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## Staying In Front

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March 2007

## Staying In Front

Roger Bernhardt

### *Wachovia Bank v Lifetime Indus.*

How the original financing that led to the trouble in *Wachovia Bank v Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 52 CR3d 168, reported at p 62, was intended to work is too complicated for any but the attorneys who drafted the original documents 14 years ago to comprehend. The lessons that the court of appeal wanted to impart would have been considerably clearer had it omitted all of those Byzantine facts and, instead, reduced the case to its simpler essentials.

Those essentials are that in 2004, an entity named PAT exercised an option to purchase property from FGHK. Since the option had been created in 1994, PAT claimed that it was free and clear of a mechanics' lien that had been recorded by Lifetime in 2002. If PAT's title stemmed from the 2004 deed, then it was subject to Lifetime's mechanics' lien; but if the title related back to the 1994 option, then it predated—and was not subject to—that lien.

An option to purchase gives the optionee two significant benefits:

- *First*, as an internal matter between optionee and optionor, it can compel the property owner (the optionor) to sell the property later on, even though she might otherwise not want to.
- *Second*, externally, as long as the option is properly recorded, the title later conveyed pursuant to it relates back to the date the option was given and thereby takes priority over any intervening rights.

Thus, leases, contracts of sale, servitudes, and anything else created subsequently will be subject to the option—and may be lost when and if it is later exercised. The same is true for liens: Lifetime's mechanics' lien would be eliminated by PAT's paramount title if that title derived from the previously given option.

There was no doubt that the option itself had been properly created, properly recorded, and, thereafter, properly exercised. (There was some question whether the option constituted a mortgage clog subject to CC §2906 because exercise of it was connected to a default. Full resolution of that issue would have required an exhaustive study of the entire financing arrangement that the court did not want to undertake; nor do I.)

Lifetime's strategy was to acknowledge these points, but declare them irrelevant because PAT's title assertedly did not derive from the option. It is true that any third party who acquired it from FGHK would take title subject to Lifetime's lien, without the benefit of any relation back. PAT exercised its option *and* it acquired title to the property, but did it acquire the title *because* it had exercised its option? Here, the court paraded some horrors (145 CA4th at 1054):

Suppose, for example, that a condition to exercising an option to purchase property does not occur, or the optionee has breached the terms of the option agreement such that he cannot enforce the option, but the optionee nevertheless purchases title to the subject property in a new transaction wholly unconnected with the option. Under these circumstances, it appears to us that

the purchaser should not have the benefit of the relation-back rule and his title should have no effect upon interests in the property that arose after the option and before the optionee's purchase.

Well, I guess that statement is true, but probably because the scales were loaded by making the new transaction "wholly unconnected." What if the final deal was only partly unconnected to the original one? In this case, the court was bothered by the fact that PAT took title by a quitclaim rather than a warranty deed, as the option called for, and by the fact that the conveyance was delayed because PAT was fighting with Lifetime over priority. If those two facts can disconnect a deed from its previous option, then holders of options must be extremely careful not to squander their priority. In this case, for instance, the option's reference to a warranty deed was obviously made by a New York attorney who neither practiced in California nor knew that such an instrument is effectively unknown here. Should California counsel, undertaking to complete the option purchase, attempt to draft such an instrument (with the attendant risks of using a nonform and untested document)? Or should she instead use a recognized California form, perhaps exposing her client to loss of relation back due to noncompliance with the terms of the option? Similarly, if there are deadlines in the option agreement that are jeopardized by external snags (here, the priority fight between PAT and Lifetime), should she advise the optionee to surrender to the third party in order to make the deadline, or dare she tell it that it can perform late as long as the optionor agrees (even if the third party doesn't)?

The court gives us the rule that relation back applies only when the optionee could compel specific performance, but I find that helpful only in an all-or-nothing context. In this case, for instance, neither party could specifically compel the other to deliver or accept a quitclaim deed, which makes it seem like there should be no relation back. Employing a hypothetical specific performance mini-trial to decide an issue between optionor and optionee seems like a dubious way to resolve a real priority contest between optionee and third party claimant.

The risk of losing relation-back status is not confined to option situations. All (but gift) deeds relate back to an earlier contract of sale, thus raising the issue of the priority of other claims that arise between execution of the contract and close of the escrow. In my experience, deals are more likely to be revised along the way than go from beginning to end without revision. The "relation back/specific performance" test thus puts the security and priority of a lot of transactions in question. Title opinions will have to do a lot of fudging.

