejection (one that is improper under Com C §2601) and an ineffective rejection (one that is procedurally defective under the requirements of Com C §2602). A buyer who makes an ineffective rejection is considered to have accepted the goods. See *In re Amica, Inc.* (Bankr ND Ill 1992) 135 BR 534. Conversely, a wrongful rejection by the buyer is a breach that entitles the seller to exercise the remedies specified in Com C §2703. See §§12.5-12.6.

Installment contract restrictions. If the nonconformity affects only the delivered installment of an installment contract, the buyer may reject only if (1) the documents are defective, or (2) the nonconformity substantially impairs the value of that installment and cannot be cured. Com C §2612(2).

- A defect in documents refers to such matters as the absence of insurance documents under a C.I.F. (cost, insurance, and freight) contract or an improper bill of lading (*e.g.,* one that fails to show shipment within the contract period or to the contract destination).
- Substantial impairment of the value of an installment may relate to the quality of the goods and to matters such as time, quantity, and assortment. Substantial impairment must be measured in terms of the normal or specifically known purposes of the contract. The parties may stipulate in the contract what they will consider to be a substantial impairment of the value that they regard as impossible to cure. The provision must have some basis in reason, however, and must avoid imposing hardship by surprise. It is also subject to waiver or displacement by practical construction. Official Comment 4 to UCC §2-612.

The buyer's right to reject future deliveries under an installment contract is limited to situations in which the nonconformity of a particular installment substantially impairs the value of the whole contract. Com C §2612. The buyer's right to reject may also be limited in this situation by the parties' agreement. Com C §§2718-2719.

Seller's right to cure. If the time for the seller's performance under the agreement has not yet expired, the seller may seasonably notify the buyer of its intention to cure and may then make a conforming delivery within the contract time. Com C §2508(1). When the buyer rejects a nonconforming tender that the seller had reasonable grounds to believe would be acceptable, the seller may have a further reasonable time to substitute a conforming tender if the seller seasonably notifies the buyer of its intention. Com C §2508(2). See also Com C §2614 regarding the seller's right to perform by substitute means if the agreed manner of delivery becomes impracticable.

"Material delay or loss" limitation. If the seller is required or authorized to send the goods to the buyer *and* the contract does not require delivery at a particular destination, the seller must (Com C §2504): (1) put the goods in the possession of a carrier and make a reasonable contract for their shipment, having regard for the nature of the goods and other circumstances relevant to shipment; (2) obtain and promptly tender in due form any document necessary to enable the buyer to obtain possession of the goods, or otherwise required by the agreement or by usage of trade; and (3) promptly notify the buyer of the shipment. The seller's failure to comply with these requirements (with the exception of the tender of a document) is grounds for the buyer's rejection of the goods *only* if material delay or loss ensues. Com C §2504.

Buyer's duty to inspect. At risk of losing its right to reject, the buyer may have a duty to inspect the goods to identify any defect that an inspection may uncover. *Lockheed Elec. Co., Inc. v Keronix, Inc.* (1981) 114 CA3d 304, 170 CR 591.

Federal agricultural products limitations. For federal limitations relating to the rejection of perishable agricultural commodities, see 7 USC §§499a-499s.

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§12.32 (3) Effect

Following proper rejection, the buyer may cancel the contract, cover, and recover damages for nondelivery. See generally Com C §§2711-2717. The buyer also acquires a security interest in the rejected goods in its possession or control to secure recovery of payments made and certain expenses. Com C §2711(3). Consequently, the buyer should retain control or possession of the goods (unless the nature or condition of the goods prevents this) to preserve its security interest while the buyer develops a strategy for dealing with the seller's default. Title to the goods revests in the seller on the buyer's rejection, whether or not the rejection was justified. Com C §2401(4).

The buyer's failure to make an "effective" rejection is considered to be an acceptance (Com C §2606(1)(b)), which precludes rejection of accepted goods but does *not* impair other remedies (Com C §2607(2)).

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.33 (4) Partial Acceptance (Com C §2601(c))

§12.33 (4) Partial Acceptance (Com C §2601(c))

As an alternative to rejecting the whole delivery, the buyer may accept one or more commercial units and reject the rest without impairing any remedy otherwise available with respect to the rejected portion of the goods. Com C §2601(c). The buyer must act in good faith and with commercial reasonableness to "avoid undue impairment of the value of the remaining portion of the goods." Official Comment 1 to UCC §2-601.

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§12.34 (5) Time and Manner of Rejection (Com C §2602)

The Commercial Code requires only that rejection of the goods be done within a reasonable time after their tender or delivery and that the buyer seasonably notify the seller. Com C §2602(1). What constitutes a "reasonable time" in a given situation depends on the parties' agreement, their prior course of dealing, the subject matter of the sale, usage of trade, and other relevant circumstances. See, *e.g., Koch Supplies v Farm Fresh Meats, Inc.* (5th Cir 1980) 630 F2d 282 (48 hours for rejection too short because of difficulties of discovery). A reasonable time for rejection may be stipulated in the agreement, in which case the agreement term controls if it is reasonable within the meaning of Com C §1205(a) (former Com C §1204).

In addition to rejecting the goods within a reasonable time, the buyer is required to give the seller "seasonable" notice of the rejection. Com C §2602(1). A buyer waives a defective tender under Com C §2605(1): (1) if the buyer fails to particularize the defect in the notice which is ascertainable by a reasonable inspection; (2) if the defect would be curable if stated seasonably; or (3) if, as between merchants, the buyer fails to comply with a seller's written request for a full and final statement of all defects on which a buyer proposes to rely. The buyer's failure to comply with these requirements precludes the buyer from relying on an unstated defect to justify rejection or to establish a breach. Com C §2605(1). These provisions are meant to permit a buyer to give "a quick and informal notice of defects in a tender without penalizing him for omissions, while at the same time protecting a seller that is reasonably misled by the buyer's failure to state curable defects." Official Comment 1 to UCC §2-605. In *Lockheed Elec. Co., Inc. v Keronix, Inc.* (1981) 114 CA3d 304, 170 CR 591, the court properly barred admission of evidence of electrical defects in computers when the defendant had not informed the selling plaintiff of the defects, which could have been remedied if proper notice had been given.

In the case of documentary delivery and tender, when payment is made against documents without reservation, the buyer waives all rights that would otherwise have arisen from defects that should have been apparent from the documents themselves. Com C §2605(2).

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§12.35 (6) Duties of Buyer With Respect to Rejected Goods (Com C §§2602-2603)

Certain obligations arise when the buyer rejects goods. If the buyer does not have a security interest in the goods (Com C §2711(3)), it has an obligation to hold the goods, with reasonable care, at the seller's disposition for a time sufficient to permit the seller to remove them. Com C §2602(2)(b).

A merchant buyer has the additional duties with respect to goods in its possession or control: (1) to follow any reasonable instructions received from the seller with respect to the goods or, in the absence of such instructions, and (2) to make reasonable efforts to sell the goods for the seller's account if they are perishable or threaten to decline speedily in value. Com C §2603(1). The seller's instructions to the buyer are not "reasonable" unless the seller, on demand, provides indemnity for the buyer's expenses. Com C §2603(1). If the buyer is required to sell the goods, the buyer is entitled to reimbursement for such expenses and to a commission. Com C §2603(2). The buyer (or merchant buyer) has no resale obligations if the goods are not perishable or will not quickly decline in value.

If the seller does not give the buyer instructions within a reasonable time after rejection, the buyer may (1) store the goods for the seller's account, (2) reship them to the seller, or (3) resell them in accordance with Com C §2603. These options apply to merchants as well as other buyers, but they do not modify a merchant's duties with respect to perishable goods. Com C §2604.

In performing these duties, the buyer is held to the standard of good faith conduct. If the buyer's duties are executed in good faith, it will not be considered to have accepted the goods, nor will it be subject to an action for conversion or for damages. Com C §2603(3). Otherwise, an acceptance may occur if the buyer uses the goods in a manner that is "inconsistent with the seller's ownership." Com C §2606(1)(c).

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b. Revoking Acceptance

§12.36 (1) What Constitutes Acceptance? (Com C §2606(1))

After a buyer has had a reasonable opportunity to inspect the goods, they are accepted under Com C §2606(1)(a)-(c) when the buyer: (1) fails to make an effective rejection; (2) signifies to the seller that the goods conform or that it will take them despite their nonconformity; or (3) when it acts in any way that is "inconsistent" with the seller's ownership. If the buyer's act is "wrongful as against the seller," the seller must ratify it before it will constitute an acceptance. Com C §2606(1)(c). The parties may expressly agree to additional acceptance terms. See Com C §2207(1).

Once it has accepted the goods, the buyer is necessarily precluded from exercising its right of rejection. After acceptance, the buyer may avoid the sale only by an effective revocation. See §§12.36-12.39. Acceptance does not impair any remedy provided by the Commercial Code (other than rejection) when goods are nonconforming. Thus, acceptance of nonconforming goods does not preclude an action for breach, although the burden is on the buyer to establish any breach with respect to the goods accepted. Com C §2607(4). The buyer must notify the seller of any breach within a reasonable time after the breach is discovered or should have been discovered. Com C §2607(3)(A). The acceptance of a nonconforming installment does not affect the buyer's rights in connection with future installments. Official Comment 3 to UCC §2-607.

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§12.37 (2) Effect of Revocation of Acceptance

A rightful and procedurally correct revocation of acceptance puts the buyer in the same position that it would have occupied if it had rejected the goods. The revoking buyer has the same remedies and duties toward the goods as a rejecting buyer. Com C §2608(3). On rightful revocation of acceptance, the buyer has a security interest in the goods in its possession or control for any payments made on their price and any expenses reasonably incurred in their inspection, receipt, transportation, care, and custody. The buyer is not required to return or offer to return the goods to the seller but may hold them for resale under terms and conditions similar to those governing an aggrieved seller's resale of goods. Com C §2711(3). See Com C §2706 regarding resale.

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§12.38 (3) Circumstances in Which Acceptance May Be Revoked

The circumstances in which the buyer may revoke acceptance are stated in Com C §§2607(2) and 2608(1). The buyer can revoke acceptance of nonconforming goods if (1) the buyer has accepted the goods either (a) on the reasonable assumption that their nonconformity would be cured but has not been seasonably cured, or (b) without discovery of the nonconformity, if acceptance was reasonably induced either by the difficulty of discovery before acceptance or by the seller's assurances, and (2) the nonconformity substantially impairs the value of the goods to the buyer.

The "substantial impairment" standard here is considerably more stringent than the same standard for rejection. See Official Comment 2 to UCC §2-608; Garland, *Determining Whether a Nonconformity Substantially Impairs the Value of Goods*: *Some Guidelines*, 26 UCC LJ 129 (Fall 1993). If there is substantial impairment, the buyer can revoke acceptance in two situations:

- The buyer's ignorance of the nonconformity is due to the difficulty of discovery or assurances by seller. The buyer has a right to inspect the goods before acceptance. Com C §2513. If a reasonable inspection would have uncovered the nonconformity, the buyer cannot revoke its mistaken acceptance. If the seller induced the buyer to accept the goods without a proper inspection, however, it is reasonable to permit the buyer to revoke acceptance once it discovers that the goods are not acceptable. Com C §2608(1)(b). If the seller gives the buyer assurances knowing that its assurances are false, revocation of acceptance is justified on the grounds of mistake or fraud.
- The buyer accepted the goods knowing of their nonconformity, but reasonably assumed that the seller would seasonably cure the nonconformity. Com C §§2607(2), 2608(1)(a). The buyer's reasonable assumption could be based on previous dealings between the parties, the buyer's knowledge of the seller's reputation, usage of trade (Com C §1303), or a contractual provision.

The buyer cannot revoke acceptance if the goods change substantially in condition while in the buyer's possession, unless the change is inherent in or caused by defects in the goods (*e.g.*, rotting). Com C §2608(2). Usage may "substantially change" the condition of the goods, in which case the buyer may waive its right to revoke. *Calvert Knit Corp. v Glendale Textiles* (NY App Div 1987) 3 UCC Rep Serv 2d 585. Reasonable use of a motor vehicle does not, as a matter of law, prevent the buyer from revoking acceptance. *Ibrahim v Ford Motor Co.* (1989) 214 CA3d 878, 263 CR 64. If the buyer discovers a defect when it begins using the goods in production, it may not revoke acceptance of goods that it has already transformed. It may, however, revoke acceptance of commercial units of the remaining goods. Com C §2608(1)-(2).

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§12.39 (4) Time and Manner of Revocation

A revocation is not effective until the buyer notifies the seller. Com C §2608(2). The notice must be given within a reasonable time after the buyer actually discovers, or should have discovered, the grounds for revocation and before any substantial change in the condition of the goods, other than changes caused by their own defects. Com C §2608(2). The time of notification may be extended by negotiations or may be specified by the parties' contract within good faith limits. See Official Comment 4 to UCC §2-608. See also Anno, *Time for Revocation of Acceptance of Goods Under* UCC §2-608(2), 65 ALR3d 354 (1975), on what constitutes a "reasonable" time.

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c. Covering

§12.40 (1) Purpose and Consequences

Buyers that receive nonconforming goods or no goods at all usually want what they ordered or a reasonable substitute as close to the scheduled time as possible. If nonconforming goods cannot be used or if the seller has not performed at all and there are no grounds for obtaining specific performance (or if specific performance would be impractical), the buyer will be forced into the market to buy substitute goods. This process is known as "cover," and corresponds to the seller's right of resale.

Cover enables the buyer to fix the damages caused by the seller's default. The measure of damages is the difference between the cost of cover and the contract price, together with any incidental or consequential damages, less expenses saved due to the seller's failure to perform. Com C §2712(2). If the buyer acts reasonably and in good faith, the Commercial Code puts the risk of a fluctuating market on the defaulting seller. The buyer is free to ignore cover and pursue its other remedies (Com C §2712(3)); however, its failure to make a reasonable attempt to cover limits its ability to receive consequential damages. Com C §2715(2)(a). See also *Gerwin v Southeastern Cal. Ass'n of Seventh Day Adventists* (1971) 14 CA3d 209, 92 CR 111.

Calculation of damages is easy if the buyer is able to purchase similar goods on comparable terms. Damages are more difficult to calculate if the substitute goods differ substantially. Similar problems regarding damage calculations will also arise if the buyer must perform work on the substitute goods that would not have been necessary on the goods the buyer contracted to purchase.

Cover does not displace other remedies available to the aggrieved buyer. Com C §2712(3). The buyer may still seek return of the price paid and sue to recover damages for nondelivery. Alternatively, the buyer may cancel the contract and make new arrangements. Com C §2711(1). Cover does not displace the buyer's security interest in rightfully rejected goods or goods whose acceptance was rightfully revoked.

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§12.41 (2) Time and Manner

Cover is available when (1) the seller fails to make delivery, (2) the seller repudiates, (3) the buyer rightfully rejects, or (4) the buyer justifiably revokes acceptance. Com C §2711(1). Cover is available to the buyer whether or not all the goods affected have been identified to the contract. Com C §2711(1)(a).

The buyer may procure substitute goods at any time and thereby fix its damages. The buyer may cover "by making in good faith and without unreasonable delay" a reasonable purchase of substitute goods or contract for their purchase. Com C §2712(1). Because the buyer is not required to cover, the good faith requirement will ordinarily be satisfied unless the buyer intentionally chooses a more expensive market over a less expensive one.

Cover is a flexible remedy, therefore the buyer may obtain nonidentical goods on differing credit and delivery terms. The test of proper cover is whether, at the time and place, the buyer acted in good faith and in a reasonable manner when procuring the substituted goods. It is immaterial that hindsight may prove the method of cover to be neither the cheapest nor the most effective means. Official Comment 2 to former UCC §2-712 (Official Comment 4 to UCC §2-712 (2003)). A buyer may cover by manufacturing the goods itself if it is unable to obtain them on the open market or can do so more economically. *Cives Corp. v Callier Steel Pipe & Tube, Inc.* (Me 1984) 482 A2d 852.

The right to cover may be subject to limitations, as follows:

- It is subject to the seller's right to cure a defective performance. Com C §2508.
- In installment contracts, the buyer's cover remedy is confined to the "goods involved" unless the seller's breach affects the whole contract. Com C §2711(1).
- The seller's failure to deliver may be excused because performance has become impracticable. Com C §2615(a).
- The contract itself also controls the buyer's choices. Com C §2719.

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§12.42 (3) Effect of Inability or Failure to Cover

In some instances, the buyer no longer needs the goods after the seller's breach. This may occur, for example, if the buyer contracted for the goods to meet a seasonal demand or the seller's failure to provide the goods at the proper time and place caused a sub-buyer to cancel its contract with the buyer, and the goods are no longer required. In these situations, the Commercial Code provides an alternative measure of damages for a buyer that chooses not to cover, *i.e.,* the difference between the contract price and the market price when the buyer learned of the breach. See Com C §2713.

The guiding principle in effecting cover is reasonableness. Cover may be delayed or even excused if the buyer reasonably believes that the seller might eventually perform under the contract. *Huntington Beach Union High Sch. Dist. v Continental Info. Sys. Corp.* (9th Cir 1980) 621 F2d 353.

The buyer has a right to replevin for goods identified in the contract if cover has not been effectuated after reasonable effort, if circumstances show that an effort to cover would be unavailing, or if the goods have been shipped under reservation and satisfaction of the security interest in them has been made or tendered. Com C §2716(3). The buyer may also obtain specific performance "where the goods are unique or in other proper circumstances." Com C §2716(1). "Other proper circumstances" may include the buyer's inability to obtain cover. See *Eastern Air Lines, Inc. v Gulf Oil Corp.* (SD Fla 1975) 415 F Supp 429.

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§12.43 d. Duty to Repair or Replace Nonconforming Consumer Goods Under Warranty

California's "Lemon Law"; repair facility requirement. The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8), commonly referred to as California's lemon law, requires every manufacturer of consumer goods sold in California to maintain service and repair facilities reasonably close to all areas where those goods are sold, so that the manufacturer can honor the terms of applicable express warranties. The manufacturer may designate independent service and repair facilities to perform warranty work on its behalf. CC §1793.2(a). See CC §1791(a) for the definition of "consumer goods."

A buyer of consumer goods has a statutory right to have nonconformities in those goods repaired during their warranty period. Unless the buyer agrees otherwise in writing, service or repair work must be completed within 30 days after its commencement. In addition, the manufacturer is required to commence the work within "a reasonable time." CC §1793.2(b). Delay caused by conditions beyond the manufacturer's control extends the 30-day repair period. Should delay occur, the conforming goods must be returned to the buyer as soon as possible after the delaying condition no longer exists. CC §1793.2(b).

Warranty period extensions. The warranty period is extended by the number of days the goods are out of the buyer's hands for service or repairs. CC §§1793.1(a)(2). If a defect arises during the warranty period, the warranty will not expire until the defect has been remedied. The warranty period will also be extended if the repairs do not remedy the defect and the buyer notifies the manufacturer of the failure of the repairs within 60 days after they were completed. If the defect has not been remedied after a reasonable number of attempts, the buyer may return the product for a replacement or refund, subject in either case to deduction of a reasonable charge for the buyer's use of the goods before the defect was discovered. CC §§1793.1(a)(2), 1793.2(d).

New motor vehicles. If the defective good is a new motor vehicle (as defined in CC §1793.22(e)(2)) and the manufacturer is unable to make the vehicle conform to applicable express warranties after a reasonable number of repair attempts (CC §1793.22(b)), the manufacturer must promptly replace the vehicle with a "substantially identical" one or make restitution to the buyer. CC §1793.2(d)(2)(A). What constitutes a "reasonable number" of repair attempts is specified in detail in CC §1793.22(b). In any event, "reasonable number" means at least two repair attempts. See *Silvio v Ford Motor Co.* (2003) 109 CA4th 1205, 135 CR2d 846.

The buyer is free to elect restitution rather than replacement. The buyer is not required to accept a substitute vehicle. CC §1793.2(d)(2). The manufacturer must also pay any sales or use tax, license fees, registration fees, and other official fees that the buyer is obligated to pay in connection with the replacement, plus any incidental damages incurred by the buyer, including reasonable repair, towing, and rental car costs. CC §1793.2(d)(2)(A). The Act contains no time limits for seeking replacement of a defective vehicle. *Krotin v Porsche Cars N. Am., Inc.* (1995) 38 CA4th 294, 45 CR2d 10. See generally *Gavaldon v DaimlerChrysler Corp.* (2004) 32 C4th 1246, 13 CR3d 793.

Buyer options if no repair facility. If the manufacturer does not provide the service or repair facilities required by the statute, the buyer has the following choices:

- The buyer can return the nonconforming goods to the retail seller. The seller has several options, including (a) service or repair of the goods, or directing the buyer to someone who can, (b) replacement of the defective goods, or (c) refunding to the buyer the original purchase price, less the amount directly attributable to the buyer's use of the goods before the nonconformity was discovered. CC §1793.3(a).
- The buyer can return the nonconforming goods to any retail seller of like goods of the same manufacturer. After the receipt of the goods, this seller will have the same duties listed above. CC §1793.3(b). The manufacturer is liable to every retail seller of its goods that incurs expenses in honoring the manufacturer's express warranties. CC §1793.5.

If neither of the above courses of action gives the buyer "appropriate relief," it may go to an independent service or repair facility where service or repair of the nonconforming goods can be economically accomplished. CC §1793.3(c). The manufacturer is liable to the buyer (or to the independent service or repair facility, on assignment of the buyer's

rights) for the actual and reasonable costs of service and repair, including a reasonable profit. (This remedy is not available if the wholesale price of the goods is less than $50.) CC §1793.3.

Federal law remedies. The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) offers similar remedies to a consumer-buyer under federal law, including repair, replacement, or refund, but only if (1) the seller is unable to provide replacement, and repair is not commercially practicable or cannot be made in a timely manner; or (2) the buyer is willing to accept a refund in place of repair or replacement. 15 USC §2301(10). The statute defines "replacement" as "furnishing a new consumer product which is identical or reasonably equivalent to the warranted consumer product." 15 USC §2301(11). "Refund" is defined as returning the actual purchase price, less reasonable depreciation based on actual use, if permitted by the rules of the Federal Trade Commission in 16 CFR pts 700-703. 15 USC §2301(12). The statute requires the warrantor to remedy product defects "within a reasonable time and without charge." 15 USC §2304(a)(1). If the product still contains a defect after a reasonable number of remedy attempts, the warrantor must permit the consumer-buyer to elect either a refund or a replacement of the product without charge. 15 USC §2304(a)(4).

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e. Enforcing Buyer's Security Interest

§12.44 (1) Purpose and Scope of Security Interest

After rightfully rejecting or justifiably revoking acceptance of nonconforming goods, the buyer has a security interest in the goods in its possession or control, to cover payments made on the price and reasonable costs of their inspection, receipt, transportation, care, and custody. Com C §2711(3). The policy reflected in Com C §2711 is to make the buyer whole for expenses it necessarily incurs in dealing with an unwanted delivery. The extent of the buyer's security interests is limited to the expenditures listed in Com C §2711(3), payments on the price (including amounts of drafts accepted and negotiable notes signed; see Official Comment 2 to UCC §2-711), and reasonable expenses of transporting, receiving, inspecting, keeping, and caring for the goods. Damages are intentionally left off the list. Official Comment 2 to UCC §2-711.

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§12.45 (2) Procedure for Sale

A sale by a buyer enforcing its security interest is governed by the same principles that apply to a resale by an aggrieved seller. See §§12.19-12.22; Com C §2706. There is one difference that distinguishes a buyer's sale to enforce its security interest from a seller's resale of goods: A buyer is required to turn over to the seller any sale proceeds that exceed the buyer's security interest. Official Comment 2 to UCC §2-711. In contrast, a seller is not accountable to the buyer for any profit made on the resale. Com C §2706(6).