I would have preferred a simpler standard. In *Meadows v Lee* (1985) 175 CA3d 475, 221 CR 22, where a court had to decide whether an original purchase contract that was performed late thereby lost its priority to a later contract sitting in backup position, the court employed a subjective test: Was the completion of the first contract "consummated between the original contracting parties in the absence of any showing of fraud or collusion as against third parties"? 175 CA3d at 483. That test is considerably more subjective than the *Wachovia Bank* standard. Under it, declarations from the optionor and optionee should be sufficient to warrant relation back unless the third party can show fraud or collusion. (I should note that the dissent in *Meadows* believed it a mistake to reach such a result "solely from the fact that the original parties are not presently disputing the validity of the second contract" (175 CA3d at 487), but the test clearly has the virtues of simplicity and certainty.)

I suggest that in any transaction, the original parties—optionor and optionee, or whoever they are—accompany their closing with a joint declaration that it derives from their original deal (if

that is true). That should matter considerably under the *Meadows* standard, and will certainly not hurt under what may be the more restrictive *Wachovia* test.

Of course, it would also be nice for an optionee or purchaser to give itself additional elbow room by providing in the original contract that it embraces all, *e.g.*, alterations, revisions, extensions thereafter, if any such occur, borrowing from the way that lenders seek to preserve their priority despite subsequent modifications of their loan arrangements. But that takes forethought as well as consent of the other party, neither of which may be easy. Even then, how confident can their attorneys be that the language will work?

There is probably no way to provide 100 percent assurance that relation back will not be lost when the terms of a deal are altered. I guess the best we can do is be alert to the risk and hope for the best.

**Evidence that optionee had obtained title to optioned property was not sufficient to extinguish intervening mechanics' lien absent evidence optionee's title was obtained under the option.**

*Wachovia Bank v Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 52 CR3d 168

In 1993, Kmart sold an estate for years in property (Property) to Shawmut Bank and deeded the remainder interest (Remainder) to FGHK; FGHK sold Shawmut Bank an option to purchase the Remainder (Option Agreement) on the occurrence of specified events; Shawmut Bank mortgaged its interest in the Property (Deed of Trust) and assigned its interest in the Option Agreement to The Bank of New York.

In 2002, Lifetime Industries, Inc. (Lifetime) recorded a mechanics' lien against the Property.

In April 2003, The Bank of New York assigned its beneficial interests under the deed of trust to Wachovia Bank as the asset trustee for the property acquisition trust (PAT). At a 2003 foreclosure sale under the deed of trust, PAT purchased the estate for years and the rights of the optionee under the Option Agreement.

In January 2004, Lifetime obtained a judgment against FGHK providing for an award against FGHK, a lien on its ownership interest in the Property for the amount of the award, and an order that FGHK's interest in the Property be sold at public auction to pay the sums owed. In February 2004, when PAT notified FGHK of its intent to exercise the option to purchase the Remainder, FGHK asserted that PAT had breached the Option Agreement (by failing to protect the Property against the mechanics' lien) and was not entitled to specific performance.

PAT sued Lifetime and FGHK seeking, among other things, to quiet title. The trial court granted PAT's motion for summary adjudication of its claims against Lifetime.

The court of appeal reversed. An option to purchase real property is not a sale of the property, but a sale of a right to purchase the property. On exercise, the option is transformed into a contract of purchase and sale. When an option to purchase real property is exercised, the right to purchase the property relates back to the time the option was made. Until title is transferred, the optionee holds only a right to complete the purchase, enforceable by specific performance. Intervening interests, while subject to this right, are not yet extinguished. Furthermore, under the mechanics' lien law, once a lien is recorded, the lien will relate back to the date the first labor or material was furnished-for the work of improvement, and transferees who take an interest in the

property after work has begun, and before the claim of lien is recorded, take subject to the lien. 145 CA4th at 1051.

Here, there was evidence to prove, or Lifetime did not dispute, that PAT held the option to purchase, the option was given and recorded prior to the date Lifetime first provided the labor or material for the work of improvement to which its mechanics' lien related, and PAT exercised the option to purchase on February 26, 2004. However, the mere exercise of the option without consummation of the purchase and sale transaction did not provide PAT with title to the Remainder. Based on the record, title to the Remainder continued to be held by FGHK. Accordingly, Lifetime's lien against FGHK's interest in the remainder had not been extinguished.

The court denied PAT's CCP §909 motion to take evidence of a quitclaim deed from FGHK to PAT dated after the hearing on the summary adjudication motion. PAT submitted no evidence that its receipt of the quitclaim deed was pursuant to its exercise of the option. If an optionee takes title to property when the optionee would not have been able to compel specific performance of the option, the relation-back rule does not apply, and the title obtained by the optionee does not extinguish intervening interests.

However, the court rejected Lifetime's argument that, under CC §2906, the exercise of the option, which was used as part of a financing transaction, could not relate back to the date of the option. Because the Remainder was not collateral within the meaning of §2906, the option, although granted to acquire an interest in the Remainder, was not granted to acquire an interest in real property collateral.