Regardless of which party is selling the goods, the sale must be conducted in "good faith" and in a "commercially reasonable" manner. Com C §2706(1); *Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 249 CR 872. Because of the lack of case authority interpreting these requirements under Com C §2706, cases decided under Division 9 of the California Commercial Code and corresponding statutes in other states may be persuasive. See *Hutchison v Southern Cal. First Nat'l Bank* (1972) 27 CA3d 572, 103 CR 816 (commercially reasonable sale of pledged stock); *U.S. v Terrey* (5th Cir 1977) 554 F2d 685 (commercially unreasonable sale of business assets).

Under Division 9, the disposition of collateral after a default is governed by Com C §9610. A secured party may dispose of collateral by either public or private proceedings, by one or more contracts, by unit or parcels, at any time and place, and on any terms, as long as all aspects of the disposition are commercially reasonable. Com C §9610(b). For further discussion of public and private dispositions of collateral under Division 9, see Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001).

Practically speaking, the issue of "commercial reasonableness" tends to devolve into an issue over price. A debtor is unlikely to complain about the conduct of a sale if a satisfactory sale price is received. A debtor and a court, however, may be alerted to the possibility that a sale was not held in a commercially reasonable manner if a relatively low price is received. For example, a sale in which a repossessed car was sold for less than 50 percent of wholesale book value, without any explanation about the discrepancy, was held to be unreasonable as a matter of law. *Credit Bureau Metro, Inc. v Mims* (1975) 45 CA3d Supp 12, 119 CR 622. The fact that a higher price could have been obtained at a different time or through a different method of sale, however, will not preclude the secured party from establishing that the disposition was in fact conducted in a commercially reasonable manner. Com C §9627(a). The specific facts of each case regarding the goods and the manner of sale will determine the court's ruling.

Enforcement of its security interest does not prevent the buyer from also seeking damages. Official Comment 2 to UCC §2-711.

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§12.46 f. Buyer's Right to Possession of Goods

The buyer has a right to claim possession of goods, even if the goods have not yet been shipped, if the following conditions exist:

- The buyer has paid all or part of the price of goods in which the buyer has a special property interest under Com C §2501. Com C §2502(1). By its express terms, Com C §2502 is limited to buyers that have prepaid, in whole or in part, for the goods sought to be recovered. A buyer that purchases on credit may simply cancel the contract if the goods are not forthcoming. Com C §2711(1).
- The buyer makes and keeps good a tender of any unpaid portion of the price. Com C §2502(1).
- If the buyer is responsible for identification of the goods to the contract, the buyer may recover the goods only if they conform to the contract. The buyer's right does not apply to nonconforming goods that the buyer would have had the right to return or reject. Com C §2502(3).
- If the goods have been bought for personal, family, or household purposes, the seller repudiates or fails to deliver the goods as required under the contract. Com C §2502(1)(a).
- In all cases, if the seller becomes insolvent within 10 days after receipt of the first installment of the price. Com C §2502(1)(b).

The buyer's right to obtain the goods on the seller's insolvency vests on acquisition of a special property and insurable interest in the goods under Com C §2501 even if the seller has not repudiated or failed to deliver the goods at the time. Com C §2502(2). This serves to establish the buyer's interest in the goods if the seller becomes insolvent before delivery of the goods to the buyer. Once the seller files a bankruptcy case, however, the buyer's rights are governed by the Bankruptcy Code, not Com C §2502. *Diesel Performance, Inc. v G. Paoletti Co. (In re G. Paoletti, Inc.)* (Bankr ND Cal 1997) 205 BR 251. If the buyer has made a partial payment for the goods, then the sales contract will be categorized as executory under 11 USC §365, and the buyer's rights will be subject to the rights of the trustee in bankruptcy to accept or reject the contract. If the buyer has fully paid the contract price, the automatic stay of 11 USC §362(a) will prevent the buyer from exercising any right of possession of the goods. The buyer will be left with an unsecured monetary claim against the estate for the amount paid.

Buyers who deal with financially unstable sellers may chose to avoid the inherent problems associated with Com C §2502(1)(b) and make a demand for assurances of performance as soon as reasonable grounds for insecurity arise regarding the performance of the contract. Com C §2609. See §8.58. A buyer may also elect to pay for the goods with a letter of credit against delivery of the goods or a negotiable document.

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§12.47 g. Offsetting Buyer's Damages Against Price

If the buyer is damaged by the seller's breach (*e.g.*, the seller delivers nonconforming goods or a short supply of conforming goods), the buyer is permitted to offset all or part of its damages from the price still due on the contract, assuming the buyer has notified the seller. Com C §2717.

A buyer's decision to offset damages under Com C §2717 permits the buyer to retain cash and exercise other remedies without breaching the contract. For example, if nonconforming goods are received, the buyer may cover, utilize the security interest in the nonconforming goods, and in effect pay for the receipt of conforming goods by setting off the damages that were fixed by the cover.

The buyer must give notice of its intention of withhold all or part of the price in order to avoid default. See Official Comment 2 to UCC §2-717. If a buyer complies with the notification requirement, the buyer is able to require the seller to deliver the goods for their contract price, minus the price offset. If the buyer's payment is due before the seller has completed performance, and the buyer deducts damages without giving the requisite notice under Com C §2717, the seller may treat the failure to pay as a breach of contract. The seller may elect to pursue the remedies specified in Com C §2703 with respect to undelivered goods.

The buyer's attempt to pay less than the full price for the goods raises the issue of accord and satisfaction. If the buyer deducts damages from the price, the buyer places the seller in a position to accept and be satisfied with less than full performance. See Com C §3311. For further discussion of accord and satisfaction, see §§8.42-8.45 and California UCC Sales and Leases (Cal CEB 2002).

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h. Canceling the Contract

§12.48 (1) Grounds and Effect

The buyer has the option to cancel the contract whenever the seller fails to deliver or repudiates the contract, or whenever the buyer rightfully rejects or justifiably revokes acceptance of the goods. Com C §2711(1). The buyer may cancel the unperformed part of an installment contract only if the seller's breach is significant enough to impair the value of the whole contract. Com C §2612(3). A buyer's remedies following a breach by the seller may be effectively precluded, with the exception of those associated with the delay, if the seller cures the breach by properly retendering delivery or sending replacement goods under Com C §2508. See Official Comment 1 to UCC §2-711.

The sale of a motor vehicle, bought for personal or family purposes with a conditional sales contract (see CC §2981(a)), must comply with the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5). If the conditional sales contract is not enforceable under CC §2983 or §2983.1, the buyer may choose to retain the motor vehicle and continue the contract in force or, with reasonable diligence, rescind the contract and return the vehicle. CC §2983.1. If the vehicle is returned, the value of the vehicle is to be credited as restitution by the buyer without any deduction in the cash price for the passage of time. CC §2983.1.

By canceling, the buyer discharges executory obligations but retains any remedy for past breaches and for breach of the whole contract or unperformed balance of the contract. Com C §2106(4). See also Com C §2720. The buyer's decision to cancel will depend on whether the buyer considers the value of the contract to sufficiently outweigh the disadvantages of the seller's breach. The buyer may welcome the opportunity to make other contractual arrangements if goods are available elsewhere at comparable prices. The buyer may be willing to accept less than perfect performance if goods are not available or prices of comparable goods have risen.

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§12.49 (2) Notice of Cancellation

The only express provision regarding a notice of cancellation is set forth in Com C §2612(3), which provides that the contract will be reinstated if the buyer accepts a nonconforming installment without seasonably notifying the seller of the cancellation. Informal notification is probably required in all cases under the obligations of good faith. See Com C §1304.

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.50 (3) Contract Reinstatement

§12.50 (3) Contract Reinstatement

In addition to a contract being reinstated when no seasonable notification has been given, Com C §2612(3) also specifies that a contract will be reinstated if (1) an action is commenced with respect to only past installments or (2) performance is demanded for future installments. This section is designed to continue the contract in the absence of an overt cancellation.

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§12.51 II. REMEDIES IN LITIGATION OVER CONTRACTS FOR THE SALE OF GOODS

Sections 12.52-12.54 address litigation remedies provided by the Commercial Code and the following enactments:

- The Consumers Legal Remedies Act (CC §§1750-1784);
- The Song-Beverly Consumer Warranty Act (CC §§1790-1795.8);
- Motor Vehicle Warranty Adjustment Programs (CC §§1795.90-1795.93);
- The Unruh Act governing retail installment sales (CC §§1801-1812.20);
- The Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5); and
- The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) with implementing Federal Trade Commission regulations (16 CFR §§700.1-703.8).

The remedies provided by the Commercial Code are *not* exclusive (see Com C §2701), and the attorney should consider whether other remedies are available under the circumstances.

If fraud is present in the transaction, the Commercial Code enlarges the remedies available. Commercial Code §2721 states that remedies for material misrepresentation or fraud include all remedies available under Division 2 for nonfraudulent breach. See also CC §3343 regarding recovery of damages in fraud actions.

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A. Seller's Remedies

§12.52 1. Damages

Once the buyer has accepted the goods or is chargeable for their loss, the seller is entitled to recover the contract price. If the buyer repudiates, wrongfully rejects, or wrongfully revokes acceptance of the goods, the seller is entitled to recover damages and has several measures of damages from which to choose. Com C §§2703(d)-(e), 2706(1), 2708, 2710.

The basic measure of damages is the difference between the contract price of the goods and their market price. By reselling properly, the seller fixes its damages and avoids having to prove market price in litigation. In certain circumstances, the seller can recover lost profits. Punitive damages are ordinarily not available. Retention or recovery of a down payment, interest, or liquidated damages is possible under certain circumstances.

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§12.53 a. Damages Measured by Market Price

The basic measure of damages for the buyer's repudiation, rejection, or wrongful revocation of acceptance of the goods is the difference between the unpaid contract price of the goods and their market price at the time and place for tender, plus any incidental damages sustained and less any expenses saved as a result of the buyer's breach. Com C §2708(1).

Where and when the seller is required to tender the goods is governed by Com C §2503 and the contract's shipment terms. The attorney should remember that the time for tender may have been (1) changed by express or implied modifications of the contract (see Com C §2209) or (2) delayed by a party's failure to cooperate (see Com C §2311). For installment contracts, the seller must establish the market price at the time and place for tender of each installment. See Com C §2703.

If the buyer repudiates the contract before the seller's tender and the seller brings an action before the tender date (see Com C §2723(1)), the market price is measured as of the time when the seller learned of the buyer's repudiation.

If the difference between the market price and unpaid contract price is not enough to put the seller in as good a position as the buyer's performance would have, the measure of damages is the profit that the seller would have made from full performance by the buyer. Com C §2708(2); *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636. This is the measure that is applied in the "lost volume seller" case. See §12.57.

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§12.54 b. Damages Measured by Resale

A proper resale of the goods fixes the seller's damages as the difference between the contract price and the resale price, plus any incidental damages and less any expenses saves as a result of the buyer's breach. Com C §§2703(d), 2706(1). This measure applies whether the resale is public or private. See *Alco Standard Corp. v F & B Mfg. Co.* (Ill 1972) 281 NE2d 652.

The seller is under no duty to resell the goods, nor is it obligated to use the resale price in establishing its loss. Even after a resale, the seller can use the difference between the market price and contract price of the goods as its measure of damages. See, *e.g., Lee Oldsmobile, Inc. v Kaiden* (Md Ct Spec App 1976) 363 A2d 270. However, a seller who fails to observe all the requirements of Com C §2706 (see §§12.19-12.22) in conducting the resale forfeits the right to use the resale measure of damages and is relegated to the market price/contract price formula of Com C §2708. Official Comment 2 to former UCC §2-706; *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636.

Even if the seller resells the goods, market price remains relevant. If it is significantly higher than the price obtained by the seller on resale, it is evidence that the resale was not "commercially reasonable." Official Comment 3 to former UCC §2-706 (Official Comment 5 to UCC §2-706 (2003)). A low resale price should be acceptable, however, if the seller conducted the sale in a proper manner. See *Allied Grape Growers v Bronco Wine Co.* (1988) 203 CA3d 432, 249 CR 872. A recent Michigan case held that on resale the seller may substitute fungible goods and, under circumstances in which the seller made a good faith effort to locate other purchasers, a 3-year delay between breach and resale was not commercially unreasonable. *Firwood Mfg. Co. v General Tire, Inc.* (6th Cir 1996) 96 F3d 163.

If the seller realizes a profit on the resale, the seller may retain it. Com C §2706(6).

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§12.55 c. Incidental and Consequential Damages

The seller is entitled to recover incidental damages in actions based on the buyer's wrongful repudiation of the contract, wrongful rejection of the goods, wrongful revocation of acceptance, or failure to make a payment due on or before delivery. Com C §§2706(1), 2708(1)-(2). Incidental damages consist of commercially reasonable expenditures that result from the buyer's breach, including the items listed in Com C §2710 (*i.e.,* expenses incurred in stopping delivery, storing or transporting the goods after breach, and returning or reselling the goods). *Bulk Oil (U.S.A.), Inc. v Sun Oil Trading Co.* (2d Cir 1983) 697 F2d 481. Postbreach interest payments on the loan are commercially reasonable and foreseeable and therefore recoverable as incidental damages. *Ballard v Equifax Check Servs., Inc.* (ED Cal 1998) 27 F Supp 2d 1201 (incidental damages do not include costs incurred in collection of underlying debt). The seller's recovery, however, is reduced by expenses saved in consequence of the buyer's breach. Com C §§2706(1), 2708(1).

The seller may not recover "consequential or special" damages unless they are allowed in specific provisions of the Commercial Code or are available under some other rule of law. Com C §1305(a). No Commercial Code provision gives sellers the right to recovery consequential damages—recovery must be had, if at all, under the Civil Code. See generally chap 10.

Commercial Code §2715(2) describes consequential damages to which a buyer may be entitled as including "[a]ny loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise" and "[i]njury to person or property proximately resulting from any breach of warranty."

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§12.56 d. Lost Profits

If the difference between the contract price and the market price or resale price does not adequately compensate the seller for its losses, Com C §2708(2) entitles the seller to recover the profits (including reasonable overhead) that the seller would have made from the buyer's full performance, together with incidental damages, due allowance for costs reasonably incurred, and due credit for the buyer's payments or proceeds of the resale.

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§12.57 e. Lost Volume Sellers

A seller who proves that, even though it resold the contract goods, it would have made the sale to some third party regardless of the buyer's breach, so that the seller would have realized profits from two sales rather than one, is called a "lost volume seller." A lost volume seller is well secured by the lost profits measure of damages. See *National Controls, Inc. v Commodore Bus. Machs., Inc.* (1985) 163 CA3d 688, 209 CR 636 (seller established itself as lost volume seller because its manufacturing plant was operating at 40-percent capacity at time of breach and it could have easily filled additional orders).

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§12.58 f. Component Sellers

A "component" seller is one who contracts with the buyer to sell an assembled product. Component sellers also benefit from the lost profits measure of damages. For example, assume that the buyer breaches the contract before final assembly and that the seller decides to stop the assembly process. The decision to complete assembly or not must be made in the exercise of reasonable commercial judgment. Com C §2704(2). Whether the seller's judgment is reasonable depends in part on whether a market exists for the finished product. *Detroit Power Screwdriver Co. v Ladney* (Mich Ct App 1972) 197 NW 2d 857.

When the seller stops production in mid-process, recovery under Com C §§2706 and 2708(1) is not available because both of those sections contemplate a market for the completed product. The Commercial Code therefore permits the seller to compute its damages by (1) adding expenses already incurred in the assembly process to the profit that it would have made if it had completed and sold the goods and then (2) subtracting the salvage value of any unfinished goods. Com C §2708(2).

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§12.59 g. Jobbers or Middlemen

Jobbers or middlemen, who only act as intermediaries in a sale of goods, also benefit from the lost profits measure. When the buyer breaches the contract, the jobber may not have any goods on hand to sell to fix its damages. Therefore, it may instead recover the profit lost by the buyer's breach. See, *e.g., Distribu-Dor, Inc. v Karadanis* (1970) 11 CA3d 463, 90 CR 231.

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§12.60 h. Punitive or Exemplary Damages

The Commercial Code prohibits recovery of punitive or exemplary damages unless they are available under some other body of law. Com C §1305(a). Punitive damages can be awarded in a Uniform Commercial Code suit in which an independent tort is also proven. See *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (entitlement to punitive damages hinged on prevailing on fraud and misrepresentation claims in addition to contract claims); *Wallis v Superior Court* (1984) 160 CA3d 1109, 129 n4, 207 CR 123. For further discussion of punitive damages, see §§10.48-10.51.

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§12.61 i. Attorney Fees

Outside of the consumer context, Division 2 of the Commercial Code contains no provision for the recovery of attorney fees in actions between sellers and buyers; accordingly, unless attorney fees are specifically provided for by statute, their recovery in any action is left to the express or implied agreement of the parties. CCP §1021. If the agreement provides for recovery of attorney fees by one party, they are also recoverable by the other party. CC §1717(a).

If the sale involves consumer goods, attorney fees may be available. See CC §§1780(e) (part of the Consumers Legal Remedies Act), 1794(d) (part of the Song-Beverly Consumer Warranty Act), and 1811.1 (part of the Unruh Act governing retail installment sales). Attorney fees may also be recoverable in a contract action based on a book account. CC §1717.5. See also *Murillo v Fleetwood Enters., Inc.* (1998) 17 C4th 985, 995, 73 CR2d 682 (prevailing seller may recover its cost of suit—including attorney fees and expert witness fees—in action brought under Song-Beverly Consumer Warranty Act).

For a detailed discussion of California law on recovery of attorney fees in contract litigation, see §§9.12-9.28.

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2. Contract Price Recovery (Com C §2709)

§12.62 a. When Available

If the buyer does not pay the contract price when due, the seller can recover the full contract price for the goods (1) if the buyer has accepted the goods, (2) if the goods have been identified but cannot be resold, or (3) when conforming goods have been lost or damaged, if risk of their loss has passed to the buyer, and loss or damage occurs within a commercially reasonable time after the buyer's breach. Com C §2709(1). In actions for the price, as well as in actions for damages, the seller can recover its incidental damages. See generally Anno, *Seller's Recovery of Price of Goods from Buyer Under UCC §2-709*, 90 ALR3d 1141 (1979; updated 2004).

Accepted goods. "Acceptance" does not include an acceptance that has been appropriately revoked. Official Comment 5 to UCC §2-709. A rejection or revocation of acceptance that is improper or ineffective, however, will be considered to be an acceptance, entitling the seller to recover the price of the goods. See Com C §§2606(1)(b), 2608(2). In situations involving an installment contract, failure of the buyer to pay one or more installments may give the seller the right to accelerate the balance due and seek the price even if the contract does not expressly provide for acceleration. *Gantry Constr. Co. v American Pipe & Constr. Co.* (1975) 49 CA3d 186, 122 CR 834.

Identified goods that cannot be resold. Price recovery is available when the goods have been identified to the contract and the seller is unable, after reasonable effort, to resell them for a reasonable price or the circumstances reasonably indicate that the seller would be unable to do so. Com C §709(1)(b). The term "reasonable" is used three times in Com C §2709 to emphasize that the drafters believed that most goods could be sold for an amount above their scrap value. Before relying on Com C §2709, the seller's attorney should ensure that the client has made all reasonable efforts to resell, including offering the goods at a substantial reduction in price.

The requirement of Com C §2709 that the goods be "identified to the contract" arises from the fact that an action for the price is, in effect, an action for specific performance. The seller is not entitled to force the buyer to specifically perform unless the seller is also willing and able to perform. If the seller wants the price, it must be able to deliver the goods. Because unidentified or unfinished goods cannot be delivered, identification is a condition precedent to recovery of the price. See Com C §2501.

If risk of loss of conforming goods has passed to the buyer. The seller may recover the contract price if the buyer refuses to pay for conforming goods that have been lost or damaged after risk of their loss has passed to the buyer and the loss or damage occurs within a commercially reasonable time after buyer's breach. Com C §2709(1)(a). See also Com C §§2509-2510 (risk of loss). Of course, the terms of the parties' contract can and often do make provision for the passing of risk of loss. If the buyer breaches the contract before the risk passes, the seller nevertheless has a limited right to "treat the risk of loss as resting on the buyer" for all losses in excess of those covered by insurance, if any, as long as the risk of loss rests on the buyer for no more than a commercially reasonable time. Com C §2510(3). In other situations, the seller must seek damages. Official Comment 6 to UCC §2-709.

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§12.63 b. Procedural Aspects

If the seller is entitled to the price under Com C §2709(1), the buyer may claim the goods intended for the contract or the net proceeds of any of the goods after resale by the seller. Com C §2709(2). In effect, resale before judgment changes an action for the price into an action for damages (measured by the resale). If the seller can collect a substantial portion of the price by resale, it will be in its interest to do so. The risk of having the commercial reasonableness of the sale attacked may be too great, however, if only a small portion of the contract price can be recovered.

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B. Buyer's Remedies

§12.64 1. Damages Generally (Com C §§2711, 2713)

If a seller repudiates the contract, fails to deliver, delivers nonconforming goods, or breaches a warranty, several possible remedies for damages are available to the buyer. See Com C §§2711-2715. Generally, the buyer's damages under Commercial Code Division 2 are the difference between the contract price and either (1) the market price or (2) the cost of cover plus incidental and consequential damages. Com C §2713. If the seller breaches a warranty after acceptance by the buyer, the buyer's basic measure of damages is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted. Com C §2714(2).

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§12.65 a. Damages Measured by Market Price (Com C §2713)

The basic measure of damages for a seller's repudiation or nondelivery is the difference between the market price and the contract price. Com C §2713(1). Market price is measured as of the time the buyer learned of the breach, at the place where the goods were to be tendered or, if the goods have arrived and have been rejected or their acceptance has been revoked, at the arrival point. Com C §2713(2).

In addition to the market price/contract price differential, the buyer can recover incidental and consequential damages to the extent that the consequential damages could not have been avoided by cover. See Com C §§2711, 2713(1), 2715(2)(a). If the buyer saves expenses (*e.g.,* shipping costs) because of the seller's breach, the expenses saved must be deducted from the amount of damages recoverable. Com C §2713(1). The measure of damages for the seller's repudiation or nondelivery is the difference between the contract price and market price, with appropriate adjustments for additional incidental and consequential damages and for expenses saved in consequence of the seller's breach. Com C §2713(1). If the market price has risen substantially, the buyer may receive a greater economic benefit than it would have received had the contract been performed.

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§12.66 b. Damages Measured by Cover (Com C §2712)

Whenever the seller repudiates the contract, fails to make delivery of the goods that the buyer properly rejects or rightfully revokes acceptance of, the buyer can fix its damages by covering, *i.e.,* by making a substitute contract or purchase. Com C §§2711(1)(a), 2712. Once the buyer covers, it cannot choose to measure its damages by market price. Official Comment 5 to former UCC §2-713 (Official Comment 2 to UCC §2-713 (2003)). When the buyer covers by making in good faith and without unreasonable delay any reasonable purchase of goods in substitution for those due from the seller, the buyer may recover from the seller as damages the difference between the cost of cover and the contract price, even though the buyer is able to pass some of its losses on to its customers. *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286.

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§12.67 c. Damages After Acceptance (Com C §2714)

Sometimes the buyer has the opportunity to choose between two courses of action: (1) to reject the goods, procure substitutes, and seek damages, or (2) to accept the goods and seek damages under Com C §2714. The decision is a practical one. If the buyer has no use for the defective goods or if it can obtain substitute goods easily, it will almost always opt to reject the goods; the buyer may decide to accept the goods, however, if no substitutes are available, the time for rejection or revocation has expired, or the defect does not interfere substantially with the buyer's purpose or expectation of value.

To obtain damages under Com C §2714, the buyer must establish that:

- It has accepted the goods;
- The goods are nonconforming;
- Notice of the breach has been given to the seller as required by Com C §2607(3)(A); and
- Damages have been incurred as a result of the breach.

The buyer may recover damages for losses "resulting in the ordinary course of events from the seller's breach." Com C §2714(1). The losses may result from the seller's breach of warranty or any other failure to perform according to its obligations under the contract. The losses may include lost profits, lost use of the goods, loss of customers and goodwill, and expenditures incurred in attempting to make defective goods conform to the condition warranted. Official Comment 2 to UCC §2-714.

Breach of warranty claims often arise long after the goods have been accepted and put into use. The measure of damages provided by Com C §2714(2) specifically for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted. If the goods are "consumer goods," the seller's breach of warranty may entitle the buyer to additional remedies. Civil Code §1794, part of the Song-Beverly Consumer Warranty Act, allows the buyer to recover reasonable attorney fees. If the seller's failure to comply with the Consumer Warranty Act was willful, the judgment may include a civil penalty of up to two times actual damages. See also CC §1791.1(d). The civil penalty for a "willful" violation will not be assessed, however, in a class action or if the buyer's action is based solely on breach of an implied warranty. CC §1794(c). Nor will it be assessed if the manufacturer maintains a qualified third party dispute resolution process in conformance with CC §1793.22. See CC §1794(b) (damages specifically allowed by CC §1794 include the rights of replacement or reimbursement or, if the buyer has accepted the goods, the cost of repairs necessary to make the goods conform).

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§12.68 (1) Determining Value of Goods as Accepted

The value of accepted goods may be determined through the use of expert testimony concerning the goods' fair market value at the time of acceptance. When available, the resale price of defective goods is also an appropriate measure of the goods' value at the time of acceptance as long as the resale occurs within a reasonable period following acceptance and the buyer knows of the defect.

Typically, courts use the "special circumstances" clause in Com C §2714(2) to measure the buyer's damages at some time after acceptance.

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§12.69 (2) Determining Value of Goods as Warranted

Many courts consider the price paid by the buyer to be the value of the goods as warranted. See, *e.g., De La Hoya v Slim's Gun Shop* (1978) 80 CA3d Supp 6, 146 CR 68; *Lone Star Ford Inc. v McGlashan* (Tex Ct App 1984) 681 SW 2d 720. But the purchase price may not provide the proper measure of damages because it reflects the value of the goods at the time of *contracting,* not the buyer's acceptance.

If the goods delivered must be repaired to make them conform to the warranty, the cost of repairs is often considered to be the difference between the value of the goods as accepted and as warranted. See, *e.g., Tarter v MonArk Boat Co.* (ED Mo. 1977) 430 F Supp 1290, aff'd (8th Cir 1978) 574 F2d 984. If, however, the buyer can establish that the repairs did not restore the goods to the value they would have had in the condition as warranted, the buyer may recover both the cost of repairs and the difference in value between the goods as repaired and as warranted.

The cost of replacement of defective parts is normally recoverable as consequential damages for breach of warranty. In some cases, the cost of replacing defective parts has been a conclusive measure of the buyer's damages.

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.70 (3) Choosing Appropriate Measures of Damages

§12.70 (3) Choosing Appropriate Measures of Damages

A variety of methods may be used to determine the damages resulting from a breach of warranty. The most appropriate method depends on the facts of each case. If either of two measures of damages will fully compensate the buyer for its loss, the measure that is less expensive to the seller should be chosen. See generally *KGM Harvesting Co. v Fresh Network* (1995) 36 CA4th 376, 42 CR2d 286 (discussing theories of damages under Civil and Commercial Codes).

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§12.71 2. Notice of Breach (Com C §2607(3))

Once the buyer has accepted a tender or delivery of the goods, notice to the seller of any breach is a prerequisite to the buyer's recovery of damages. Com C §§2607(3), 2714(1); *Cardinal Health 301, Inc. v Tyco Electronics Corp.* (2008) 169 CA4th 116, 135, 87 CR3d 5; *Fieldstone Co. v Briggs Plumbing Prods., Inc.* (1997) 54 CA4th 357, 62 CR2d 701. The time for notice is extended, however, if the warranty is prospective and the breach is not reasonably discoverable until the goods fail to perform. *Kaiser Cement & Gypsum Corp. v Allis-Chalmers Mfg. Co.* (1973) 35 CA3d 948, 111 CR 210. If the buyer's claim for defective goods is based on the tort theory of strict liability rather than the contract theory of breach of warranty, no notice is necessary. *Greenman v Yuba Power Prods., Inc.* (1963) 59 C2d 57, 27 CR 697.

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§12.72 3. Incidental Damages (Com C §2715(1))

Whether the buyer seeks damages based on cover (Com C §2712) or market price (Com C §2713) or claims damages following acceptance of the goods (Com C §2714), it can recover, as incidental damages, expenses reasonably incurred as a result of the seller's breach (Com C §2715(1)). Incidental damages include "expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach." UCC §2-715. This is a nonexclusive list of incidental damages. See Official Comment 1 to UCC §2-715. If the buyer has possession of the goods, as it often does after a rejection or revocation of acceptance, it has a security interest in them to the extent of its incidental damages as well as payments it has made on the price. Com C §2711(3).

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§12.73 4. Consequential Damages (Com C §2715(2))

Consequential damages are generally prohibited in cases subject to Commercial Code Division 2 unless specifically allowed by a particular Commercial Code provision or by non-Code law. Com C §1305(a). All Commercial Code sections relating to the *buyer's* damages, however, provide for consequential damages, as limited by the definition of "consequential damages" in Com C §2715(2). That section provides that consequential damages include any loss resulting from the seller's breach, provided that the loss (a) results "from general or particular requirements and needs of which the seller at the time of contracting had reason to know" and (b) "could not reasonably be prevented by cover or otherwise." Com C §2715(2)(a). See Com C §§2712-2714. The seller must have reason to know of the buyer's requirements (foreseeability), and only losses not reasonably preventable can be recovered (mitigation).

Consequential damages include "[i]njury to person or property proximately resulting from any breach of warranty." Com C §2715(2)(b). If the injury follows use of the goods without discovery of the defect causing the injury, whether proximate cause exists depends on whether it was reasonable for the buyer to use the goods without an inspection that would have revealed the defect.

Compensatory damages available to a buyer under the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) are limited to the same categories, and measured in the same manner, as those available to a buyer for a seller's breach of contract for the sale of goods. See CC §1794(b). See also *Bishop v Hyundai Motor Am.* (1996) 44 CA4th 750, 758, 52 CR2d 134 (no recovery for emotional distress or *nonfinancial* loss of use damages when car was destroyed by fire caused by manufacturing defect); *Kwan v Mercedes-Benz of N. Am., Inc.* (1994) 23 CA4th 174, 188, 28 CR2d 371 (no recovery for emotional distress alleged to have resulted from repeated unsuccessful efforts to have car repaired); *Kately v Wilkinson* (1983) 148 CA3d 576, 579, 195 CR 902 (buyer-operator of defective speedboat could recover for emotional trauma caused when boat ran over and killed water skier).

Although the buyer may not recover damages that are too speculative, it is not required to prove consequential damages with mathematical precision. In general, almost any injury resulting from defective goods is compensable as long as the loss can be translated into monetary terms, proven with reasonable certainty, and shown to be reasonably foreseeable.

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§12.74 a. Lost Profits

Lost profits are probably the most common form of consequential damages sought by buyers. In general, lost profits may be recovered when a sufficient factual basis for them is shown. No recovery for lost profits is allowed, however, if the amount is too speculative to be measured or there is no basis on which lost profits can be computed with reasonable certainty. Even though its business is new, the buyer may be awarded lost profits if they can be computed with reasonable certainty. Past profits of an established business may be used to prove loss of prospective profits. Proof of profits for a new business may be evidenced by the buyer's subsequent profits.

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.75 b. Loss of Goodwill

§12.75 b. Loss of Goodwill

Loss of goodwill is generally too speculative to be compensated, unless the buyer can establish with reasonable certainty that there was such a loss and its dollar value.

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§12.76 c. Contractual Exclusion of Consequential Damages (Com C §2719(3))

Courts will uphold a contractual provision that excuses a seller from liability from consequential damages, including lost profits. Com C §2719(3). If such a provision is found to be unconscionable, however, it will not be enforced. See CC §1670.5; Com C §2719(3); *A & M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114. In the case of consumer products, the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act (15 USC §§2301-2312) allows a warrantor to exclude or limit consequential damages for breach of any written or implied warranty provided that the exclusion "conspicuously appears on the face of the warranty." 15 USC §2304(a)(3). For further discussion of the doctrine of unconscionability, see §§5.76-5.80.

A provision that bars recovery of consequential damages does not preclude recovery of incidental damages. As with consequential damages, the parties may also exclude recovery of incidental damages if the exclusion is not unconscionable and does not deprive a party of all effective remedies. See Official Comment 1 to UCC §2-719.

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§12.77 d. Mitigation of Damages (Com C §2715(2))

Recoverable consequential damages are those not reasonably preventable "by cover or otherwise." Com C §2715(2)(a). "Cover" is "making in good faith and without unreasonable delay any reasonable purchase of or contract to purchase goods in substitution for those due from the seller." Com C §2712(1). Failure to cover or otherwise mitigate the loss does not bar all recovery, it merely reduces the buyer's recovery by any amount that could have been avoided.

The breaching party has the burden of proof on the inadequacy of the aggrieved party's efforts to mitigate its consequential damages. *Carnation Co. v Olivet Egg Ranch* (1986) 189 CA3d 809, 229 CR 261.

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§12.78 5. Attorney Fees

Unless attorney fees are specifically provided for by statute—and the Commercial Code does not do so—their recovery in any action is left to the parties' express or implied agreement. For a detailed discussion of California law on recovery of attorney fees in contract litigation, see §§9.12-9.28. If a contract for sale of goods involves consumer goods, however, attorney fees may be recoverable by statute. See CC §1780(e) (part of the Consumers Legal Remedies Act), §1794(d) (part of Song-Beverly Consumer Warranty Act), §1811.1 (part of the Unruh Act governing retail installment sales); 15 USC §2310(d)(2) (part of the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act). See §9.28.

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§12.79 6. Punitive or Exemplary Damages

The Commercial Code prohibits recovery of punitive or exemplary damages unless they are available to an aggrieved party under some other body of law. Com C §1305(a). Punitive damages can be awarded if an independent tort is also proven. See, *e.g., Douglas v Ostermeier* (1991) 1 CA4th 729, 2 CR2d 594; *Cantrell v Amarillo Hardware Co.* (Kan 1979) 602 P2d 1326 (punitive damages awarded against seller who continued to manufacture ladder knowing it to be unsafe); *Fousel v Ted Walker Mobile Homes* (Ariz Ct App 1979) 602 P2d 507 (fraud).

If a sale of consumer goods involves an unfair or deceptive act prohibited by the Consumers Legal Remedies Act (CC §§1770, 1780(a)(4)), a consumer who is a senior citizen or disabled person (defined in CC §1761(f)-(g)) may recover up to $5000 in addition to punitive damages, if the conditions of CC §1780(b) are satisfied.

A willful violation of the Song-Beverly Consumer Warranty Act (CC §§1790-1795.8) may entitle an aggrieved buyer of consumer goods to a statutory penalty of up to two times the buyer's actual damages. The penalty is not available in class actions or actions based solely on breach of an implied warranty. Nor is the penalty available if the defendant manufacturer maintains a "qualified third-party resolution dispute process" that substantially complies with the Act's requirements. CC §1794(c), (e)(2).

Certain willful violations of the Unruh Act governing retail installment sales (CC §§1801-1812.20) may also entitle an aggrieved buyer to a statutory penalty. If the violation related to the imposition, computation, or disclosure of finance charges on two or more contracts, the buyer may recover an amount equal to three times the total of the finance charges and any delinquency, collection, extension, deferral, or refinance charges imposed by the seller. CC §1812.9.

If the subject of the sale is a motor vehicle, bought for personal or family use, and the seller or holder of the conditional sales contract violates any provision of CC §2982(*l*) concerning prepayment and permissible charges, the buyer may recover three times the amount of the finance charge paid to that person, unless the violation was accidental or a bona fide error of computation. CC §2983.1

For further discussion of punitive damages, see §§10.48-10.51.

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.80 7. Deduction of Damages From Price (Com C §2717)

§12.80 7. Deduction of Damages From Price (Com C §2717)

A buyer who has a right to damages under the Commercial Code may deduct them "from any part of the price still due under the same contract." Com C §2717. The buyer must give the seller notice of its intention to withhold all or part of the price if the buyer wishes to avoid a default within the meaning of Com C §2609, which deals with insecurity and the right to adequate assurances of performance.

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§12.81 8. Replevin (Com C §2716(3))

To accommodate buyers who want the goods that they bargained for rather than damages, the Commercial Code provides the buyer with the remedies of replevin—an action for specific recovery of personal property, triable to a jury—and specific performance. Under Com C §2716(3), a buyer has a right of replevin if the goods are identified to the contract and the buyer is unable to cover after reasonable effort or it reasonably appears that any effort to cover would be fruitless. See Com C §2716(3). Replevin is also available if the goods have been shipped under reservation (*i.e.*, the seller has retained some title or a possessory right to secure the buyer's performance, see Com C §2505), in which case the buyer can obtain the goods on satisfying or tendering the amount of the security. Com C §2716(3). With goods purchased for personal, family, or household purposes, the buyer's right to replevin vests on identification of the goods to the contract; the buyer will take the goods free of any security interest that attaches after the goods have been identified. See Official Comment 3 to former UCC §2-716.

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§12.82 9. Specific Performance (Com C §2716(1)-(2))

The drafters of the Commercial Code expanded the common law remedy of specific performance. Commercial Code §2716(1) provides for specific performance "where the goods are unique or in other proper circumstances." In effect, the Commercial Code broadened the definition of "unique" in this context. See Official Comment 2 to former UCC §2-716 ("The test of uniqueness must be made in terms of the total situation which characterizes the contract"). A decree for specific performance may include terms and conditions regarding payment of the price, damages, or other just relief. Com C §2716(2). Output and requirements contracts involving a unique source or market present a typical commercial situation when specific performance may be available.

Specific performance may also be granted "in other proper circumstances." Com C §2716(1). Most frequently, "other proper circumstances" exist when the buyer cannot reasonably cover on the open market.

The remedy of specific performance does not require that the goods first be identified to the contract. If the buyer wants more than the mere seizure of the goods, it should bring an action for specific performance because the court can order payment of the price, award damages, or provide additional relief that it considers just. Com C §2716(2). If the buyer needs to obtain the goods immediately, pending a judgment in the specific performance action, it may be able to utilize the provisional remedy of claim and delivery. If a buyer is unsuccessful in its attempt to have specific performance ordered, it may still recover damages.

For a general discussion of the remedy of specific performance outside the context of the Commercial Code, see §§11.7-11.39.

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10. Restitution of Payments

§12.83 a. After Breach by Seller (Com C §2711(1))

Whenever the buyer is entitled to pursue any of its remedies (except when it has actually received the goods), it may also recover any part of the price that it has paid. Com C §2711(1). If the buyer has possession of the goods (as it often does when it is rejecting or revoking acceptance), it has a security interest in them for the amount of the price paid. Com C §2711(3). An award of lost profits and the restitution of sums paid by the buyer for the goods are not necessarily inconsistent remedies.

If the subject of the sale is a motor vehicle bought primarily for personal or family use and the seller breaches the conditional sales contract or purchase order, the buyer may recover any motor vehicle it left with the seller as a down payment. CC §2981(k). If the seller does not return the vehicle for whatever reason, the buyer may recover either the fair market value of the vehicle or its value as stated in the contract or purchase order, whichever is greater. The vehicle or its value must be tendered to the buyer within 5 business days after the breach. CC §2982.7.

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§12.84 b. After Breach by Buyer (Com C §2718(2))

When a buyer has prepaid in whole or in part and then breaches, the seller may be able to retain the sums paid as liquidated damages if the contract so provides. If the parties have agreed on a reasonable liquidated damages provision, the buyer can recover any payments made in excess of the amount set. Com C §2718(2)(a). If the agreement does not contain such a provision (or if the provision is invalid), the seller may keep 20 percent of the value of the total performance for which the buyer is obligated, but not more than $500. Com C §2718(2)(b). The seller may also keep any provable damages to which it is entitled and the amount or value of any benefits received by the buyer directly or indirectly by reason of the contract. Com C §2718(3)(b).

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III. RESTRICTION, QUALIFICATION, AND ENLARGEMENT OF REMEDIES

§12.85 A. Liquidated Damages (Com C §2718)

A validity of a liquidated damages clause in a contract for the sale of goods is subject to the requirements of Com C §2718 and CC §1671.

Civil Code §1671 states that liquidated damages provisions are valid unless unreasonable at the time of contracting. CC §1671(b). Civil Code §1671(d), however, voids all provisions allowing recovery of liquidated damages from a consumer in any sale of consumer goods, unless from the nature of the case it would be impracticable or extremely difficult to fix actual damages. For further discussion of liquidated damages clauses and CC §1671, see §§10.37-10.44.

Under Com C §2718, damages for breach may not be liquidated in an amount unreasonably high or unreasonably low compared to anticipated harm. If the damages are set too high, the clause is a penalty; if the damages are set too low, the clause may be considered to be unconscionable. Some liquidated damages clauses, masquerading as late charges or provisions for alternative performance, may be void for that reason. See, *e.g., Sybron Corp. v Clark Hosp. Supply Corp.* (1978) 76 CA3d 896, 143 CR 306 ($28,000 penalty for delay in payment of $30,000 made liquidated damages provision unenforceable).

If the liquidated damages provision is invalid, it is void and the parties measure their damages as they would in the absence of the provision. Com C §2719(2). The burden of proof is on the party attempting to establish that the provision is invalid.

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B. Contractual Modification of Remedies (Com C §2719)

§12.86 1. Power to Modify

Subject to certain limitations, Com C §2719 allows the parties to modify the Commercial Code's scheme of remedies in their contract by providing for remedies in addition to or in place of those in the Commercial Code and by limiting or altering the measure of damages recoverable. More generally, Com C §1302 authorizes the parties to vary the effect of Code provisions, except that the obligations of good faith, diligence, reasonableness, and care prescribed by the Code may not be disclaimed by agreement.

For example, the parties may limit the measure of damages to profits. The seller may require the buyer to measure its damages solely by market price at some fixed time after a breach. The buyer may require the seller to measure its damages solely by resale or solely by market price at some fixed time after a breach. In *S. M. Wilson & Co. v Smith Int'l* (9th Cir 1978) 587 F2d 1363, the Ninth Circuit Court of Appeals held that the failure of the parties' repair or replace remedy did *not* also cause the parties' disclaimer of consequential damages to fail when (1) the repair-or-replace remedy and disclaimer of consequential damages were each carefully negotiated at arm's length between commercial equals; (2) the machinery sold (a tunnel-boring machine) was so complicated that is was understood to involve risk; (3) the parties agreed to allocate that risk to the buyer in the form of the damages disclaimer; and (4) the seller did not ignore its obligation to repair but simply was unable to perform it.

In *Milgard Tempering, Inc. v Selas Corp.* (9th Cir 1990) 902 F2d 703, however, the Ninth Circuit Court of Appeals suggested that a consequential damages limitation will not be enforced if the seller's failure to repair is "total and fundamental" or when the limitation becomes "oppressive." Although the court acknowledged the four factors discussed in *S.M. Wilson & Co. v Smith Int'l, Inc., supra,* its primary focus was whether the seller's default caused a loss that was a bargained-for element of the parties' risk allocation. See *Milgard Tempering, Inc.,* 902 F2d at 709. See also *Fiorito Bros., Inc. v Fruehauf Corp.* (9th Cir 1984) 747 F2d 1309 (question of whether disclaimer of consequential damages can survive failure of repair or replace remedy should be answered on case-by-case basis).

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2. Limitations

§12.87 a. Overview

There are several limitations on the parties' right to provide for or modify remedies by contract:

- The contract cannot deprive a party of all effective remedies. See Com C §2719(2); Official Comment 1 to UCC §2-719.
- The limitation or exclusion cannot be unconscionable. See Com C §2719(3). A limitation of consequential damages for personal injury in the case of consumer goods is subject to a rebuttable presumption that it is unconscionable. Com C §2719(3).
- Under the Airline Deregulation Act of 1978 (49 USC §41713), federal common law governs contractual clauses that limit interstate carriers' liability for damage to goods shipped by air. State law is preempted in this area. *King Jewelry, Inc. v Federal Express Corp.* (9th Cir 2003) 316 F3d 961, 964; *Wayne v DHL Worldwide Express* (9th Cir 2002) 294 F3d 1179, 1183.

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§12.88 b. Types of Clauses

Clauses limiting the seller's liability to repair or replace defective parts may fail of their essential purposes. The Commercial Code allows the seller to limit by contract the seller's warranties and the buyer's remedies. Limiting remedies and limiting warranties are distinct concepts, each governed by a different Code provision and body of law. Warranty limitations are governed by Com C §2316; remedy limitations are governed by Com C §2719.

Although remedy and warranty limitations are distinct, they often appear together in contracts and can raise interrelated legal issues. Commercial Code §2316 authorizes a seller to negate or limit a warranty concerning the goods. If the seller complies with the requirements specified in Com C §2316, it effectively reduces the quality standards that the goods must otherwise meet. If a limited warranty is nevertheless breached, a limitation on contractual remedies may still apply to the buyer's recourse against the seller.

The buyer and seller can contractually agree that remedies such as cancellation (Com C §2711), cover (Com C §2712), market price damages (Com C §2713), and consequential damages (Com C §2715) will not be available to the buyer and that the buyer's only remedy is the repair or replacement of defective parts. In fact, the Commercial Code creates a presumption in favor of cumulation rather than restriction of remedies. See Official Comment 2 to UCC §2-719. Accordingly, a contractual provision that gives one party a particular remedy is considered to create an optional, rather than a sole, remedy unless the remedy provided "is expressly agreed to be exclusive." Com C §2719(1)(b).

The parties cannot agree to remedies that violate the restrictions of Com C §2718 on liquidated damages. Com C §2719(1).

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§12.89 c. Repair Time

If the seller cannot fix the goods, refuses to fix them, or takes so long to fix them that the buyer cannot receive the benefit of its bargain, the buyer may resort to its regular Commercial Code remedies because the exclusive or limited remedy "fail[ed] of its essential purpose." Com C §2719(2). Unfortunately, the Commercial Code does not provide a clear guideline for when the seller's allotted time for repair runs out. In one case, the court held that the repair-or-replace remedy failed of its essential purpose when the breaching seller was unable to make the repairs within a "reasonable" time period. See *Milgard Tempering, Inc. v Selas Corp.* (9th Cir 1990) 902 F2d 703.

A time limitation fails if latent defects are not discoverable until after the time has expired. See *Held v Mitsubishi Aircraft Int'l* (D Minn. 1987) 672 F Supp 369 (design defects in airplane not discovered until after its crash). In addition, a clause excluding consequential damages in accordance in Com C §2719(3) should be stated separately in the sales contract. The contract should provide that the disclaimer will not be affected by any failure of the repair or replace remedy. The contract should also state that the buyer has accepted the exclusion of damages as part of the bargain to lower the price of the goods and that the buyer understands that the price of the goods would be higher if the seller were required to bear consequential damages.

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§12.90 d. Consumer Goods

If the sale involves consumer goods, there may be remedies that the seller cannot require the buyer to waive, such as warranty protections and related remedies. See, *e.g.,* CC §§1751, 1792.3, 1801.1, 1804.1, 2983.7. Specifically, CC §1790.1 (part of the Song-Beverly Consumer Warranty Act) states that any waiver by the buyer of consumer goods, except as expressly allowed in the statute, shall be deemed contrary to public policy and shall be unenforceable and void. The Consumer Warranty Act also states that implied warranties of merchantability or fitness are not waived in the sale of consumer goods unless the Act's provisions concerning "as is" or "with all faults" sales have been strictly followed. CC §1792.3.

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§12.91 C. Cumulation and Election of Remedies

In addition to Commercial Code remedies, there are remedies available outside the Code for material misrepresentation or fraud (see CC §§1709-1710, 3343) that apply to sales contracts. Com C §1103. The Code rejects any doctrine of election of remedies. Official Comment 1 to UCC §2-703. A party's remedies will be protected even if its words or actions might otherwise be held to constitute an election or waiver of rights. For example, a party's expressions of "cancellation" or "rescission" will not be construed as a renunciation or discharge of any claim unless that intention "clearly appears." Com C §2720. An attorney drafting a cancellation of a contract should include a release of claims under the contract to ensure that cancellation will be given practical effect. See Official Comment to UCC §2-720.

Regardless of the Commercial Code's treatment of the cumulation of remedies issue, exercising some non-Code remedies may result in an election by the plaintiff. These remedies include attachment, claim and delivery, and creditors' claims against a bankruptcy estate. Thus, to avoid violating non-Code election-of-remedy principles, the attorney should exercise caution when combining Code and non-Code remedies.

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IV. REMEDIES FOR BREACH OF LEASES OF GOODS

A. Lessee's Remedies

§12.92 1. General Provisions

Because lease agreements subject to Division 10 may not detail the events that would constitute a default by the lessor, or the remedies available to the lessee when the lessor defaults, Commercial Code provisions addressing these matters have particular importance. The Code identifies the following events as defaults by the lessor (Com C §10508(a)):

- The lessor's failure to deliver the goods in conformity with the lease agreement;
- The lessor's repudiation of the lease agreement;
- The rightful rejection of the goods by the lessee; and
- The rightful revocation of acceptance of the goods by the lessee.

If the lessor's default is not one of those listed above, the lessee is entitled to any remedies that are available under the lease agreement and to recover its foreseeable losses. Com C §§10508(c), 10519(c).

A party seeking to enforce the lease may reduce its claim to judgment or otherwise employ self-help or any available judicial procedure or nonjudicial procedure, including an administrative proceeding, arbitration, or the like, under Division 10. Com C §10501(c). Unless otherwise provided in the Commercial Code, all rights and remedies under the lease contract and Division 10 are cumulative. Com C §10501(d).

Following the occurrence of an event of default, the lessee may (Com C §10508(a)(1)-(4)):

- Cancel the lease agreement (Com C §10505);
- Recover as much of the rent and security previously paid as is just under the circumstances;
- Cover and recover damages as to all affected goods, whether or not they have been identified to the lease (Com C §§10518, 10520) or recover damages for nondelivery (Com C §§10519-10520); or
- Exercise any other right or pursue any other remedy set forth in the lease agreement.

If a lessor fails to deliver the goods in conformity to the lease contract or repudiates the lease contract, the lessee may also (1) recover the goods if they have been identified (Com C §10522), or (2) in a proper case, obtain specific performance or replevy the goods (Com C §10521). Com C §10508(b). Subject to Com C §10407, a lessee, on notifying the lessor of the lessee's intention to do so, may deduct all or any part of the damages resulting from any default under the lease contract from any part of the rent still due under the same lease contract. Com C §10508(f). Commercial Code §10407 states an exception to this right applicable to finance leases, giving the lessor statutory "hell or high water" protection. See Com C §§10407, 10508(f).

If the lease in question covers both goods and real property, the aggrieved party may proceed either under Division 10 with respect to the goods but not the real property, or under real property law, in which case Division 10 does not apply by its own terms. Com C §10501(e).

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§12.93 2. Notice to Lessor (Com C §10502)

Notice of default is required only to the extent provided in Division 10 or in the lease agreement. Com C §10502. If a tender has been accepted, (1) the lessee must notify the lessor and the supplier (if any) within a reasonable time after the lessee discovers or should have discovered any default, or be barred from any remedy against the party not notified, and (2) if the lessee receives notice of litigation for infringement, the lessee must notify the lessor within a reasonable time or be barred from any remedy over for liability established by the litigation. Com C §10516(c). These provisions do not apply to consumer leases. Com C §10516(f). Special notice requirements apply in the event a lessee is sued for breach of a warranty or other obligation for which a lessor or a supplier is answerable (Com C §10516(d)-(e)) and the lessor or the supplier may demand in writing that the lessee turn over control of the litigation. See Com C §10516(d).

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§12.94 3. Rejection of the Goods (Com C §§10509-10510, 10513-10514)

If the goods or the tender or delivery under a lease of goods fail in any respect to conform to the lease contract, the lessee may reject or accept the goods or accept any commercial unit or units and reject the rest of the goods. Com C §10509(a). Rejection of goods is ineffective unless it is done within a reasonable time after tender or delivery of the goods and the lessee seasonably notifies the lessor. Com C §10509(b). In cases involving installment lease contracts, the rules for rejection are substantially the same as those for rejection of installment sales contracts. See Com C §§2612(2), 10510; §12.31.

If any tender or delivery is rejected because it is nonconforming and the time for performance has not yet expired, the lessor or supplier may seasonably notify the lessee of its intention to cure and may then make a conforming delivery within the time provided in the lease contract. Com C §10513(a). If the lessee rejects a nonconforming tender that the lessor or the supplier had reasonable grounds to believe would be acceptable with or without money allowance, the lessor or the supplier may have a further reasonable time to substitute a conforming tender with seasonable notice to the lessee. Com C §10513(b).

If a lessor or supplier could have cured a defect had it received seasonable notice of its existence, or (for leases between merchants) if the lessor or the supplier had requested in writing a full and final written statement of all defects after rejection, but the lessee failed to notify the lessee or supplier of a particular defect that was ascertainable by reasonable inspection, the lessee cannot rely on that defect to justify rejection or to establish default. Com C §10514(a).

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§12.95 4. Revocation of Acceptance (Com C §10517)

A lessee may revoke acceptance of a lot or commercial unit whose nonconformity substantially impairs its value to the lessee after the lessee has accepted it if (1) except in the case of a finance lease, on the reasonable assumption that its nonconformity would be cured but it has not been seasonably cured, or (2) without discovery of the nonconformity if the lessee's acceptance was reasonably induced either by the lessor's assurances or, except in the case of a finance lease, by the difficulty of discovery before acceptance. Com C §10517(a). A lessee may revoke acceptance of a lot or commercial unit if the lessor defaults under the lease contract and the default substantially impairs the value of that lot or commercial unit to the lessee. Com C §10517(b). Lease agreements providing that the lessee may revoke acceptance of a lot or commercial unit because of other defaults by the lessor are enforceable according to their terms. Com C §10517(c).

Revocation of acceptance must occur within a reasonable time after the lessee discovers or should have discovered the ground for it and before any substantial change in condition of the goods that is not caused by the nonconformity. Revocation is not effective until the lessee notifies the lessor. Com C §10517(d). A lessee who so revokes has the same rights and duties with regard to the goods involved as if the lessee had rejected them. Com C §10517(e).

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§12.96 5. Security Interest (Com C §10508(e))

On rightful rejection or justifiable revocation of acceptance, a lessee has a security interest in goods in the lessee's possession or control for any rent and security that has been paid and any expenses reasonably incurred in their inspection, receipt, transportation, or care and custody. The lessee may hold the goods and dispose of them in good faith and in a commercially reasonable manner, but is accountable to the lessor for any amounts received over the amount of the lessee's security interest. Com C §§10508(e), 10527(e).

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6. Damages

§12.97 a. Measure of Damages Following Cover (Com C §10518)

Following the lessor's default, the lessee has the right to cover by either purchasing or leasing substitute goods. Com C §10518(a). Although the lessee is not *required* to cover, failure to do so may bar the lessee's recovery of consequential damages. Com C §10520(b)(1). To qualify for this measure of damages, the cover lease must be substantially similar to the original lease and must be entered into in good faith and in a commercially reasonable manner. Com C §10518(b). The damages recoverable with qualifying cover lease equal (Com C §10518(b)):

- The present value of rental payments payable for the portion of the cover lease term that is comparable to the remaining term of the original lease, minus
- The present value of the rent payable for the remaining term of the original lease.

As a result, a lessee that improves its position under a cover lease would not recover damages by this measure.

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§12.98 b. Measure of Damages Without Cover or Nonqualifying Cover (Com C §10519)

If a lessee covers by purchasing goods or obtains a covering lease that for any reason is not considered to be comparable to the original lease, it is as if the lessee has elected not to cover at all. In such a case, the measure of damages is (Com C §10519(a)):

- The present value of a market rate of rent for a period equaling the remaining balance of the original lease term, minus
- The present value of the actual rent payable under the original lease agreement for the balance of the term.

Thus, if the market rate is less than the rate of rent under the original lease agreement, the lessee will have suffered no damages under this formula. Market rent is determined as of the place for tender or, in cases involving rejection after arrival or revocation of acceptance, as of the place of arrival. Com C §10519(b).

If the lessee accepts nonconforming goods but notifies the lessor of the nonconformity within a reasonable period after acceptance (see Com C §10516(c)(1)), the lessee preserves the right to recover damages. The measure of damages is the loss resulting in the ordinary course of events from the lessor's default, determined in any reasonable manner. Com C §10519(c).

If the lessee's loss results from the lessor's breach of warranty, the measure of damages is the difference between the present value of the goods at the time of acceptance if they had been as warranted for the lease term and the actual value of the goods as accepted, unless special circumstances show proximate damages of a different amount. Com C §10519(d).

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§12.99 c. Incidental and Consequential Damages

In addition to the damages measures described in §§12.97-12.98, a lessee is entitled to receive incidental and consequential damages. See Com C §§10518(b), 10519. Incidental damages resulting from a lessor's default include the expenses incurred by the lessee in the inspection, transportation, receipt, care, and custody of goods that have been rightfully rejected (or with respect to which acceptance has been rightfully revoked), plus any charges, expenses, or commissions incurred by the lessee in effecting cover, and any other reasonable expense incident to the default. Com C §10520(a).

Consequential damages resulting from a lessor's default include losses stemming from any general or particular requirements of the lessee that the lessor had reason to know and that could not reasonably be prevented by cover or other means. Com C §10520(b)(1). See *Bescos v Bank of America* (2003) 105 CA4th 378, 129 CR2d 423. Consequential damages also include any loss resulting from injury to person or property that was proximately caused by a lessor's breach of warranty. Com C §10520(b)(2).

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.100 7. Specific Performance and Other Remedies (Com C §10521)

§12.100 7. Specific Performance and Other Remedies (Com C §10521)

The remedy of specific performance is available to the lessee if the leased goods are unique or there are other circumstances that provide the basis for a decree of specific performance. Com C §10521(a). A decree of specific performance may include any terms and conditions regarding payment of rent, damages, or other relief that the court considers just. Com C §10521(b). A lessee also has the right to remedies such as replevin, detinue, sequestration, and claim and delivery, if the lessee makes a reasonable attempt to effect cover but is unable to obtain substitute goods (or if it is clear from the circumstances that such an effort would be unsuccessful). Com C §10521(c).

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§12.101 8. Restitution

If the lessor justifiably withholds or stops delivery of goods because of the lessee's default or insolvency, the lessee is entitled to restitution of a portion of any payments already made. If the lessee's payments exceed the liquidated damages to which the lessor is entitled under a valid liquidated damages clause, the lessor must return the difference to the lessee. Com C §10504(c)(1).

If the lease agreement does not contain a valid liquidated damages clause, the amount that the lessor must return is determined by calculating the present value of the rent payable for the balance of the lease term and then subtracting 20 percent of that figure from the amount of lease payments already made. The balance of any lease payments made must be returned to the lessee. Com C §10504(c)(2). This is essentially a statutory form of liquidated damages that allows the lessor to keep 20 percent of whatever remaining value the lease has. If the lease agreement does not specify an interest rate that can be used for calculating present value, the discount is determined using a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into. Com C §10103(a)(21). The same approach is used if the parties have chosen a discount rate that is "manifestly unreasonable." Com C §10103(a)(21).

In making a payment of restitution, the lessor is entitled to offset its other damages (*i.e.,* those not already included in the liquidated damages remedy) together with the amount or value of any benefits that the lessee has received through performance of the lease agreement. Com C §10504(d).

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B. Lessor's Remedies

§12.102 1. General Provisions (Com C §10523)

The Commercial Code identifies the following events as defaults by the lessee (Com C §10523(a)):

- Wrongful rejection of the goods;
- Wrongful revocation of the lessee's acceptance of the goods;
- Failure to make a payment due under the lease agreement;
- Repudiation of the lease agreement; and
- Commission of some other default that substantially impairs the value of the lease agreement to the lessor.

On the occurrence of one of the above events, the lessor may take the following actions (Com C §10523(a)(1)-(5)):

- Cancel the lease agreement;
- Dispose of the goods (or salvage or complete uncompleted goods);
- Withhold delivery of the goods or retake possession of goods previously delivered;
- Stop delivery of the goods;
- Dispose of the goods and recover damages;
- Retain the goods and recover damages; and
- In a proper case, recover rent.

In addition, the lessor may exercise any other right or pursue any other remedy provided by the lease agreement. Com C §10523(a)(6). If the lessor does not fully exercise a right or obtain a remedy described above, the lessor may recover the loss resulting in the ordinary course of events from the lessee's default as determined in any reasonable manner, together with incidental damages, less expenses saved in consequence of the lessee's default. Com C §10523(b).

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§12.103 2. Retention or Repossession of Goods (Com C §10525)

The lessor has the right to either retain or retake possession of leased goods under the circumstances specified in the lease, and also if the lessor discovers before delivery of the goods that the lessee has become insolvent, or if the lessee commits one of the defaults identified in §12.102. Com C §10525(a)-(b). A lease agreement may require the lessee to assemble goods at the lessor's direction and make them available for the lessor's repossession. In addition, the lessor may render goods unusable without repossession and dispose of them on the lessee's premises. Com C §10525(b).

A lessor is permitted to exercise the right of repossession through self-help if the lessor can do so without risking a breach of the peace. Otherwise, the lessor must proceed by court action. Com C §10525(c). As a practical matter, unless a lessee agrees to relinquish possession to the lessor, the lessor will be required to forgo the self-help remedy and proceed in court. A lessor is not required to dispose of repossessed goods. However, if the lessor chooses to dispose of repossessed goods, by sale or otherwise, no notice to the lessee is necessary and the lessor is not accountable to the lessee for any profit from the disposition. See Com C §10527.

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.104 3. Disposition of Goods Under Substantially Similar Lease (Com C §10527)

§12.104 3. Disposition of Goods Under Substantially Similar Lease (Com C §10527)

Under certain circumstances, the lessor has the right to dispose of leased goods and recover damages. The right of disposition is triggered by any event that gives the lessor the right to retain possession of the goods or retake possession under Com C §10525. Com C §10527(a). See §12.103. If the lessor, acting in good faith and in a commercially reasonable manner, disposes of the goods by a new lease agreement that is substantially similar to the original lease agreement, the lessor is entitled to recover the damages specified in Com C §10527(b). Otherwise, the measure of damages is as specified in Com C §10528. Com C §10527(c). See §12.105. Whether the new lease agreement is substantially similar to the original is determined on a case-by-case basis. See Official Comment 5 to UCC §2A-527.

Under Com C §10527(b), the lessor can receive the accrued and unpaid rent under the original lease plus the difference between the present value of total rent for the remaining term of the original lease as of the date of recovery and the present value of rent under the new lease for the comparable period, plus incidental damages and less any expenses saved as a result of the lessee's default. On calculating present value, see Com C §10103(a)(21).

If the lessor's position improves under the new lease, the formula in Com C §10527(b) will not result in any damages for future rentals owed to the lessor. The lessor, however, is not accountable to the lessee for any profit made by the reletting. Com C §10527(e). In contrast, a lessee must account for any excess over the amount of the lessee's security interest under Com C §10508 on disposition of goods following a rightful rejection or justifiable revocation of acceptance. Com C §10527(e). See §12.96.

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4. Damages

§12.105 a. Measure of Damages in Absence of Qualifying Disposition (Com C §10528)

Unless the lease agreement has a liquidated damages clause or specifies some other remedy, the amount of damages recoverable by a lessor who does not dispose of retained or repossessed goods is governed by Com C §10528(a). The same provision applies if the retained or repossessed goods are sold by the lessor or the goods are relet under a new lease agreement that is not substantially similar to the original lease and that has been entered into in good faith and in a commercially reasonable manner. Com C §10528(a). In either situation, the lessor is entitled to receive the accrued and unpaid rent as of the date of the default (if the lessee never took possession of the goods) or else the date of repossession or tender of the goods back to the lessor (if the lessee took possession but the goods have been returned to the lessor). Com C §10528(a). In addition, the lessor is entitled to receive, as of the same date (whichever applies), the present value of the rent for the remaining term of the original lease, minus the present value of market rent for the goods for the same period. Com C §10528(a). See Com C §10103(a)(21) on calculating present value.

In some circumstances, recovery of the foregoing damages may be inadequate to put a lessor in as good a position as performance would have. In those circumstances, the lessor is entitled to receive (a) the present value of the profit, including reasonable overhead, that the lessor would have made if the lessee had completely performed the lease agreement, (b) any incidental damages, and (c) an allowance for reasonably incurred costs and credit for payments or proceeds of disposition. Com C §10528(b).

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.106 b. Recovery of Rent for Balance of Lease Term (Com C §10529)

§12.106 b. Recovery of Rent for Balance of Lease Term (Com C §10529)

Under certain conditions, the lessor has the right to recover rent for the balance of the lease term. For this remedy to apply, the lessee must have committed one of the defaults listed in Com C §10523(a) or §10523(c)(1) or some other default for which the parties have agreed that rent recovery will be available as a remedy. The remedy is available following such a default when the circumstances make it impractical for the lessor to sell or relet the property. This may arise in the following situations:

- When the lessee has retained possession of the goods after acceptance and has not tendered them back to the lessor, and the lessor has not repossessed them (Com C §10529(a)(1));
- When the goods were damaged or lost after the risk of loss (see Com C §10219) passed to the lessee (Com C §10529(a)(1)); or
- When the goods were identified to the lease agreement but were not delivered, or were delivered but repossessed or tendered back by the lessee, and the lessor is unable to dispose of them after making a reasonable effort (or encounters circumstances that would make an attempt to sell or relet futile) (Com C §10529(a)(2)).

In the foregoing situations, the lessor is entitled to receive any accrued and unpaid rent under the lease agreement plus an amount equal to the present value of rent for the remaining term of the lease. Com C §10529(a). On calculating present value, see Com C §10103(a)(21).

If a lessor is entitled to receive rent for the balance of the lease term as damages, the lessee is entitled to the possession and use of the goods for the balance of the term in accordance with the terms of the lease agreement. In such circumstances, the lessor is required to hold for the lessee any goods in the lessor's control that are identified to the lease contract. Com C §10529(b)-(d).

If a lessor obtains a judgment against a lessee for unpaid rent, however, the lessor is free to dispose of the goods before collecting that judgment. Com C §10529(c). In that situation, the lessor's recovery against the lessee is governed by either Com C §10527 or Com C §10528, depending on the nature of the disposition. The lessee is entitled to receive a credit against the judgment to the extent that the rental damages recovered under Com C §10529 exceed the amount of disposition damages that would have been available under §10527 or §10528.

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§12.107 c. Incidental Damages (Com C §10530)

Whenever the lessor is entitled to recover damages on account of the lessee's default, those damages include incidental damages. "Incidental damages" are defined to include any commercially reasonable charges, expenses, or commissions incurred in stopping delivery, transporting, or providing for the care and custody of goods after the lessee's default in connection with return or disposition of the goods or otherwise resulting from the lessee's default. Com C §10530. Thus, the incidental damages to which a lessor is entitled are substantially the same as those to which a seller is entitled under Division 2. See Com C §2710; §12.55.

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§12.108 d. Consequential Damages

The Commercial Code does not create a right to recover, or directly prohibit the recovery of, consequential damages by a lessor. Although Division 10 expressly addresses the issue of consequential damages with respect to a claim for damages by a lessee, there is no corresponding provision that address the rights of a lessor. Com C §1305(a) (former Com C §1106(1)) states that consequential damages are not recoverable unless specifically allowed by a provision of the Commercial Code "or by other rule of law." In considering whether a lessor is entitled to recover consequential damages, one court concluded that the absence of a provision in the Commercial Code meant only that such damages were recoverable under a lease to the same extent as in any contract. *Linc Equip. Servs., Inc. v Signal Med. Servs., Inc.* (7th Cir 2003) 319 F3d 288.

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C. Other Remedies

§12.109 1. Liquidated Damages (Com C §10504)

The parties may by agreement liquidate the damages payable by either party on account of a default, including consequential damages. Com C §§10503(c), 10504(a). Any liquidated damages provision, however, must comply with CC §1671. See §§10.39-10.47. Division 10 does not incorporate two other tests that under Division 2 (Com C §2718) determine the enforceability of liquidated damages clauses, *i.e.,* the difficulty of proving loss and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. Cal Comment to Com C §10504. See §12.85.

One liquidated damages formula that is common in leasing practice provides that the lessor's damages include the sum of lease payments past due, accelerated future lease payments (discounted to present value), and the lessor's estimated residual interest (discounted to present value), less the net proceeds of disposition of the leased goods (whether by sale or re-lease). Tax indemnities, costs, interest, and attorney fees are also added to the lessor's damages. Another common formula provides for a fixed number of periodic payments as a means of liquidating damages. Stipulated loss or stipulated damages schedules are also common. Whether these formulas are enforceable will be determined by applying the reasonableness test of CC §1671. See California Comment to Com C §10504. Division 10 expressly acknowledges the legitimacy of including loss of anticipated tax benefits in a liquidated damages provision. Com C §10504(a).

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Source: Business Law/California Law of Contracts/12 Remedies: Commercial Code/§12.110 2. Cancellation; Termination (Com C §10505)

§12.110 2. Cancellation; Termination (Com C §10505)

The Commercial Code distinguishes between "cancellation" and "termination" of a lease agreement. Cancellation occurs when either party puts an end to the lease contract on account of a default by the other party. Com C §10103(a)(2). Termination occurs when either party, under a power created by agreement or law, puts an end to the lease contract other than on account of the other party's default. Com C §10103(a)(26). In either situation, the parties' obligations that are still executory on both sides are completely discharged. Com C §10505(a)-(b). If the lease was canceled rather than terminated, the canceling party retains any remedy for the other party's default in performance of all or part of the lease contract. Com C §10505(a).

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13

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§13.1 I. INTRODUCTION

The United Nations Convention on Contracts for the International Sale of Goods, opened for signature April 11, 1980, S Treaty Doc. No. 9 (1983), 19 ILM 671, reprinted in 15 USC App at 333 (the "CISG") and the UNIDROIT Principles of International Commercial Contracts 2004 (the "UNIDROIT Principles") are two bodies of contract law principles created with the twin aims of harmonizing the law of trading nations and producing international rules to govern international commerce. See generally Goplan, *Transnational Commercial Law: The Way Forward*, 18 Am U Int'l L Rev 803 (2003). Although most judges and practitioners may be unaware of this, the CISG is a treaty of the United States and, therefore, by operation of the Supremacy Clause of the U.S. Constitution, is the law of all 50 of the United States and the federal territories and commonwealths. See Gordon, *Some Thoughts on the Receptiveness of Contract Rules in the CISG and Unidroit Principles as Reflected in One State's (Florida) Experience of (1) Law School Faculty, (2) Members of the Bar with an International Practice, and (3) Judges*, 46 Am J Comp L 361 (1998).

Unlike the CISG, however, the UNIDROIT Principles have not been enacted or adopted by any nation state. Accordingly, they lack the force of law and, to apply, must be affirmatively selected by the parties at the time of contracting or thereafter. See UNIDROIT Principles, Preamble. See §13.56. Although lacking the force of law, the UNIDROIT Principles have had some success, mostly in their application in arbitrations. See Bonell, *UNIDROIT Principles 2004— The New Edition of the Principles of International Commercial Contracts adopted by the International Institute for the Unification of Private Law*, Uniform L Rev 2004 at 5-40 (2004). Despite appearing to remain largely "under the radar" in American jurisprudence, the CISG and UNIDROIT Principles are important for California attorneys and judges to understand and use in the increasingly international field of business law.

The CISG is the work of the United Nations Commission on International Trade Law (UNCITRAL), an important source of model codes, conventions, and similar documents in addition to the CISG. There are other groups of states and nongovernmental organizations that seek to influence or harmonize international contract law (see, *e.g.,* Malloy, *The Interamerican Convention on the Law Applicable to International Contracts: Another Piece of the Puzzle of the Law Applicable to International Contracts*, 19 Fordham Int'l LJ 662 (1995), but none is anywhere near as influential as the work of UNCITRAL.

This chapter describes the CISG and the UNIDROIT Principles in some detail and provides information on the activities and work product of UNCITRAL and UNIDROIT.

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II. UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (UNCITRAL)

§13.2 A. Overview

The United Nations Commission on International Trade Law (UNCITRAL), the body that produced the CISG, is the core legal body within the United Nations dealing with international trade law. It was established by the General Assembly in 1966. UNCITRAL is composed of sixty member States elected by the General Assembly. Membership is intended to be representative of the world's various geographic regions and its principal economic and legal systems. In addition to the CISG, UNCITRAL has produced over 25 model codes, conventions, rules, and practical guides on the subject and provides educational and technical assistance on these matters worldwide. See generally http://www.uncitral.org. The Secretariat of UNCITRAL is the International Trade Law Branch of the United Nations Office of Legal Affairs in Vienna. See http://www.uncitral.org/uncitral.

UNCITRAL's stated goal is the modernization and harmonization of rules on international business to promote trade and, with it, faster growth, higher living standards, and new opportunities through commerce. To increase these opportunities worldwide, UNCITRAL seeks to formulate modern, fair, and harmonized rules on commercial transactions, including conventions, model laws and rules; practical legal guides and recommendations; updated information on case law and enactments of uniform commercial law; technical assistance in law reform projects; and regional and national seminars on uniform commercial law. Information on UNCITRAL's current projects and recent accomplishments may be found at http://www.uncitral.org/uncitral.

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Source: Business Law/California Law of Contracts/13 Selected International Issues/§13.3 B. Selected UNCITRAL Model Codes, Rules, and Conventions

§13.3 B. Selected UNCITRAL Model Codes, Rules, and Conventions

Following is a partial list of some of the UNCITRAL model codes, rules, and conventions relating to international contracts. The UNCITRAL Yearbook, published in English, French, Russian, and Spanish, is a compilation of all substantive documents related to UNCITRAL's work. Information on this and other publications is available at http://www.uncitral.org/uncitral/en/about_us.html.

- **United Nations Convention on the Limitation Period in the International Sale of Goods (1974, in force 1988).** This Convention establishes uniform rules governing the period of time within which legal proceedings arising from an international sales contract must be commenced. It was amended by a Protocol adopted in 1980.
- **UNCITRAL Arbitration Rules (1976).** The UNCITRAL Arbitration Rules provide a comprehensive set of procedural rules on which parties may agree for the conduct of arbitral proceedings arising out of their commercial relationship. In 1982, UNCITRAL also published recommendations to assist arbitral tribunals and other interested bodies with regard to arbitrations under the UNCITRAL Arbitration Rules.
- **UNCITRAL Conciliation Rules (1980).** When parties to a commercial dispute wish to settle their disputes amicably through conciliation, these rules may be adopted to govern the conciliation proceedings.
- **United Nations Convention on Contracts for the International Sale of Goods (1980, in force 1988).** The CISG establishes a comprehensive code of legal rules governing the formation of contracts for the international sale of goods, the obligations of the buyer and seller, remedies for breach of contract, and other aspects of international sales contracts. The CISG is discussed further in §§13.4-13.51.
- **UNCITRAL Model Law on International Commercial Arbitration (1985).** This Model Law is designed to assist nations in reforming and modernizing their laws on arbitral procedures so as to take into account the particular features and needs of international commercial arbitration.
- **United Nations Convention on International Bills of Exchange and International Promissory Notes (1988).** This Convention provides a comprehensive code of legal rules governing new international instruments for optional use by parties to international commercial transactions. It is designed to overcome the major disparities and uncertainties that have existed for instruments used for international payments. The Convention applies if the parties use a particular form of a negotiable instrument indicating that the instrument is subject to the UNCITRAL Convention.
- **UNCITRAL Model Law on International Commercial Conciliation (2002).** This Model Law is designed to assist nations in creating new, or enhancing existing, legislation governing the use of conciliation or mediation conducted by a neutral third party (or parties) to amicably settle disputes that may arise in the course of international commercial relations.
- **UNCITRAL Model Law on International Credit Transfers (1992).** This Model Law deals with operations beginning with an instruction by an originator to a bank to place at the disposal of a beneficiary a specified amount of money.
- **United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1995).** This Convention is designed to facilitate the use of independent guaranties and stand-by letters of credit. The Convention also solidifies recognition of common basic principles and characteristics shared by independent guaranties and stand-by letters of credit.
- **UNCITRAL Model Law on Electronic Commerce (1996).** This Model Law is intended to facilitate the use of modern means of communications and storage of information, such as electronic data interchange (EDI), electronic mail, and telecopy, with or without the use of such support as the Internet. It is based on the establishment of a functional equivalent for paper-based concepts such as "writing," "signature," and "original."
- **UNCITRAL Model Law on Cross-Border Insolvency (1997).** The purpose of this Model Law is to promote modern and fair legislation for cases in which the insolvent debtor has assets in more than one State.
- **UNCITRAL Model Law on Electronic Signatures (2001).** This Model Law is intended to bring additional legal certainty regarding the use of electronic signatures. Building on the flexible principles contained in article 7 of the

UNCITRAL Model Law on Electronic Commerce (1996), it establishes a presumption that if they meet certain criteria of technical reliability, electronic signatures shall be treated as equivalent to hand-written signatures. The Model Law follows a technology-neutral approach and avoids favoring the use of any specific technical product.

- **United Nations Convention on the Assignment of Receivables in International Trade (2001).** The main objective of this Convention is to promote the movement of goods and services across national borders by facilitating increased access to lower-cost credit. To achieve this objective, the Convention, among other things, removes legal obstacles to certain international financing practices (*e.g.,* by validating assignments of future receivables and bulk assignments and by partially invalidating contractual limitations to the assignment of receivables).

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III. UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS (CISG)

§13.4 A. Introduction

As noted in §13.1, the CISG, as a treaty of the United States, is the law of California and the rest of the states. It applies to contracts within its scope absent an express, affirmative opt-out by the parties. A choice of law provision that merely selects the law of California is *not* sufficient to opt out of the CISG—the CISG *is* the law of California. See *Asante Technols., Inc. v PMC Sierra, Inc.* (ND Cal 2001) 164 F Supp 2d 1142, 1149.

The full text of the treaty is available online at http://www.cisg.law.pace.edu/cisg/text/treaty.html. Ratified by the U.S. Senate in 1986, the CISG is a self-executing treaty that creates a private right of action in federal court. *Genpharm Inc. v Pliva-Lachema* (ED NY 2005) 361 F Supp 2d 49, 54.

The United States is one of 57 nations, including Australia, Canada, Chile, China, France, Germany, Italy, Mexico, and Russia, that have ratified the CISG. One should not assume that all European countries, or all "first world" countries, are signatories. See, *e.g., Valero Marketing & Supply Co. v Greeni Oy* (D NJ 2005) 373 F Supp 2d 475, 479, rev'd on other grounds (3d Cir 2007) 242 Fed Appx 840 (unpublished opinion) (Finland and United States are signatories, so CISG applied to all issues except contract formation, which Finland has opted out of).

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§13.5 B. Some Key Differences Between CISG and UCC

American attorneys confronting the CISG for the first time may be taken with its apparent similarity to the Uniform Commercial Code and may tend to assume that it represents the internationalization of the UCC. This would be a mistake. Although there are many similarities, there are also some significant differences between the CISG and the UCC. Among others:

- **The UCC's and CISG's differing scope of applicability.** The UCC applies to "all things [that] are movable at the time of identification to the contract," excluding the monetary purchase price for the goods, investment securities, and causes of action, but including the unborn young of animals, growing crops, and other things attached to the land that are later to be severed from it." Former UCC §2-105(1). The CISG, on the other hand, does not apply to sales of consumer goods, sales at auction, execution sales and other sales by operation of law, sales of investment securities, sales of ships and aircraft, sales of electricity, or sales in which the buyer provides the bulk of the raw material for the production of the goods as in a "turn-key" or "screwdriver plant" operation. CISG arts 2-3.

NOTE: The National Conference of Commissioners on Uniform State Laws amended UCC Article 2 in 2003, although neither California nor any other state has yet adopted the revised version. In its amended form, UCC §2-105 no longer requires that goods be "movable"; instead, goods "must be both existing and identified before any interest in them may pass." UCC §2-105(1) (2003).

- **The statute of frauds.** Unlike the UCC, the CISG contains no statute of frauds or requirement of a writing. Compare former UCC §2-201(1) (requiring writing for sales of goods over $500 ($5000 under UCC §2-201(1) (2003)) with CISG art 11 ("contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form").
- **The parol evidence rule.** The CISG has no bar to parol evidence. Compare UCC §2-202 (parol evidence rule) with CISG art 11 (the contract "may be proved by any means, including witnesses"). See generally *MCC-Marble Ceramic Ctr., Inc. v Ceramica Nuova D'Agostino, S.P.A.* (11th Cir 1998) 144 F3d 1384, 1389.
- **Offer and acceptance.** The rules for offer and acceptance deal with similar concepts but are stated differently and may lead to different results. Compare former UCC §2-207 and UCC §§2-206—2-207 (2003) with CISG art 19.
- **Statute of limitations.** The CISG has a 2-year statute of limitations (which may be expressly contractually modified by the parties) for the reporting of nonconforming goods or tender. CISG art 39(2). See also CISG art 39(1); UCC §2-607(3)(a).
- **Different standards for consequential damages.** The CISG allows consequential damages that a party "ought" to have foreseen. CISG art 74.
- **Disclaimer of warranties.** The CISG has no formal requirements for disclaimers of warranties (see CISG art 35), unlike the UCC's requirements that a waiver of the implied warranty of merchantability be conspicuous and use the term "merchantability." See UCC §2-316(2).

In the sections that follow, the terms of the CISG are explored in light of the sparse American case law applying the treaty. It bears noting that some jurisdictions may be hostile to the CISG, whether out of ignorance, a belief in American superiority and isolationism, or a love of the Uniform Commercial Code. See Gordon, *Some Thoughts on the Receptiveness of Contract Rules in the CISG and UNIDROIT Principles as Reflected in One State's (Florida) Experience of (1) Law School Faculty, (2) Members of the Bar with an International Practice, and (3) Judges*, 46 Am J Comp C 361 (1998).

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C. Application of CISG

§13.6 1. Application; Choice of Law

For the CISG to apply to a contract, all parties to that contract must have their business in a signatory or "contracting" state. See §13.4. This requirement has been interpreted to require that all parties to the contract *at the time of contracting* have their place of business in a contracting nation-state. Subsequent assignment of the contract to a nonsignatory country party may not cause the CISG to spring into effect or cause it to apply if it was not in effect before. *Impols I.D. Internacional, S.L. v Psion-Teklogix Inc.* (SD Fla 2002) 234 F Supp 2d 1267, 1270.

The CISG places greater emphasis on freedom of contract than the Uniform Commercial Code and may be a trap for unwary business people who do not realize that it applies to their transaction unless they expressly opt out of its coverage.

The CISG gives the parties the option of excluding the operation of the CISG by agreement. CISG art 6. If the parties enter such an agreement, the terms of their contract displace any inconsistent provision of the CISG. CISG art 6. The CISG offers little guidance as to whether the parties may implicitly exclude the operation of CISG by, for example, providing an alternate sales law. The CISG states only, "The parties may exclude the application of this Convention or, subject to Article 12 [the CISG Statute of Frauds election], derogate from or vary the effect of any of its provisions." CISG art 6. Thus, if there is any question regarding whether the CISG applies, or if the parties wish it not to, they should explicitly and clearly opt out of the CISG. *Travelers Prop. Cas. Co. v Saint-Gobain Tech. Fabrics Canada Ltd.* (D Minn 2007) 474 F Supp 2d 1075. If the parties do so, usual choice of law rules will apply to determine what domestic law prevails. The parties may also negotiate the choice of applicable law.

A standard choice of law clause will not normally suffice to opt out of the CISG. To be effective, the clause should expressly opt out of the CISG, stating that the treaty shall not apply and specifying the law that is to apply. *American Mint LLC v GOSoftware* (MD Pa 2006) 2006 US Dist Lexis 1569; *Asante Technols., Inc. v PMC Sierra, Inc.* (ND Cal 2001) 164 F Supp 2d 1142, 1149. See, *e.g., Fischer v Thyssen Mannesman Handel GMbH* (ND Ill 2006) 2006 US Dist Lexis 2270 (clause specifying German law and expressly opting out of CISG). If the choice of law clause does not specify a particular law or group of laws but rather identifies the body of law by naming the jurisdiction, *i.e.*, "California law," it may represent nothing but a circular reference back to the CISG. *Asante Technols., Inc. v PMC Sierra, Inc., supra* (discussing choice of law clauses specifying application of either law of British Columbia or California, both of which include the CISG—British Columbia by express adoption and California by incorporation through Supremacy Clause of U.S. Constitution). See also *BP Oil Int'l, Ltd. v Empressa Estatal Petroleos De Ecuador* (5th Cir 2003) 332 F3d 333, 337 (accord). But see *American Biophysics Corp v Dubois Marine Specialties* (D RI 2006) 411 F Supp 2d 61, 62, in which the court held that language requiring the contract to "be construed and enforced in accordance with the laws of the state of Rhode Island" was sufficient to exclude application of the CISG.

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§13.7 2. Scant U.S. Case Law

Because there is no effective, binding system for international judicial interpretation, substantial variation in the application of the CISG is possible. In the United States, only a relatively small handful of cases address the substantive portions of the CISG, with many of these noting the paucity of CISG decisions. "Because there is virtually no American caselaw under the CISG, courts look to its language and to the 'general principles' upon which it is based." *Chicago Prime Packers, Inc. v Northam Food Trading Co.* (ND Ill 2004) 320 F Supp 2d 702, 708. See also *Usinor Industeel v Leeco Steel Prods., Inc.* (ND Ill 2002) 209 F Supp 2d 880, 884.

Courts applying the CISG in the United States routinely turn to its article 7 and recite that its interpretation is to be "informed by its international character and… the need to promote uniformity in its application and the observance of good faith in international trade" with little explanation as to what this means. See, *e.g., Chicago Prime Packers, supra,* 320 F Supp 2d at 709. See also Ferrari, *International Sales Law and the Inevitability of Forum Shopping: A Comment on Tribunale Di Rimini* (2004) 23 J L & Com 169. Although courts note that the Uniform Commercial Code (and case law interpreting it) is not per se applicable, if a CISG provision tracks the UCC, the UCC provision and its interpreting case law may have some influence over interpretation of the CISG provision in question. *Delchi Carrier SpA v Rotorex Corp.* (2d Cir 1995) 71 F3d 1024, 1028. See, *e.g., Genpharm Inc. v Pliva-Lachema* (ED NY 2005) 361 F Supp 2d 49. The relationship of the UCC to the CISG can be overstated. See, *e.g., Vision Sys., Inc. v EMC Corp.* (Mass Super 2005) 56 UCC Rep Serv 2d 875 ("CISG is an international version of the UCC").

The sections that follow include selected citations to major reported U.S. decisions interpreting or applying various of the CISG articles.

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§13.8 D. Scope of CISG

The CISG governs the formation of international sales contracts as well as the rights and obligations of the parties. It applies to contracts for the sale of goods, not services. *Genpharm Inc. v Pliva-Lachema* (ED NY 2005) 361 F Supp 2d 49, 55. In cases in which the contract at issue covers both goods and services, then, as under the Uniform Commercial Code, a court is to look to the "essence" or main objective of the contract. If the services component of the contract predominates, then the contract is not subject to either the UCC or the CISG. *Genpharm Inc. v Pliva-Lachema, supra,* citing *Medinol Ltd. v Boston Scientific Corp.* (SD NY 2004) 346 F Supp 2d 575, 593.

The CISG leaves third party beneficiary contracts to domestic law, and there are no provisions of the CISG governing bona fide purchasers, the rights of creditors, warranty terms, the regulation of disclaimer clauses, or definitions of trade terms. In other words, unless it expressly provides otherwise, the CISG is concerned only with the formation of the contract and the rights and obligations of the parties arising under it, not with the validity of the contract itself or of any of its provisions, or with any usage, or with the effect the contract may have on the property in the goods sold. CISG art 4.

Whether the CISG applies to distributorship agreements, *i.e.,* agreements that will lead to agreements to buy and sell goods, has been a question repeatedly facing courts. Although the answer is far from clear and the number of cases to date is small, the emerging rule appears to be that a distributorship agreement that gives a party merely the right to purchase an unspecified amount of goods in the future for an unspecified price is not a contract for the sale of goods covered by the CISG. *Amco Ukrservice & Prompriladamco v American Meter Co.* (ED Pa 2004) 312 F Supp 2d 681, 686; *Helen Kaminski Pty. Ltd. v Marketing Australian Prods., Inc.* (SD NY, July 21, 1997) 1997 US Dist Lexis 10630. See also *Shuttle Packaging Sys., L.L.C. v Jacob Tsonakis, INA, S.A.* (WD Mich, No. 1:01-CV-691, Dec 17, 2001) 2001 US Dist Lexis 21630 (covenant not to compete that was part of international sale of goods transaction was severable and not governed by CISG but by Michigan law). But see *Genpharm Inc. v Pliva-Lachema* (ED NY 2005) 361 F Supp 2d 49, 55 (CISG applied).

The CISG is further narrowed by exclusion of certain sales including sales for personal, family, or household use, unless the seller knows or ought to have known that the goods were bought for such use; sales by auction; sales by execution or otherwise by authority of law; sales of intangible assets, *i.e.,* stocks, shares, investment securities, negotiable instruments, or money; sales of ships, vessels, hovercraft, and aircraft; and sales of electricity. CISG art 2. The CISG also does not apply to mixed goods and services contracts when the buyer either supplies a substantial part of the materials or in which the furnishing of services, including labor, is a preponderant part of the obligation. CISG art 3. Finally, the CISG does not cover products liability actions. CISG art 5. See also *Viva Vino Import Corp. v Farnese Vini* (ED Pa, Aug. 29, 2000, No. 99-6384) 2000 US Dist Lexis 12347 (CISG does not apply to tort claims, including tortious interference with business relations or advantage).

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§13.9 E. Preemption Issues

As a treaty of the United States, the CISG is federal law and, to the extent that state laws are inconsistent with it, they are preempted by the Supremacy Clause of the U.S. Constitution. *Usinor Industeel v Leeco Steel Prods., Inc.* (ND Ill 2002) 209 F Supp 2d 880, 884. But this preemption is not "field" preemption; the issue is one of scope. State law causes of action within the scope of the CISG are preempted; those outside its scope are not. *Caterpillar, Inc. v Usinor Industeel* (ND Ill 2005) 393 F Supp 2d 659, 673.

Although case law interpreting the preemptive effect of the CISG is sparse, there is a wealth of case law on federal preemption generally that can be applied. Thus, courts will likely be reluctant to embrace sweeping preemption arguments when the subject matter at issue is traditionally one of state law. *Caterpillar, Inc. v Usinor Industeel, supra.* Looking to the text of the CISG as the best evidence of Congress' intent, one notes that the treaty relates only to the sale of goods between buyers and sellers, not third parties, and governs only the formation of the contract. *Caterpillar, Inc. v Usinor Industeel, supra,* citing CISG art 4. The CISG itself largely excludes from its scope issues pertaining to the validity of the contract or the effect of the contract on the property right of persons relative to the goods. *Caterpillar, Inc. v Usinor Industeel, supra.*

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§13.10 F. Jurisdiction and Venue Issues

Because the United States has declared a reservation under article 95 of the CISG, the United States is not bound by the CISG's choice of law provision. CISG art 95. See also Hunter, *Modern Law of Contracts* §23:6 (1999). Thus, in the United States, the CISG is limited to contracts between parties that have places of business in different signatory nations. CISG art 1(a). See *Grace Label, Inc. v Kliff* (SD Iowa 2005) 355 F Supp 2d 965, 971 (contract between two U.S. companies that provided for shipment of goods to third party Mexican company not covered by CISG); *Asante Technols., Inc. v PMC Sierra, Inc.* (ND Cal 2001) 164 F Supp 2d 1142, 1148*; Vision Sys., Inc. v EMC Corp.* (Mass Super 2005) 56 UCC Rep Serv 2d 875 (contracts between U.S. company and U.S. subsidiary of foreign company not within ambit of CISG).

The CISG applies when it is apparent from the contract or from any dealings between the parties that the parties have places of business in different signatory nation-states, and neither the civil or commercial character of the parties nor their nationality may be taken into consideration. CISG art 1, ¶¶2-3. Thus, for instance, a contract between two U.S. firms could be subject to the CISG if one of the firms has a place of business in another country and the contract is to be performed there. See Hunter, Modern Law of Contracts §23:7 (3d ed 2007). The CISG may also apply when a "party representing a foreign firm is only temporarily conducting business in a signatory state or when a US citizen is acting as agent for a foreign principal." Hunter, Modern Law of Contracts §23:7. But see *Vision Sys., Inc. v EMC Corp., supra,* holding that the CISG does not apply to a sale of goods if one party has multiple business locations, unless the party's international location has the closest relationship to the contract and its performance.

Despite its importance, the phrase "place of business" is not defined in the CISG. Article 10 does provide, however, that when the parties have multiple places of business, the applicable place of business is the one with the closest relationship to the contract and its performance. CISG art 10. See *American Mint LLC v GOSoftware* (MD Pa 2006) 2006 US Dist Lexis 1569 (CISG did not apply and court lacked subject matter jurisdiction when there was lack of complete diversity of signatory nations).

The CISG has supported the grant of a motion to dismiss on grounds of forum non conveniens in suits in which the CISG applies. When the law in either forum is the CISG, the choice-of-law—prejudice-to-the-parties factor that is part of the forum non conveniens analysis does not militate in favor of retaining jurisdiction over a dispute. See, *e.g., Chateau Des Charmes Wines Ltd. v Sabate USA, Inc.* (ND Cal, Nov. 10, 2003, No. C-01-4203 MMC) 2003 US Dist Lexis 20337. See also *Supermicro Computer Inc. v Digitechnic, S.A.* (ND Cal 2001) 145 F Supp 2d 1147, 1151 (refusing to exercise discretion to determine whether warranty disclaimer in purchase order was valid under CISG when same issue was already pending before French court in separate action).

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§13.11 G. Terms and Definitions

The CISG is to be interpreted with regard to its international character and the need to promote uniformity in its application as well as the observance of good faith in international trade. CISG art 7, ¶1. Matters not explicitly settled by the CISG are "to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law." CISG art 7, ¶2.

Unless they otherwise agree, the parties to a CISG contract are considered to have made applicable to the contract or its formation the terms of international trade usage in the particular trade or industry of the contract CISG art 9(2); *St. Paul Guardian Ins. Co. v Neuromed Med. Sys. & Support, Gmbh* (SD NY, Mar. 26, 2002, No. 00-Civ-9344) 2002 US Dist Lexis 5096.

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§13.12 1. Incoterms

Terms used in international trade include the international commercial terms known as "Incoterms," published by the International Chamber of Commerce. *St. Paul Guardian Ins. Co. v Neuromed Med. Sys. & Support, Gmbh* (SD NY, Mar. 26, 2002, No. 00-Civ-9344) 2002 US Dist Lexis 5096. "Incoterms" is an abbreviation for International Commercial Terms. Incoterms provide a common set of rules for the most often used terms of international trade. Examples of Incoterms incorporated in the contract though CISG art 9 are "CIF" (Cost, Insurance, and Freight) and "CFR" (Cost and Freight). See *BP Oil Int'l, Ltd. v Empressa Estatal Petroleos De Ecuador* (5th Cir 2003) 332 F3d 333, 337. See also International Chamber of Commerce, Incoterms 2000, available at http://www.iccwbo.org/incoterms/id3045/index.html. Incoterms attempt to reduce confusion over interpretations of shipping terms by outlining exactly who is obligated to insure or take control of goods at particular points in the shipping process. The terms also outline the parties' obligations for clearance of the goods for export or import and packing requirements for the goods.

The 13 Incoterms fall into four different groups, divided by the first letter of each term, including Departure (E), Main Carriage Unpaid (F), Main Carriage Paid (C), and Arrival (D). Well known Incoterms include EXW (Ex Works), FOB (Free on Board), CIF (Cost, Insurance, and Freight), DDU (Delivered Duty Unpaid), and CPT (Carriage Paid To). To ensure using them correctly, practitioners may need to consult the full ICC texts. The International Chamber of Commerce publishes a brief introduction to Incoterms on its website. See http://www.iccwbo.org/incoterms.

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§13.13 2. Goods

The CISG does not define the term "goods," except by negative implication. See CISG art 2. Presumably the framers meant for the CISG to be widely applicable. See §13.8 for discussion of contracts for mixed goods and services.

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H. Intent

§13.14 1. Objective and Subjective

The CISG applies two standards for interpretation of the intent of the parties: the subjective, or knowing, standard, and the objective theory of contract. See CISG art 8, ¶1. Under the subjective standard, if one of the parties knew, or could not have been unaware, of the other party's intent, the other party's statements and conduct will be interpreted according to that intent. CISG art 8, ¶1. If, however, a party did not know or could not have known the other party's intent, then the objective standard applies, and statements and conduct are to be interpreted "according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances." CISG art 8, ¶2. See *Guang Dong Light Headgear Factory Co. v ACI Int'l, Inc.* (D Kan, Sept. 28, 2007, No. 03-4165-JAR) 2007 US Dist Lexis 76844 (in accordance with CISG art 8, enforceable contract found when evidence failed to show seller was aware of buyer's belief that forms were confirmations, not contracts).

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§13.15 2. Relevant Factors

In determining intent under either the subjective or objective standard, all relevant circumstances must duly considered. CISG art 8, ¶3. These include the negotiations between the parties, any practices they have established between themselves, usages, and the parties' subsequent conduct. CISG art 8, ¶3. Parties who have agreed to any usage or have established any practices between themselves are bound to those usages and practices. CISG art 9, ¶1. Moreover, unless the parties have agreed otherwise, international trade usages may be implied in the contract if those usages are widely known to and regularly observed by parties to contracts involved in the particular trade concerned. CISG art 9, ¶2.

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I. Contract Formation

§13.16 1. Offer

Articles 14-24 of the CISG cover contract formation. A proposal addressed to "one or more specific persons" is an offer if it is sufficiently definite (*i.e.,* if it indicates the goods in question and expressly or implicitly fixes or makes provision for determining quantity and price, and indicates the offeror's intent to be bound in case of acceptance). CISG art 14, ¶1. A proposal not addressed to "one or more specific persons" will be construed as an invitation to make offers, unless the person making the proposal clearly indicates an intent to the contrary. CISG art 14, ¶2. An offer is effective when it reaches the offeree. CISG art 15. The CISG distinguishes between revocation and withdrawal of offers. An offer may be withdrawn, even if it is irrevocable, if the withdrawal reaches the offeree before or at the same time as the offer. CISG art 15, ¶2. An offer may be revoked if the revocation reaches the offeree before the offeree has dispatched its acceptance. CISG art 16, ¶1.

The CISG does not mention firm offers. However, an offer cannot be revoked if it indicates its irrevocability by stating a fixed time for acceptance or otherwise, or if the offeree could reasonably rely on the irrevocability of the offer and has acted in reliance on the offer. CISG art 16, ¶2.

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§13.17 2. Acceptance

The CISG contains no mirror image rule, but instead defines acceptance as a "statement made by or conduct of the offeree indicating assent to an offer." CISG art 18, ¶1. The CISG provides that acceptance will be ineffective if it does not reach the offeror within the time fixed for acceptance. CISG art 18, ¶2. Provided certain conditions are met, an offer may be accepted by performance, and the power of revocation is presumably terminated once performance begins. CISG art 18, ¶3. Rejection, however, will terminate an offer when the rejection reaches the offeror, even if the offer is irrevocable. CISG art 17.

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§13.18 a. Time Limits

If no time for acceptance is stated in the offer, the acceptance will be rendered ineffective if it does not reach the offeror within a reasonable time, taking into account the circumstances of the transaction, including the rapidity of the means of communication employed by the parties. CISG art 18, ¶2. An oral offer, however, "must be accepted immediately unless the circumstances indicate otherwise." CISG art 18, ¶2.

If an offer fixes a time for acceptance in a telegram or letter, the clock begins to run as of the date of the offer, the moment the telegram is handed in for dispatch, or the date of the letter or of the postmark, if the date of the letter is not shown. CISG art 20, ¶1. If the offer fixes a time for acceptance by means of instantaneous communication, the clock begins to run at the moment the offer reaches the offeree. CISG art 20, ¶1. Official holidays and nonbusiness days can extend the offer, but only if they fall on the last day the offer can be accepted. CISG art 20, ¶2. In such a case, the offer will be extended to the first business day that follows. CISG art 20, ¶2. Unless the offeror without delay orally notifies the offeree to the contrary, a letter or other writing containing a late acceptance will not be invalidated if it shows that the circumstances in which it was sent were such that the delay was not the fault of the offeree, but of a transmitting agent, *e.g.,* the mail. See CISG art 21, ¶2. The CISG mentions no mitigating circumstances that may apply. A late acceptance may nevertheless be effective if the offeror orally informs the offeree without delay or dispatches a notice to that effect. CISG art 21, ¶1.

An acceptance may be withdrawn as long as the withdrawal reaches the offeror either before or at the same time the acceptance would have become effective. CISG art 22. A person or entity receives a communications when the communication is made orally to such person or entity or delivered by any other means to it personally, or to its place of business or mailing address, or, in the absence of those, to its habitual residence. See CISG art 24. A contract is formed at the moment acceptance becomes effective. CISG art 23.

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§13.19 b. New or Different Terms

Article 19 of the CISG deals with acceptances that include new or different terms from those stated in the offer. A purported acceptance that varies the terms of the offer constitutes a rejection and counter offer, unless the new terms do not materially alter the offer. CISG art 19, ¶¶1-2. In that case the acceptance will not be a counter offer, unless the offeror without undue delay objects orally to the discrepancy, or dispatches a notice to that effect. CISG art 19, ¶2. If the offeror does not object, the terms of the contract are the terms of the offer as modified by the terms contained in the acceptance. CISG art 19, ¶2. Article 19 provides a list of terms that are deemed to materially alter the terms of the offer, but commentators state that the list is illustrative only and not exclusive. See CISG art 19, ¶3.

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§13.20 3. Statute of Frauds

The CISG does not contain a statute of frauds provision. See CISG art 11. Because the U.S. has not declared a reservation allowing it to incorporate a statute of frauds, a contract to which the CISG is applicable and which involves a U.S. company would not include a statute of frauds. See CISG arts. 12, 96; Hunter, Modern Law of Contracts §23:12 (3d ed 2007).

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§13.21 4. Parol Evidence Rule

Unlike the law of most U.S. jurisdictions (including the UCC), a contract subject to the CISG does not require a writing. The contract may be proved by any means; any evidence that may bear on the issue of formation is admissible. CISG art 11. Put another way, the formalities of the parol evidence rule do not apply under the CISG. *Calzaturificio Claudia S.N.C. v Oliveri Footwear Ltd.* (SD NY, Apr. 6, 1998, No. 96-CIV-8052) 1998 US Dist Lexis 4586. See generally Dimatteo, *An International Contract Law Formula: The Informality of International Business Transactions Plus the Internationalization of Contract Law Equals Unexpected Contractual Liability*, 23 Syracuse J Int'l L & Com 67, 103 (1997).

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§13.22 J. Risk of Loss

The CISG rules on risk of loss are written in terms of concrete commercial events, such as the handing over of goods to the carrier. See CISG arts 66-70. In the case of goods already in transit or at sea, the risk passes to the buyer at the time of contract conclusion. CISG arts 67, 68. If the circumstances so indicate, however, the risk is assumed by the buyer at the time the goods are handed over to the carrier. CISG arts 67-68. See *Chicago Prime Packers, Inc. v Northam Food Trading Co.* (7th Cir 2005) 408 F3d 894. If the seller knew or ought to have known at contract conclusion that the goods had been lost or damaged and did not disclose this to the buyer, the loss or damage is at the risk of the seller. CISG arts 67-68.

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§13.23 1. Third Party Claims

Sellers must deliver goods that are free and clear of any right or claim of a third party, unless the buyer agreed to take the goods subject to that claim. CISG art 41. See CISG art 42 (claims based on industrial or other intellectual property).

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§13.24 a. Intellectual Property Rights

Article 42 of the CISG carves out a special rule for industrial or other intellectual property rights. CISG art 42. The seller must deliver the goods free of intellectual property rights if the seller knew (or could not have been unaware) of the rights and if the rights were based either (1) on the law of the state where the goods would be sold or otherwise used, if this was contemplated by the parties at the time of contract conclusion, or (2) in any other case, on the law of the state where the buyer has its place of business. CISG art 42, ¶1(a)-(b). The rule does not apply if at the conclusion of the contract the buyer knew or could not have been unaware of the intellectual property rights, or if the claim results from the seller's compliance with technical drawings, designs, formulae, or other specifications furnished by the buyer. CISG art 42, ¶2.

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§13.25 b. Need to Notify

A buyer who does not notify the seller of the third party claim within a reasonable time after the buyer has or should have become aware of it loses the right to rely on CISG arts 41-42. However, the buyer may reduce the price in accordance with CISG art 50 or claim damages, except for lost profits, if the buyer has a reasonable excuse for failing to give the requisite notice. CISG art 43, ¶1, art 44. Even if the buyer failed to give the seller the required notice, the buyer may continue to rely on articles 41 and 42 if the seller knew of the right or claim of the third party and the nature of it. See CISG art 43, ¶2.

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§13.26 2. Conforming and Nonconforming Goods

The CISG requires that the seller deliver goods that conform to the quantity, quality, description, and packaging terms of the contract. CISG art 35, ¶1. Unless the parties agree to the contrary, goods do not conform to the contract unless they are fit for their ordinary uses as well as any particular use made known to the seller at the time of contract formation, unless the buyer did not rely on the seller's skill and judgment. CISG art 35, ¶2(a)-(b). see also CISG arts 39-40, 50-51 (addressing notice of lack of conformity, damages for nonfundamental breach from nonconforming nature of goods, and fundamental breach). To conform, if sold based on a sample or model, the goods must have the characteristics of the sample or model. CISG art 35, ¶2(c). See generally *Chicago Prime Packers, Inc. v Northam Food Trading Co.* (7th Cir 2005) 408 F3d 894 (nonconforming beef shipment); *Caterpillar, Inc. v Usinor Industeel* (ND Ill 2005) 393 F Supp 2d 659 (nonconforming steel); *In re Siskiyou Evergreens, Inc.* (Bankr D Or, Mar. 29, 2004, No. 02-66975) 2004 Bankr Lexis 1044 (nonconforming trees).

If the goods are nonconforming, the seller is liable, in accordance with the contract and the CISG, for any lack of conformity existing at the time the risk of loss passes to the buyer, even if the nonconformity becomes apparent only after that time. CISG art 36, ¶1. The seller is liable for any nonconformity that becomes apparent after the passage of the risk of loss to the buyer, if the nonconformity is caused by the seller's breach of any of the seller's obligations, including "any guarantee that for a period of time the goods will remain fit for their ordinary purpose or for some particular purpose or will retain specified qualities or characteristics." CISG art 36, ¶2. However, the seller is not liable for nonconformities if, at the time of conclusion of the contract, the buyer knew (or could not have been unaware) of the lack of conformity. CISG art 35, ¶3. This rule is consistent with the buyer's duty to examine the goods on delivery, subject to deferment of inspection if the circumstances so warrant. CISG art 38.

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K. Buyer's Duties

§13.27 1. Examination of Goods

Articles 38 and 39 of the CISG govern the buyer's duties. These duties include the duty to examine the goods (or cause them to be examined) within as short a period of time as practicable under the circumstances. CISG art 38, ¶1. An exception is made for contracts involving the carriage of goods. In such cases, examination may await the arrival of the goods. CISG art 38, ¶2. Likewise, if the seller knew or should have known that the goods would be redirected in transit or redispatched by the buyer without a reasonable opportunity for the buyer to examine the goods when the contract was concluded, the duty of examination may be deferred until after the goods arrive at their new destination. CISG art 38, ¶3, art 40.

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§13.28 2. Notice of Nonconformity

The buyer loses the right to rely on nonconformity to claim damages if it does not give notice to the seller specifying the nature of the nonconformity within a reasonable time after the buyer discovered or should have discovered the nonconformity. CISG art 39, ¶1. If the buyer has a reasonable excuse for its failure, however, it may reduce the price in accordance with CISG art 50 or claim damages, except for lost profits. CISG art 44. Unless the contractual guaranty exceeds 2 years, 2 years is the latest the buyer may give notice of the nonconformity. CISG art 39, ¶2. If the seller knew (or could not have been unaware) of the nonconformity and did not disclose it, the seller loses the right to rely on the buyer's duty to examine the goods and notify the seller of the nonconformity. See CISG art 40.

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§13.29 a. Seller's Opportunity to Cure

The CISG resembles the UCC in the case of a nonconforming tender. If the seller delivers the goods prior to the date of delivery, the seller may deliver any missing part, make up any deficiency in quantity, deliver replacement goods, or remedy any lack of conformity of the goods delivered up to the delivery date, as long as the seller does not thereby cause the buyer unreasonable inconvenience or expense. CISG art 37. The buyer, however, retains the right to seek damages. CISG art 37. Subject to provisions governing the buyer's right to avoid the contract, the seller may remedy at its own expense any failure of performance, even after the date of delivery, as long as it can do so without unreasonable delay or without causing the buyer unreasonable inconvenience or uncertainty of reimbursement of expenses advanced by the buyer. Similarly, the buyer retains the right to seek damages under the CISG. CISG art 48, ¶1.

The seller may ask the buyer to make known whether it will accept performance. CISG art 48, ¶¶2-3. If the buyer does not reply within a reasonable time, the seller may perform within the time it indicated in its request. CISG art 48, ¶2. During this period the buyer may not resort to any remedy inconsistent with performance by the seller. CISG art 48, ¶2. To be effective, however, a notice of performance by the seller must be received by the buyer. See CISG art 48, ¶4.

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§13.30 b. Breach

The CISG generally restricts the right to avoid a contract for a minor breach. See CISG arts 29, 49, 64. If one of the parties is simply delaying performance, however, the aggrieved party may notify the offending party that it must perform within a reasonable amount of time. See CISG arts 47, ¶1; 49, ¶1(b); 63, ¶1; 64, ¶1(b). If the delaying party does not comply with the notice, the aggrieved party may declare the contract avoided without regard to the materiality of the breach. See CISG arts 47, ¶1; 49, ¶1(b); 63, ¶1; 64, ¶1(b).

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3. Terms of Delivery

§13.31 a. Place of Delivery

The seller must deliver the goods, hand over any documents relating to them, and transfer the property in the goods, as required under the contract and under CISG. CISG art 30. If the contract involves the carriage of the goods, and the seller is not bound to deliver the goods to any particular place, the seller must hand the goods over to the first carrier for transmission. CISG art 31(a). If the parties knew at the time of contract conclusion that the goods were, or were to be manufactured or produced, at a particular place, and the seller is not bound to deliver the goods to any particular place, the seller must place the goods at the buyer's disposal at the place where they are located or are to be manufactured or produced. CISG art 31(b). In all other cases, the seller must place the goods at the buyer's disposal at the place where the seller had its place of business at the time of contract conclusion. CISG art 31(c).

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§13.32 b. Consignment

For goods that are not clearly identified to the contract by markings on the goods, shipping documents, or otherwise, the seller must give the buyer notice of the consignment, specifying the goods. CISG art 32, ¶1. If the seller is to arrange for the carriage of the goods, it must make shipping contracts that are appropriate under the circumstances and in accord with the usual terms for such transportation. CISG art 32, ¶2. If the seller is not bound to insure the goods, it is required at the buyer's request to provide the buyer with information necessary to allow the buyer to insure the goods. CISG art 32, ¶3.

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§13.33 c. Time of Delivery

The seller must comply with the contract in delivering the goods, *i.e.,* it must deliver them on the date specified in the contract, or within the period stated in or determinable from the contract, "unless circumstances indicate that the buyer is to choose a date." CISG art 33(a)-(b). Failure to do so may constitute a fundamental breach giving rise to the buyer's avoidance of the contract. CISG art 49(2). If no time for delivery is fixed, the seller must deliver the goods within a reasonable time. CISG art 33(c).

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§13.34 d. Documentation

If the seller is required to hand over documents relating to the goods, the seller must hand them over at the time and place and in the form required by the contract. CISG art 34. Up to the time of delivery, the seller may cure any lack of conformity in the documents it has already handed over, as long as doing so does not cause the buyer any unreasonable expense or inconvenience. CISG art 34. The buyer retains the right to claim damages. CISG art 34.

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§13.35 4. Payment

The buyer has two fundamental obligations: to pay the price for the goods and to take delivery of them as required by the contract and the CISG. CISG art 53. The duty to take delivery includes taking over the goods and doing all acts that could reasonably be expected of the buyer to enable the seller to make delivery. CISG art 60. The duty to pay the price is active and includes taking steps and complying with such formalities as may be required by the contract and any laws or regulations to enable payment to be made. CISG art 54.

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§13.36 a. Price of Goods

If the price term is left open and no provision is made in the contract for its determination, in the absence of an indication to the contrary, the price will be what was generally charged at the time of the contract for such goods sold under comparable circumstances in the trade. CISG art 55. If the price is to be determined according to the weight of the goods, the net weight is to be used in cases of doubt. CISG art 56.

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§13.37 b. Place of Payment

If the buyer is not bound to pay for the goods at a particular place, it must pay for the goods at the place of the seller's business, or if payment is to be made against the delivery of documents or goods, then at the place of the delivery. CISG art 57, ¶1. If the seller changes its place of business after the conclusion of the contract, the seller must pay any increase in the expense of payment occasioned by that change. CISG art 57, ¶2.

Unless the buyer is bound to pay the price at some other specified time, payment is to be made when the seller places the goods or documents controlling their disposition at the buyer's disposal in accordance with the contract and the CISG. CISG art 58, ¶1. The seller may make the handing over of the goods or documents conditional on payment. CISG art 58, ¶1. If the contract involves carriage of the goods, the seller may make handing over of the goods or documents of title conditional on payment of the price for the goods. CISG art 58, ¶2. As long as the agreement of the parties or the procedures for delivery are not inconsistent with inspection, the buyer is not bound to pay the price until it has inspected the goods. CISG art 58, ¶3. However, the buyer must pay the price fixed by or determinable from the contract and the CISG without need for any request to do so, or without compliance with any formality, by the seller. CISG art 59.

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§13.38 c. Preservation of Goods Pending Payment or Return

The seller must take reasonable steps to preserve the goods in its possession or control, if the buyer takes delayed delivery of them, or does not pay when concurrent payment and delivery are to be made. CISG art 85. The seller is entitled to reasonable expenses thus incurred and may hold the goods until these expenses are covered by the buyer. CISG art 85.

The buyer must take reasonable steps to preserve goods it has received and elected to reject, and is entitled to reimbursement from the seller for expenses thus incurred and may retain the goods until those expenses have been covered. CISG art 86, ¶1. Moreover, the buyer will be required to take possession of (and take reasonable steps to preserve on behalf of the seller) goods that were not delivered to the buyer but were placed at its disposal, as long as taking possession of the goods can be done without paying the price and will not entail unreasonable expense or inconvenience. CISG art 86, ¶2. The buyer is entitled to reimbursement from the seller for doing so and may retain the goods until those expenses have been covered. CISG art 86, ¶2. This provision does not apply if the seller or another person authorized by the seller to take possession of the goods is present at the destination. CISG art 86, ¶2.

As long as the expense is reasonable, a party bound to preserve goods may deposit them at a third person's warehouse at the expense of the other party. CISG art 87. On giving the required notice, a party may sell goods that it is bound to preserve if there has been an unreasonable delay in taking possession of the goods, retaking them or in paying their price or the cost of preservation by the other party. CISG art 88, ¶1. If the goods are subject to rapid deterioration or if preserving them would be unreasonably expensive, the party must take reasonable steps to sell them, giving notice to the other party to the extent possible. CISG art 88, ¶2. The party selling the goods may withhold from the sale price the reasonable expense of preserving and selling the goods, but must account to the other party for the balance. CISG art 88, ¶3.

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L. Anticipatory Breach

§13.39 1. Suspending Performance

A party may suspend its performance if after the conclusion of the contract, it "becomes apparent that the other party will not perform a substantial part of his obligations as a result of… a serious deficiency in his ability to perform or his credit worthiness [or as a result of] his conduct in preparing to perform or in performing the contract." CISG art 71, ¶1. The seller may prevent the handing over of goods that have already been shipped to the buyer, even if the buyer holds a document entitling him to obtain them. CISG art 71, ¶2. A party suspending performance must give immediate notice to the other party, and if the other party provides adequate assurance of its performance, the suspending party must continue its performance. CISG art 71, ¶3.

If prior to performance it is clear that one of the parties will commit a fundamental breach, the other party may avoid the contract. CISG art 72, ¶1. Unless the other party has declared that it will not perform, and if time allows, a party intending to declare avoidance due to a fundamental breach must give notice to the other party to allow the other party to provide adequate assurance of performance, and ward off the avoidance. CISG art 72, ¶¶2-3.

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§13.40 2. Installment Contracts

If failure of one party to perform any of its obligations under an installment contract constitutes a fundamental breach of contract with respect to that installment, the other party may declare the contract avoided as to that installment. CISG art 73, ¶1. Provided it does so within a reasonable time, the nonbreaching party may avoid the entire contract if the failure to perform gives the other party good grounds to believe that a similar fundamental breach will occur with respect to subsequent performances. CISG art 73, ¶2. A buyer who declares a contract avoided "in respect of any delivery may, at the same time, declare he avoided in respect of deliveries already made or of future deliveries if by reason of their interdependence, those deliveries could not be used for the purpose contemplated by the parties" when the contract was concluded. CISG art 73, ¶3.

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§13.41 M. Excusing Performance

A party will not be held liable for its failure to perform "any of his obligations if it proves that the failure was due to an impediment beyond his control and that it could not reasonably be expected to have taken the impediment into account at the time of conclusion of the contract or to have avoided or overcome it or its consequences." CISG art 79, ¶1. See also *Raw Materials, Inc. v Manfred Forberich GMbH & Co., KG* (ND Ill, July 7, 2004, No. 03-C-1154) 2004 US Dist Lexis 12510. The party unable to perform must notify the other party of the impediment and its effect on its ability to perform. If the other party does not receive the notice within a reasonable time after it becomes aware (or should have become aware) of the impediment, it will be liable for damages occasioned by its failure to notify the other party. CISG art 79, ¶4. Moreover, the party is only excused from liability so long as the impediment exists, and the parties are not prevented from exercising any other rights, such as declaration of avoidance. CISG art 79, ¶¶3, 5. Only damages are precluded. CISG art 79, ¶5. A party is, however, excused from performance if the failure was caused by the other party's act or omission. CISG art 80.

A party who fails to perform due to a failure of a person it has engaged to perform all or part of the contract is exempt from liability only if the impediment was beyond its control or that of the person it engaged and it or the person it engaged could not have been reasonably expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided it or overcome it. CISG art 79, ¶¶1-2.

In applying article 79, courts may look to the case law interpreting UCC §2-615, which is plentiful. *Raw Materials Inc. v Manfred Forberich GMBH & Co., KG, supra* (analyzing claim of excuse by *force majeure* based on ice-bound shipping port under UCC standard when applying CISG art 79).

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N. Remedies for Breach

§13.42 1. Remedies for Buyer's Breach

In case of breach, the seller may exercise its rights under articles 62-65 of the CISG or claim damages under articles 74-79, but will not be precluded from claiming damages if it exercises its rights to other remedies. CISG art 61, ¶¶1-2. If the seller exercises a remedy, no court or tribunal may grant the buyer a grace period. CISG art 61, ¶3. Unless the seller has resorted to an inconsistent remedy, the seller may require the buyer to pay the price, take delivery, or perform its other obligations, or alternatively may fix an additional reasonable time for performance by the buyer. During that time, the seller must refrain from exercising its other remedies, unless the buyer notifies the seller that it will not perform. CISG arts 62-63.

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§13.43 a. Delayed Performance

If the buyer does not perform or declares that it will not perform within the additional time period, the seller may declare the contract avoided. CISG art 64, ¶1(b). The seller may still claim damages for the delay, however. See CISG art 61. A special rule applies if the buyer has already paid the price. See CISG art 64, ¶2. The seller may then avoid the contract only (1) within a reasonable time after the seller knows (or should have known) of the breach, other than the buyer's late performance, (2) after the lapse of any additional period of time fixed by the seller, (3) after a declaration by the buyer that it will not perform within the additional time, or (4) in the case of later performance, if the seller is not yet aware of the late performance. CISG art 64, ¶2.

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§13.44 b. Failure to Provide Specifications

If the buyer fails to make specifications required under a contract on the agreed date or within a reasonable period of time after the seller requests the specification, the seller, without prejudice to any other rights it may have, may make the specifications in accordance with any requirements of the buyer of which it is aware. CISG art 65, ¶1. The seller must inform the buyer of its choices and set a reasonable time for the buyer to respond with different specifications. If the buyer does not do so within the time set, the seller's specifications are binding. CISG art 65, ¶2.

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§13.45 2. Remedies for Seller's Breach

If the seller breaches the contract, the buyer may exercise its rights and remedies under CISG arts 46-52 or claim damages under CISG arts 74-77; however, the buyer's right to claim damages will not be impaired by its exercise of its rights and remedies. CISG art 45, ¶¶1-2. No court or tribunal may grant the seller a grace period if the buyer resorts to a remedy for breach of contract. CISG art 45, ¶3.

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§13.46 a. Nonconforming Goods

Unless the buyer has resorted to a remedy inconsistent with performance, the buyer may require performance by the seller. CISG art 46, ¶1. If the goods are nonconforming, the buyer may require delivery of substitute goods, but only if the nonconformity is so substantial as to constitute a fundamental breach of the contract. The buyer's request for substitute goods must be made in conjunction with notice given under article 39 or within a reasonable time thereafter. CISG art 46, ¶2. Alternatively, the buyer may require that the seller repair the nonconforming goods, but only if repair would not be unreasonable under the circumstances. CISG art 46, ¶3. A request for repair must be made either in conjunction with notice given under article 39 or within a reasonable time thereafter. CISG art 46, ¶3. The buyer may also reduce the price of the nonconforming goods "in the same proportion as the value that the goods actually delivered had at the time of the delivery bears to the value that conforming goods would have had at that time." This remedy applies whether or not the price has been paid. CISG art 50. The buyer may not reduce the price, however, if the seller remedies any failure to perform in accordance with article 37 or 48, or if the buyer refuses to accept performance by the seller in accordance with those articles. CISG art 50. The buyer may fix an additional reasonable period of time for the seller to perform during which time the buyer must refrain from exercising its other remedies, unless the seller notifies the buyer that it will not perform. CISG art 47. The buyer may still seek damages for the delay in performance. CISG art 47, ¶2. If the seller does not perform or declares that it will not perform within the additional time period, the buyer may declare the contract avoided. CISG art 47, ¶2.

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§13.47 b. Imperfect Delivery

If the seller makes only partial delivery, or if only part of the goods conform, the buyer may exercise its rights and remedies or claim damages, but it will not be able to declare the contract avoided in its entirety unless the partial delivery amounts to a fundamental breach. CISG art 51. The buyer need not accept goods delivered before the date of delivery or accept a greater quantity of goods than what is provided for in the contract. CISG art 52. If the buyer does take delivery of the excess quantity, it must pay for the excess at the contract rate. CISG art 52, ¶2.

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§13.48 c. Avoiding the Contract

The buyer may declare the contract avoided if the seller's nonperformance amounts to a fundamental breach of the seller's obligations under the contract or the CISG, or, in the case of nondelivery, if the seller fails to, or declares that it will not, deliver the goods in accordance with any additional period of time granted by the buyer under CISG art 49, ¶1. If the seller has delivered the goods, the buyer's rights to declare avoidance are limited. See CISG art 49, ¶2. A buyer who wishes to avoid the contract on account of a late delivery must do so within a reasonable time after the buyer has become aware that the delivery has been made. CISG art 49, ¶2(a). In all other cases, the buyer must declare avoidance (1) within a reasonable time after it knew or should have known of the breach, (2) after the expiration of any additional time fixed by the buyer in accordance with article 47, (3) after the seller's declaration of refusal to perform within the additional period, (4) after the expiration of any additional time fixed by the seller under article 48, or (5) after the buyer has declared its refusal to accept performance. CISG art 49, ¶2(b).

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§13.49 (1) Refund and Restitution

Avoidance releases both of the parties from their obligations under the contract, subject to any damages that may be due. Any contract provision that governs rights on avoidance remains unaffected, however. CISG art 81, ¶1. If any party has performed in whole or in part, it may seek restitution from the other party of whatever the party has supplied or paid under the contract. CISG art 81, ¶2. The seller required to refund the purchase price must pay interest on it from the date on which the price was paid. CISG art 84, ¶1. A buyer who is required to make restitution of all or part of the goods or who has declared the contract avoided even though restitution is not feasible must account to the seller for the all the benefits that the buyer derived from any of the goods. CISG art 84, ¶2.

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§13.50 (2) Damages

Damages consist of the sum equal to the loss, including lost profits, suffered by the nonbreaching party as a consequence of the breach. CISG art 74. Damages may not exceed what the breaching party expected or should have expected at the time the contract was made in light of facts and matters known to it or which should have been known to it. CISG art 74. This provision is designed to place the aggrieved party in as good a position as if the other party had performed the contract—*i.e.,* it is an award of "expectancy" or "benefit of the bargain" damages. The measure of damages is limited to reasonably foreseeable damages under the rule of *Hadley v Baxendale* (1854) 9 Ex 341, 156 Eng Rep 145. *Delchi Carrier SpA v Rotorex Corp.* (2d Cir 1995) 71 F3d 1024, 1029.

A party claiming breach of contract is obligated to try to mitigate its damages. CISG art 77; *Treibacher Industrie, A.G. v Allegheny Technols., Inc.* (11th Cir 2006) 464 F3d 1235. The breaching party may claim "a reduction in the damages in the amount by which the loss should have been mitigated." 464 F3d at 1240.

If the buyer has bought replacement goods or the seller has resold the goods within a reasonable time after the avoidance of the contract, the party claiming damages may recover the "difference between the contract price and the price in the substitute transaction," as well as any further damages under article 74. CISG art 75. If the party claiming damages has not purchased replacement goods or made a resale, and there is a current price for the goods, the party may recover the difference "between the price fixed by the contract and the current price at the time of avoidance," as well as any further damages available under article 74. CISG art 76, ¶1.

NOTE: A party (either buyer or seller) is entitled to interest on any sum that the other party has failed to pay or that is in arrears. CISG art 78. The payment of interest does not prejudice any claim of damages the party may have. There is no defined interest rate or any method for setting one. See CISG art 78.

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§13.51 (3) Current Price

If the party has taken over the goods and then declares the contract avoided, the current price at the time of taking over the goods is applied, not the current price at the time of avoidance of the contract. CISG art 76, ¶1. Current price refers to the prevailing price at the place where the goods should have been delivered, or, if no current price is available there, then the price at "such other place as serves as a reasonable substitute, making due allowances for differences in the cost of transporting the goods." CISG art 76, ¶2. The nonbreaching party has a duty to mitigate its loss, including loss of profits, and if it does not do so, then the breaching party may claim a reduction in damages "in the amount by which the loss should have been mitigated." CISG art 77.

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IV. INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW (UNIDROIT)

§13.52 A. Introduction

The International Institute for the Unification of Private Law (Unidroit) is an independent intergovernmental organization headquartered in Rome. Its purpose is to study needs and methods for modernizing, harmonizing, and coordinating private law, particularly commercial law, among nations and groups of nations. First established in 1926 as an auxiliary of the League of Nations, UNIDROIT was reestablished in 1940 after the demise of the League on the basis of a multilateral agreement. UNIDROIT is somewhat similar, on an international scale, to the National Conference of Commissioners on Uniform State Laws, which promulgates the Uniform Commercial Code and other uniform laws within the United States. See http://www.unidroit.org.

UNIDROIT has 60 member nation-states drawn from five continents, representing a variety of cultures and different legal, economic, and political systems. Its primary objective is to prepare modern and, if appropriate, harmonized uniform rules of private substantive law. Occasionally UNIDROIT is involved in areas of public law when transactional law and regulatory law are intertwined. UNIDROIT is mainly concerned with new technologies and commercial practices in transactions that tend to be transnational by their very nature and call for harmonized, widely acceptable solutions.

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§13.53 B. UNIDROIT Instruments

The uniform rules drawn up by UNIDROIT normally take the form of international conventions designed to apply in preference to a nation-state's internal law. However, the low priority that tends to be accorded by governments to the implementation of these conventions and the time required for them to become force of law have led to the increasing popularity of alternative forms of unification in areas where a binding instrument is not essential. Such alternatives include model laws that states may consider when drafting domestic legislation, or general principles addressed directly to judges, arbitrators, and contracting parties who are free to decide whether or not to use them. If a subject is not ripe for uniform rules, another alternative is preparation of legal guides on new business techniques for use in countries unfamiliar with contractual practice in emerging areas of commerce. See generally Gopalan, *Transnational Commercial Law: The Way Forward*, 18 Am U Int'l L Rev 803 (2003) (discussing reasons for and methods of harmonization of law and creation of international rules to govern international commerce).

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Source: Business Law/California Law of Contracts/13 Selected International Issues/§13.54 C. List of UNIDROIT Instruments Issued

§13.54 C. List of UNIDROIT Instruments Issued

To date, the following instruments have been finalized and issued by UNIDROIT.

Issue Date	Name of UNIDROIT Instrument
1954	Convention for the Protection of Cultural Property in Case of War
1955	European Convention on Establishment
1955	Benelux Treaty on Compulsory Insurance Against Civil Liability in Respect of Motor Vehicles
1956	Convention on the Contract for the International Carriage of Goods by Road
1958	Convention on the Recognition and Enforcement of Decisions Involving Obligations to Support Minor Children
1959	European Convention on Compulsory Insurance Against Civil Liability in Respect of Motor Vehicles
1961	International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations
1962	European Convention on the Liability of Hotel-keepers Concerning the Property of their Guests
1964	Convention Relating to a Uniform Law on the Formation of Contracts for the International Sale of Goods
1964	Convention Relating to a Uniform Law on the International Sale of Goods
1965	Protocol No. 1 Concerning Rights *In Rem* in Inland Navigation Vessels and Protocol No. 2 on Attachment and Forced Sale of Inland Navigation Vessels Annexed to the 1965 Convention on the Registration of Inland Navigation Vessels
1970	International Convention on the Travel Contracts
1973	Convention providing a Uniform Law on the Form of an International Will
1980	United Nations Convention on Contracts for the International Sale of Goods
1983	Convention on Agency in the International Sale of Goods (not yet in force)
1988	UNIDROIT Convention on International Financial Leasing
1988	UNIDROIT Convention on International Factoring
1994	Principles of International Commercial Contracts
1995	UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects

1998	Guide to International Master Franchise Arrangements
2001	Convention on International Interests in Mobile Equipment (not yet in force)
2001	Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (not yet in force)
2002	Model Franchise Disclosure Law
2004	ALI/UNIDROIT Principles of Transnational Civil Procedure
2004	Principles of International Commercial Contracts
2007	Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock

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V. UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS

§13.55 A. Introduction

The Principles of International Commercial Contracts drafted by the International Institute for the Unification of Private Law (the "UNIDROIT Principles") are a part of UNIDROIT's work. See Bonell, *The UNIDROIT Principles of International Commercial Contracts: Why? What? How?*, 69 Tul L Rev 1121, 1127 (1995); Bonell, An International Restatement of Contract Law (3d ed 2005). The UNIDROIT Principles were first published by UNIDROIT in 1994, with the goal of establishing a balanced, uniform set of rules that could be applied throughout the world regardless of the legal traditions and economic and political conditions present in the countries in which the rules were to be applied. They are not law per se, but rather are analogous to the Restatement of Contracts and Restatement (Second) of Contracts. Like the Restatements, they indicate a consensus opinion about what the law should be, based in part on what it is. Parales-Viscasillas, *UNIDROIT Principles of International Commercial Contracts: Sphere of Application and General Provisions*, 13 Ariz J Int'l & Com L 383 (1996). Thus, they constitute nonbinding, persuasive authority that attempts to codify general contract principles across common and civil law jurisdictions. To date, only one reported case decision in the United States has referred to the UNIDROIT Principles. See *Ministry of Defense & Support for the Armed Forces of the Islamic Republic of Iran v Cubic Defense Sys., Inc.* (SD Cal 1998) 29 F Supp 2d 1168.

Revised and expanded UNIDROIT Principles were adopted in 2004. The new version is largely identical to the 1994 Principles, but with a series of additions, bringing the total number of articles from 120 to 185. Substantial changes and additions were made to the comments that accompany each article. Citations in the following sections are to the 2004 version of the UNIDROIT Principles unless otherwise indicated.

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B. Summary of UNIDROIT Principles

§13.56 1. Purpose and Scope

The UNIDROIT Principles address contract formation, performance, assignments, third party rights, and remedies. They embrace freedom of contract, which is viewed as central to an open, market-oriented, and competitive international economic order. UNIDROIT Principles art 1.1.

The UNIDROIT Principles do not supplant the requirements of domestic laws or of treaties such as the CISG, and they do not apply if the parties wish them not to. Like the Restatement (Second) of Contracts (1981), however, the UNIDROIT Principles may be used as default rules when it is unclear what principles apply to the transaction or which domestic laws govern. The UNIDROIT Principles apply only to contracts that are international in nature; excluded are contracts "where all relevant elements… are connected with one country only." UNIDROIT Principles, Comment to Preamble.

Like the rules of the American Arbitration Association, the UNIDROIT Principles can be contracted for, *i.e.,* the parties may agree that they should apply to the contract to the full extent permitted by the country whose law governs the contract. UNIDROIT Principles, Preamble. Unless validly contracted for, the Principles function as an interpretative aid for litigants and courts faced with matters that are not addressed by positive governing law such as the CISG.

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§13.57 2. Application of UNIDROIT Principles

The agreement itself is the key to the relationship between the parties, and although the agreement may be freely modified, the original agreement will govern the means by which any modifications may take place. UNIDROIT Principles art 1.3. Except as otherwise provided in the Principles, the parties may exclude parts of the Principles or modify them in their agreement. UNIDROIT Principles art 1.5. The Principles are to be interpreted with regard to the international character of the transactions that they govern and with an eye toward encouraging uniformity in their application. UNIDROIT Principles art 1.6(1).

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§13.58 3. Contract Form

In lieu of a statute of frauds provision, the Principles state that no writing is necessary to evidence or conclude a contract or to modify or terminate the original agreement. UNIDROIT Principles art 1.2, and comment 1. A termination or modification of, or an amendment to, a written agreement must be in the particular form specified in the writing. UNIDROIT Principles art 2.1.18.

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§13.59 4. Meaning of Terms

Parties are bound by any usage to which they have agreed and any practices they have established between themselves, as well as any usages widely known and regularly observed in the trade, unless application of those usages would be unreasonable. UNIDROIT Principles art 1.9. Trade usage and practices established between the parties will generally control over any of the Principles unless a Principle is mandatory. UNIDROIT Principles art 1.9, and comment 6.

General rules of contract formation apply to standard terms. UNIDROIT Principles art 2.1.19, and comment 3. If standard terms could not have been reasonably expected, they will not be enforced in the absence of express assent. UNIDROIT Principles art 2.1.20(1). In determining whether a standard term is so surprising as to be unenforceable, content, presentation, and language may be considered. UNIDROIT Principles art 2.1.20(2). A negotiated or nonstandard term will prevail over a conflicting standard term. UNIDROIT Principles art 2.1.21. If both parties use standard terms and reach agreement except for those terms, the contract will consist of the terms that are agreed on or negotiated, as well as standard terms that are common in substance. UNIDROIT Principles art 2.1.22. A party may avoid the other party's standard terms by stating either in advance, or without undue delay after the apparent conclusion of the agreement, that it does not intend to be bound by such a contract. UNIDROIT Principles art 2.1.22.

An integration clause will prevent supplementation or contradiction by prior statements or agreements between the parties, but prior statements and agreements may be used to interpret the writing that is the subject of the integration clause. UNIDROIT Principles art 2.1.17.

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§13.60 5. Good Faith and Fair Dealing

Except as otherwise provided in the Principles, the parties may exclude parts of the Principles or modify them in their agreement. UNIDROIT Principles art 1.5. Because good faith and fair dealing are central to the Principles and because business standards may vary, the parties may not exclude the requirement to act in good faith and fair dealing "in international trade." UNIDROIT Principles art 1.7, and comment 3. The requirement of good faith and fair dealing extends throughout the life of the contract, including the negotiation process. UNIDROIT Principles art 1.7, comment 1.

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§13.61 6. Prohibition of Inconsistent Behavior

The prohibition of inconsistent behavior in UNIDROIT Principles art 1.8 is an application of the general principle of good faith in art 1.8. The prohibition operates when one party has caused the other party to have an understanding on which the other has reasonably relied, and the other party would suffer detriment if the first party acted inconsistently with that understanding. Article 1.7 may create a right in the other party irrespective of the first party's intentions.

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7. Elements of Contracting

§13.62 a. Offer

Like the UCC, the Principles include a presumption in favor of finding an agreement if the parties appear to have intended to reach one. Thus, contracts may be formed either by the acceptance of an offer or by conduct of the parties that is sufficient to show the existence of an agreement. UNIDROIT Principles art 2.1.1. The Principles adopt the objective theory of contract. Because negotiations often extend over time and it may not be possible to identify the precise moment of contract formation, conduct consistent with an intent to be bound is sufficient to show the existence of an agreement, even in the absence of a clear time of formation. UNIDROIT Principles art 2.1.1, and comment 2.

UNIDROIT Principles art 2.1.2 provides that a "proposal for concluding a contract constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance." The offeror need not designate a communication as an offer for it to be effective as such, and an offer may be discerned from a series of communications undertaken during the course of negotiations. See UNIDROIT Principles art 2.1. An offer may be sufficiently definite even in the absence of such essential terms as a precise description of the goods or services to be delivered or rendered, the price to paid for them, or the time and place of performance. UNIDROIT Principles art 2.1, comment 1. Whether the offer is sufficiently definite depends on "whether or not the offeror by making the offer, and the offeree by accepting it, intends to enter into a binding agreement, and whether or not the missing terms can be determined by interpreting the language of the agreement" in accordance with UNIDROIT. Moreover, indefiniteness may be "overcome by reference to practices established between the parties or to usages." UNIDROIT Principles art 2.1.2, comment 1.

An offer is not effective until receipt, and may be withdrawn, even if said to be "irrevocable," as long as notice of the withdrawal of the "irrevocable offer" reaches the offeree before or at the same time as the offer. UNIDROIT Principles art 2.1.3. However, an offer cannot be revoked if the offer indicates that it is irrevocable by setting a fixed time for acceptance or otherwise, or when the offeree has acted in reasonable reliance on the intention for the offer to be irrevocable. UNIDROIT Principles art 2.1.4(2).

An offer rejected by the offeree is terminated as soon as the notice of rejection reaches the offeror. UNIDROIT Principles art 2.1.5. An offer must be accepted by a statement or other conduct made known to the offeror. Silence or inactivity is in itself insufficient. UNIDROIT Principles art 2.1.6(1). Performance of an act can constitute an acceptance, if dictated by the offer, or indicated by the practices of the parties or usage. UNIDROIT Principles art 2.1.6(3).

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§13.63 b. Acceptance

The offeree must accept the offer within the time stated in the offer, or within a "reasonable time," taking into account circumstances including the rapidity of the communications employed by the offeror. UNIDROIT Principles art 2.1.7. Unless circumstances indicate otherwise, an oral offer must be accepted immediately. UNIDROIT Principles art 2.1.7. "A period of acceptance fixed by the offeror begins to run from the time that the offer is dispatched. A time indicated in the offer is deemed to be the time of dispatch unless the circumstances indicate otherwise." UNIDROIT Principles art 2.1.8.

An offeror may excuse a late acceptance and treat it as effective on notice to the offeree. A late acceptance expressed in a letter or other written communication may likewise be excused if the offeree acted promptly but other factors delayed the delivery. UNIDROIT Principles art 2.1.9. The offeree may withdraw the acceptance as long as the withdrawal arrives before or at the same time as the acceptance. UNIDROIT Principles art 2.1.10.

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§13.64 c. Acceptance With Different Terms

A response that adds to, modifies, or limits the original offer constitutes a rejection and counteroffer. UNIDROIT Principles art 2.11(1). However, a response that purports to be an acceptance is effective, even if it contains additional or different terms, as long as those terms do not "materially alter" the offer. The offeror can avoid a nonconforming acceptance if it objects to the discrepancy without undue delay; but if it does not do so, a contract will be formed that includes the additional or different terms. UNIDROIT Principles art 2.1.11(2). The determination of whether a term constitutes a material alteration of the offer is fact specific and depends on the circumstances of each case. An alteration will normally, but not necessarily, be material if the additional or different terms relate to price or mode of payment, the time and place of performance of a nonmonetary obligation, the settlement of disputes, or the extent of one party's liability to the other. Whether or not the additional or different terms are commonly used in the trade sector and would therefore come as a surprise to the offeror is an important factor to be taken into account. UNIDROIT Principles art 2.1.11. Postcontractual confirmations that purport to confirm additional or different terms will also become part of the contract, unless they are material alterations or the original offeror gives timely notice of its objection to them. UNIDROIT Principles art 2.1.12.

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§13.65 d. Missing Terms

During negotiations, a party may insist that no contract has been formed until agreement has been reached on a specific term or the contract has taken a specific form. UNIDROIT Principles art 2.1.13. A contract may be concluded, however, even if one or more terms are left open for subsequent negotiation or for determination by a third party. Even if the parties subsequently fail to reach agreement on the open term or the third party fails to provide it, the contract will remain binding as long as alternate means of gap-filling are available that are reasonable and consistent with the overall intentions of the parties. UNIDROIT Principles art 2.1.14.

There is no obligation to reach an agreement, and a party will not be liable for failed negotiations. UNIDROIT Principles art 2.1.15(1). Bad faith negotiations will, however, make a party liable for losses incurred by the other party, including expenses incurred in negotiation and the value of the lost opportunity to conclude an agreement with the other party. See UNIDROIT Principles art 2.1.15(2), and comment 2. Bad faith occurs in particular when a party negotiates without intending to be bound or to conclude an agreement. UNIDROIT Principles art 2.1.15(3). Lost profits or expectation damages, *i.e.*, what could have been expected had the contract gone forward, are not included in the losses that may be compensated in the event of negotiations in bad faith. UNIDROIT Principles art 2.1.15, comment 2.

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§13.66 e. Authority of Agents

Article 2.2.1 of the UNIDROIT Principles governs the authority of an agent to bind its principal directly in relation to a contract with a third party and applies only with the external relations of the principal or the agent on the one hand and a third party on the other, not the internal relations between the principal and agent. These internal relations are governed by otherwise applicable law. See UNIDROIT Principles art 2.2.1. Section 2 consists of ten articles corresponding generally to the 1983 Geneva Convention on Agency in the International Sale of Goods. Section 2 provides that for the establishment of a direct contractual relationship between the principal and a third party, it is sufficient that the agency is disclosed, *i.e.*, the third party knows or ought to have known that the agent is acting on behalf of a principal. See UNIDROIT Principles arts 2.2.2, 2.2.3.

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§13.67 8. Forming a Valid Contract

Chapter 3 of the UNIDROIT Principles deals with formation of the contract, as well as a variety of excusing contingencies and fairness issues, although it expressly excludes illegality, immorality, and lack of capacity. See UNIDROIT Principles art 3.1. It applies to all communications between the parties. Except in regard to the binding effect of the agreement, initial impossibility, or mistake, its provisions are mandatory for all agreements subject to the Principles. UNIDROIT Principles arts 3.19-3.20. The parties are assumed to be sophisticated business people, they are therefore understood to know the implications of reaching agreement, without need of any further formalities.

The agreement itself is the basis for contract enforcement, and may be enforced without any further requirement, including cause or consideration. UNIDROIT Principles art 3.2, and comment. Although impossibility may affect the remedies available for nonperformance, the contract itself is valid, even if impossible. UNIDROIT Principles art 3.3, and comment 1.

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§13.68 a. Mistake

Mistake is defined to include mistakes of law or fact. UNIDROIT Principles art 3.4. A mistake must be so substantial that, had a reasonable person known the true state of affairs, it would not have concluded the agreement or would have insisted upon materially different terms. UNIDROIT Principles art 3.5. The other party must also have been mistaken, or must have caused the mistake, or must not have acted in reliance on the contract. UNIDROIT Principles art 3.5(1). Moreover, the mistaken party cannot avoid liability under the contract, if the party "was grossly negligent in committing the mistake," or if the mistake relates to a matter in regard to which the risk of mistake was assumed by or, under the circumstances, should be borne by the mistaken party. UNIDROIT Principles art 3.5(2). A mistaken transmission or declaration is presumed to be attributable to the party responsible for the transmission or declaration. UNIDROIT Principles art 3.6.

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§13.69 b. Reasons for Avoidance

Avoidance of the contract is disfavored, and "preference is given for the remedies for nonperformance since they seem to be better suited and are more flexible than the radical solution of avoidance." UNIDROIT Principles art 3.7, comment 1. However, fraud and unjustified threat justify avoidance. UNIDROIT Principles arts 3.8-3.9. Unjustified threat is similar to duress, including economic duress: The threat must be "so imminent and serious" that the recipient of the threat has no reasonable alternative to assenting to the threatening party's terms. UNIDROIT Principles art 3.9.

Although the Principles do not include a provision on unconscionability, they do include a provision on "gross disparity," which allows avoidance if, at the time of contracting, a term or the contract itself "unjustifiably gave the other party an excessive advantage." UNIDROIT Principles art 3.10(1). The test for disparity is whether, given the nature and purpose of the contract, one party has taken advantage of the other's "dependence, economic distress or urgent needs, or of its improvidence, ignorance, inexperience or lack of bargaining skill." UNIDROIT Principles art 3.10(1).

The contract or an offending term may be reformed by a court to conform with what is reasonable and fair in the trade. UNIDROIT Principles art 3.10(2). Either party may request reformation of the contract, but the nonavoiding party must promptly inform the other party of its intent to request reformation before the other party has acted in reliance on its notice of avoidance. UNIDROIT Principles art 3.10(2)-(3). Acts of third parties may be attributed to the contracting parties if the third parties acted in ways leading to fraud, threat, or gross disparity, and if the contracting parties knew or should have known about the acts, or were responsible for them. UNIDROIT Principles art 3.11.

As long as it is given within a reasonable time, simple notice will suffice to avoid a contract. UNIDROIT Principles arts 3.14-3.15. The right to avoid a contract can be lost, however, if the other party agrees to cure the problem. UNIDROIT Principles art 3.13. Avoidance of a contract is precluded by a party's confirmation of the contract by words or conduct after the time for asserting grounds for avoidance. UNIDROIT Principles art 3.12. Moreover, avoidance of a single provision rather than of the entire contract is the appropriate remedy if sufficient to cure the problem. UNIDROIT Principles art 3.16. Avoidance operates retroactively, and both parties are entitled to restitution of what they provided under the contract up to the time of avoidance. The avoiding party is entitled to damages as if the contract had been performed. UNIDROIT Principles arts 3.17-3.18.

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9. Interpretation

§13.70 a. Determining Intent

Under the UNIDROIT Principles, if one of the parties knew (or could not have been unaware) of the other party's intent, the other party's statements and conduct will be interpreted according to that intent. UNIDROIT Principles art 4.2(1). If a party did not know or could not have known what the other party's intent was, however, then the objective standard applies, and statements and conduct will be interpreted "according to the meaning that a reasonable person of the same kind as the other party would give to it in the same circumstances." UNIDROIT Principles art 4.2(2), and comment 2. If words are not used in their ordinary and usual sense, the parties are assumed to have mutually understood and consented to that use, and in the absence of that mutual intention, the meaning of the word or phrase will revert to its ordinary and usual meaning within the trade. UNIDROIT Principles art 4.1, and comment 1.

A party's statements and conduct are to be interpreted according to the expressed intentions of the parties, or in accordance with the expectations of persons similarly situated. UNIDROIT Principles art 4.2. Moreover, when interpreting a contract, attention is to be given to the entire set of circumstances surrounding the contract, and specifically to practices established between the parties, preliminary negotiations, the parties' conduct subsequent to the contract, the nature of the contract, and its purpose, usages, and the meaning of terms in the trade. UNIDROIT Principles art 4.3.

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§13.71 b. Words and Terms

Words and terms are to be construed within the context of the entire agreement, with the aim of giving effect to all the terms in the agreement. UNIDROIT Principles arts 4.4-4.5. If one party has supplied unclear language, an interpretation against that party is preferred. UNIDROIT Principles art 4.6. When the agreement is written in two or more languages, in the absence of agreement regarding which version will be controlling, the original draft is to be preferred, although this preference is not conclusive, and the outcome is uncertain in a case in which two or more languages were employed from the beginning. UNIDROIT Principles art 4.7, and comment. Omitted terms may be supplied on the basis of the parties' intentions, the purpose and nature of the agreement, reasonableness, and good faith and fair dealing. UNIDROIT Principles art 4.8.

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§13.72 10. Express and Implied Obligations

Contractual obligations may be express or implied. UNIDROIT Principles art 5.1.1. The sources of implied obligations are reasonableness, good faith and fair dealing, usages, the practices established between the parties, and the nature and purpose of the agreement. UNIDROIT Principles art 5.1.2. A contract is "a common project in which each party must cooperate," and the parties thus have a mutual obligation to bring about the performance expected by the agreement. UNIDROIT Principles art 5.1.3, comment. The duty to cooperate is constrained within certain limits so as to assure that the allocation of performance under the agreement is not hindered. Although the duty not to hinder the other party's performance is paramount, there may be circumstances that would call for more active cooperation, however. UNIDROIT Principles art 5.1.3, comment.

The requirement to use best efforts goes beyond simple good faith, and the determination of what constitutes a best effort appears to be similar to a cost-benefit analysis, taking into account the contract itself, the price and other terms of the contract, the risk involved, and the other party's ability to influence performance. UNIDROIT Principles arts 5.1.4-5.1.5. In the absence of an express warranty or quality-of-performance provision, the parties are required to perform in a way "that is reasonable and not less than average in the circumstances." UNIDROIT Principles art 5.1.6.

If price is not included or determinable, unless there is evidence to the contrary, the price will be one generally charged in comparable circumstances in the relevant market when the contract was made, or, if such a price is not available, a reasonable price in the trade with reference to currently prevailing prices. UNIDROIT Principles art 5.1.7.

A contract for an indefinite time may be terminated by either party on reasonable notice. UNIDROIT Principles art 5.1.8.

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§13.73 11. Third Party Rights

The parties' intention to confer a right on a third party need not necessarily be stated expressly, but may also be inferred from the terms of the contract and the circumstances of the case. UNIDROIT Principles art 5.2.1(1). Further, the parties are not only free to confer a right on a third party or to exclude the creation of any such right, but also may subject the third party's right to any condition or limitation, including the possibility of revoking it until the beneficiary has accepted it. UNIDROIT Principles art 5.2.1(2); art 5.2.5, comment.

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§13.74 12. Performance

Chapter 6 of UNIDROIT deals with general standards of performance, many of them relatively technical and involving matters such as methods of payment, or payments in various currencies, obtaining government approval, and the timing, order, and place of performance. See UNIDROIT Principles arts 6.1.1-6.1.10, 6.1.14-6.1.17. These provisions are governed by general standards of good faith, fair dealing, and reasonableness under the circumstances. See, *e.g.*, UNIDROIT Principles art 1.7.

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§13.75 a. Part Performance

The Principles reject the perfect tender rule. UNIDROIT Principles art 6. Unless the obligee has no legitimate interest in doing so, the obligee may reject a partial tender of performance, with the burden on the other party to prove that the obligee has no legitimate interest in refusing the partial performance. UNIDROIT Principles art 6.1.3(1). If the other party proves that the obligee has no legitimate interest in refusing partial performance, the obligee cannot treat the partial performance as a breach. UNIDROIT Principles art 6.1.3, comment 3. The obligor is responsible for any additional costs incurred by the obligee as a result of the tender of the partial performance. UNIDROIT Principles art 6.1.3(2).

The obligee may also reject the tender of an early performance unless the obligee has no legitimate reason for doing so. UNIDROIT Principles art 6.1.5(1). Any additional costs associated with the tender of early performance will be assigned to the obligor. UNIDROIT Principles art 6.1.5(3).

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§13.76 b. Hardship

Ordinarily, when contract performance becomes more onerous for one of the parties, that party remains bound to perform its obligations subject to UNIDROIT's hardship rules. UNIDROIT Principles art 6.2.1. Hardship exists when events fundamentally alter the equilibrium of the contract, either because the cost of performance has increased or the value of the performance has diminished. UNIDROIT Principles art 6.2.2. The events must occur or become known to the disadvantaged party after the conclusion of the contract, must be such that the disadvantaged party could not have taken them into account when the contract was concluded, and must be beyond the control of the disadvantaged party, and the disadvantaged party must not have assumed the risk that the events would occur. UNIDROIT Principles art 6.2.2(a)-(d). The equilibrium of the contract must be fundamentally altered, as determined by the particular circumstances of the agreement. UNIDROIT Principles art 6.2.2, comment 2. If hardship exists, a party may request that the agreement be renegotiated, although this request will not excuse nonperformance in the meantime. UNIDROIT Principles art 6.2.3(1)-(2). If no agreement can be reached within a reasonable time, the parties may resort to a tribunal. If a tribunal finds hardship, it may, if reasonable, either reform the contract or fix a certain date and terms on which the contract may be terminated. UNIDROIT Principles art 6.2.3(3)-(4).

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§13.77 13. Nonperformance

Nonperformance is for all intents and purposes the same as breach. See UNIDROIT Principles art 7.1.1. Any defect in performance, including late performance or failure to perform, constitutes nonperformance. See UNIDROIT Principles art 7.1.1. The consequences of nonperformance will vary depending on a host of other factors.

A party may not complain of nonperformance if the nonperformance results from the party's own act or failure to act or an event as to which that party bears the risk. UNIDROIT Principles art 7.1.2.

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§13.78 a. Option to Cure

A nonperforming party has the right to cure, as long as notice of the proposed manner and timing of the cure is given to the other party, the cure is appropriate and is effected promptly, and the other party has no legitimate reason to refuse the cure. UNIDROIT Principles art 7.1.4(1). The aggrieved party retains the right to seek damages for delay and any other harm occasioned, or not prevented, by the cure. UNIDROIT Principles art 7.1.4(5).

Cure may include "repair and replacement as well as any other activities that remedy the nonperformance and give to the aggrieved party all that it is entitled to expect under the contract." UNIDROIT Principles art 7.1.4, comment 6. Repairs will constitute cure only when "they leave no evidence of the prior nonperformance and do not threaten the value or the quality of the product as a whole." UNIDROIT Principles art 7.1.4, comment 6. The courts are to determine how many times a nonperforming party may cure. UNIDROIT Principles art 7.1.4, comment 6.

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§13.79 b. Clauses Limiting Liability

Taking into account the purpose of the contract, a clause that limits or excludes a party's liability for nonperformance or permits a party to render performance substantially different from what the other party reasonably expected may not be invoked if invoking it would be grossly unfair. UNIDROIT Principles art 7.1.6.

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§13.80 c. Force Majeure

Although UNIDROIT Principles art 7.1.7 covers the common law doctrines of frustration and impossibility, it is not identical with those doctrines. For example, nonperformance may be excused if it was due to an impediment beyond the nonperforming party's control that the party could not have been reasonably expected to have taken into account at the time of contract conclusion or to have avoided or overcome the impediment or its consequences. UNIDROIT Principles art 7.1.7(1). This provision must be read together with the provisions on hardship. See §13.77.

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§13.81 d. Specific Performance

A party entitled to receive money under a contract may always demand payment, but may demand performance of nonmonetary obligations as well. UNIDROIT Principles arts 7.2.1-7.2.2. There is a presumption in favor of performance of nonmonetary obligations. Specific performance is favored over substituted performance, although peculiarly personal contracts and those for which performance has become impossible are excluded. A court must order specific performance unless one of the exceptions set forth in the Principles applies. See UNIDROIT Principles art 7.2.2(a)-(e), and comment 2. Included in the right to demand performance is the right to demand a cure of defective or nonconforming goods. UNIDROIT Principles art 7.2.3. If a party is ordered to perform and does not do so, a court may order the party to pay a penalty to the aggrieved party without any diminution in the aggrieved party's claim for damages. UNIDROIT Principles art 7.2.4. An aggrieved party is not necessarily bound by its election of remedies, as the aggrieved party is free to invoke any other remedies in the event of nonperformance. See UNIDROIT Principles art 7.2.5.

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§13.82 14. Termination

Termination of the contract is possible when the other party's failure to perform amounts to a "fundamental nonperformance." UNIDROIT Principles art 7.3.1(1). Whether a failure of performance is fundamental is decided on a case-by-case basis considering the following factors: (1) whether the aggrieved party is substantially deprived of the essence of the contract by the nonperformance; (2) whether the nonperformance is intentional or reckless; (3) whether the aggrieved party has reasonably lost confidence in the other party's ability or willingness to perform; (4) whether termination of the contract will result in a disproportionate loss to the nonperforming party; and (5) whether the nonaggrieved party foresaw or could have foreseen that the aggrieved party would be substantially deprived of what it was entitled to under the contract. UNIDROIT Principles art 7.3.1(2).

When appropriate, the right of termination may be exercised by simple notice given within a reasonable time and in a reasonable manner. UNIDROIT Principles art 7.3.2.

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§13.83 a. Anticipatory Repudiation

Notice of termination may be given based on an anticipated fundamental nonperformance, because a fundamental nonperformance that is expected to occur is equated with nonperformance that has already occurred. UNIDROIT Principles art 7.3.3, and comment. When there is adequate reason to believe that the other party will not perform, the aggrieved party may demand adequate assurances of performance in place of termination, but, if the assurance is inadequate or not given, the aggrieved party may proceed with notice of termination. UNIDROIT Principles art 7.3.4.

Termination ends the mutual responsibilities of the parties with respect to future performance, although the parties are responsible to each other for performances and payments up to the date of termination. After the date of termination, the parties are further entitled to restitution of supplies and services that were provided in anticipation that performance would occur. UNIDROIT Principles art 7.3.5-7.3.6.

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§13.84 b. Damages

If restitution cannot be provided, the equivalent monetary value should be provided whenever reasonable. See UNIDROIT Principles art 7.3.6. The aggrieved party in any event retains its right to seek damages for the nonperformance. UNIDROIT Principles art 7.3.5.

Unless the nonperformance is excused, damages are available in every instance of nonperformance, either exclusively or together with other remedies. UNIDROIT Principles art 7.4.1. A party is entitled to full compensation for the harm sustained, including damages for any loss suffered, and for any gain of which it was deprived, account being taken of any gain the aggrieved party received from its avoidance of harm or cost. UNIDROIT Principles art 7.4.2(1). Compensable harm may be nonpecuniary and includes physical suffering and emotional distress. UNIDROIT Principles art 7.4.2(2).

The breadth of damage recoveries is somewhat limited by the requirement that the harm be reasonably foreseeable. UNIDROIT Principles art 7.4.4. The standard for foreseeability relates not only to the existence of the harm but to its extent, and the nonperforming party will be held to account "only for harm which it foresaw or could reasonably have foreseen at the time of the conclusion of the contract as being likely to result from its nonperformance." UNIDROIT Principles art 7.4.4.

The Principles adopt common law measurement standards, including cost of contract cover or replacement and current price of performance reduced by the aggrieved party's duty to mitigate and by expenses attributable to the aggrieved party. UNIDROIT Principles arts 7.4.5-7.4.8.

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Source: Business Law/California Law of Contracts/13 Selected International Issues/§13.85 (1) Interest

§13.85 (1) Interest

When the nonperformance involves the payment of money, even if the nonperformance is excused, the aggrieved party is entitled to interest from the time the nonperformance occurred. UNIDROIT Principles art 7.4.9(1). Interest is calculated according to the bank short-term rate for prime borrowers at the place where performance was to have occurred, although the default rules fall back on domestic law when the short-term prime rate is not calculable. UNIDROIT Principles art 7.4.9(2). Damages for nonperformance other than the failure to pay money are also entitled to interest from the time the nonperformance occurred. UNIDROIT Principles art 7.4.10.

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Source: Business Law/California Law of Contracts/13 Selected International Issues/§13.86 (2) Payment Methods

§13.86 (2) Payment Methods

Although a tribunal may order installment payments, damages are ordinarily to be paid in a lump sum, in either the currency expressed in the obligation, or the currency in which the harm was suffered, whichever is more appropriate. UNIDROIT Principles arts 7.4.11-7.4.12. The parties may enforce liquidated damages provisions, although a tribunal has reserved the power to modify the amount due, if it is "grossly excessive in relation to the harm suffered." UNIDROIT Principles art 7.4.13.

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§13.87 15. Set-off

Set-off of mutual debts is common in commercial dealings. In general, the conditions for set-off are (1) that the two obligations are of the same kind and fixed as to their existence and amount, and (2) that performance is due. UNIDROIT Principles art 8.1(1). If the two obligations arise from one and the same contract, one party may set off its obligation against the other party's obligation even if the latter is not yet ascertained either as to its existence or amount. UNIDROIT Principles art 8.1(2).

The right of set-off is not automatic, but does not require a court order; it is exercised by notice to the other party. UNIDROIT Principles art 8.3. Once set-off has been declared, the obligations of both parties are discharged as if the two reciprocal payments has been made, although, if the two obligations differ in amount, set-off will discharge the obligations up to the amount of the lesser obligation. UNIDROIT Principles art 8.5(1)-(2). Set-off takes effect at the time of notice rather than when the conditions for set-off have been met. UNIDROIT Principles art 8.5(3).

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§13.88 16. Assignment of Rights, Transfer of Obligations, and Assignment of Contracts

Chapter 9 of UNIDROIT includes sections on assignment of rights, transfer of obligations, and assignment of contracts. Section 1 covers all voluntary transfers, including transfers for security of the assignor's right to payment of a monetary sum or other performance from a third party obligor. UNIDROIT Principles art 9.1.1. It does not include transfers of instruments such as bills of exchange, bills of lading, stocks, or bonds, or transfers of rights in the course of transferring a business, if such transfers are made under special rules. UNIDROIT Principles art 9.1.2. Section 1 provides that, for an assignment to be effective, the obligor's consent is generally not required (UNIDROIT Principles art 9.1.7(1)) although there is an exception in art 9.1.7(2) for obligations of an essentially personal character. In general, the obligor is entitled to compensation only for any additional costs caused by the assignment (UNIDROIT Principles art 9.1.8), although art 9.1.3 prohibits an assignment of nonmonetary rights if the assignment would render the obligation significantly more burdensome for the obligor. The obligor will be discharged by paying the assignor until it receives notice of the assignment; the obligor must commence paying the assignee only after receiving notice of the assignment. UNIDROIT Principles art 9.1.10. The assignor, however, may be liable to the obligor for breach of contract. UNIDROIT Principles art 9.1.9(1). An assignment of monetary rights is effective notwithstanding any previous agreement to the contrary between the assignor and the obligor. (The Principles favor the assignment of rights as an efficient means of financing.) See UNIDROIT Principles art 9.1.9, comments 1-2.

Any transfer of obligations requires consent of the obligee. UNIDROIT Principles art 9.2.3. When the obligor agrees with another person, without the obligee's consent, that the other person will perform the obligor's obligation, such an agreement is effective unless the obligation has an essentially personal character. The obligee retains its claims against the obligor. UNIDROIT Principles art 9.2.6. The obligee's consent may be given in advance, in which case the transfer is effective when notice of it is given to the obligee or when the obligee acknowledges it. UNIDROIT Principles art 9.2.4.

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§13.89 17. Limitation Periods

Chapter 10 of UNIDROIT deals with limitation periods—when they begin to run, whether and under what circumstances they may be suspended or begin to run again, and whether they may be shortened or extended by agreement. UNIDROIT Principles arts 10.1-10.11. Chapter 10 adopts a two-tier system of limitation periods, with a short general limitation period of 3 years combined with a maximum cut-off period of 10 years. UNIDROIT Principles art 10.2(1). The general limitations period begins to run on the day after the claimant has actual or constructive knowledge of its claim, rather than when the claim accrues (such as the date of breach). UNIDROIT Principles art 10.2(1). This is substantially the same rule as the American "discovery" rule. Commencement of suit or arbitration tolls the limitations period. Tolling is also provided for "alternative dispute resolution proceedings whereby the parties request a third person to assist them in their attempt to reach an amicable settlement of their dispute." UNIDROIT Principles arts 10.5-10.7. Force majeure, death, or incapacity tolls the limitation period. UNIDROIT Principles art 10.8. Further, any acknowledgment by the obligor of the obligee's right or claim before the expiration of the general limitation period resets the limitation period. UNIDROIT Principles art 10.4.

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