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The Cost of Free Looks—Ruminations on *Steiner v Thexton*

Roger Bernhardt

Background

Because real estate purchase transactions inevitably begin with a contract of sale between the parties, what the California Supreme Court says about the rules of contract formation is fairly important to the real estate community. The supreme court has spoken quite a bit in these past few years, although I have regarded its pronouncements as constituting a rather mixed blessing. For instance, in *Patel v Liebermensch* (2008) 45 C4th 344, 86 CR3d 366, reported at 32 CEB RPLR 60 (Mar. 2009), when it advised the bar that a sales contract can be specifically enforced even though it fails to specify the manner and time of payment, because those components can be implied, I thought that not only entirely conformed to the traditional rules but also made matters easier for attorneys when called on to advise their clients whether the handwritten notes they had exchanged with their counterparties did or did not constitute enforceable contracts. See Bernhardt, *The Editor's Take*, 32 CEB RPLR 60 (Mar. 2009).

On the other hand, when the court held, in *Sterling v Taylor* (2007) 40 C4th 757, 55 CR3d 116, reported at 30 CEB RPLR 54 (Mar. 2007), that a memorandum that was ambiguous as to the price could be helped by extrinsic evidence in one direction but not the other, I brooded that its ruling worsened rather than improved predictable advice-giving for attorneys. See Bernhardt, *Midcourse Corrections: Attorney Fees and Lien Priorities; Statute of Frauds*, 30 CEB RPLR 75, 77 (May 2007). I now have a similar reaction to the high court's decision last month in *Steiner v Thexton* (2010) 48 C4th 411, 226 P3d 359, reported at p 64 of this issue: I fear advice to clients about the status of their deals is not only more precarious than before, but it is now precarious in a wider range of situations.

Steiner v Thexton

In *Steiner*, the parties signed a contract (homemade, I am told, but very similar in appearance to standard-form real estate purchase agreements used by most brokers) that gave the buyer three years to obtain all of the appropriate entitlements for subdivision and to purchase 10 of the seller's 12 acres of land. One paragraph of the contract recited, "It is expressly understood that the buyer may, at its absolute and sole discretion during this period, elect not to continue in this transaction and this purchase contract will become null and void." After the buyer spent the following year investing significant time and money on permit approval, the seller abruptly withdrew from the contract. The buyer sued him for specific performance.

The trial court upheld the seller's withdrawal, characterizing the transaction as "an option not supported by any consideration," which conclusion the Third District Court of Appeal, and a lengthy (and thoughtful) opinion by Presiding Judge Sims, endorsed. But the California Supreme Court ruled that the deal amounted to an option that was supported by consideration, thereby disagreeing with both lower courts.

The high court's decision comprises two rulings, both of which include footnotes that real estate counsel may find unsettling.

Illusory Promises

The first holding was that the buyer's reservation of an absolute right to withdraw did make his promises to perform illusory and reduced the transaction from an enforceable bilateral contract to an option, from which the seller could withdraw at any time before it had been accepted. That holding was no different than what both the trial and appellate courts had concluded, and in fact seems even stronger on that point due to its explicit rejection of the argument that an implied covenant of good faith and fair dealing could trump the termination provision. In order, I think, to have this decision not jeopardize too many real estate deals, the court then sought to carve out an exception by declaring that the provision before it was different from what appears in standard real estate contracts. (Footnote 8 declares, "Thus, bilateral contracts subject to a contingency, which are widely used in real estate transactions, are not affected by our holding.") But since many real estate contracts do include provisions that are not that different from the one Steiner used in his deal with Thexton, I do believe that brokers (and attorneys for buyers and sellers) should worry about the impact of this decision.

The San Francisco Association of Realtors form currently provides (in Paragraph 12) that "Buyer's obligations under this contract are conditioned upon Buyer's written *approval at Buyer's sole discretion* of both the physical condition of the Property and any other matter affecting the Property." (Emphasis added.) I do not perceive that the "sole discretion" buyers have given themselves in the San Francisco form is that different from the "absolute and sole" discretion that Steiner reserved for himself (or that it matters that the discretion may be limited in the San Francisco form to particular subject matters—a remorseful buyer can probably hide behind the clause for any reason, as long as she chooses her words carefully). The SFAR provision—which, I am told, is not going to be revised because of *Steiner*—puts an offer to purchase property on a very different legal footing than an offer made through the Professional Publishing form, which does not give the buyer similar back-out rights. A vendor with misgivings should have a much better chance of being able to withdraw under the SFAR form than under the PP form, in light of *Steiner v Thexton*.

The California Association of Realtors (CAR) Residential Purchase Agreement has for some years given buyers 17 days to "approve all matters affecting the property." I have long mistrusted CAR's belief that the implied covenant of good faith saved it from the fate of illusoriness. The new form (RPA-CA), which took effect April 28th of this year, now faces attempts to deal with that issue by adding the statement, "*Any removal of contingencies or cancellation under this paragraph by either buyer or seller must be exercised in good faith and in writing.*" (Paragraph 14; emphasis added.) While I doubt that a buyer's obligation is realistically any more burdensome under this new provision than it was under the old one, I must confess that—given the supreme court's obvious reluctance to have its *Steiner* rule apply to all real estate transactions—CAR's new revision is likely to save the agreement from judicial accusations of illusionism, as long as no one examines the differences and similarities too closely.

Substitute Consideration

The second part of the high court's opinion concluded that the efforts and funds that Steiner subsequently expended toward getting the property subdivided constituted sufficient consideration to convert the previously illusory noncontract into an irrevocable option.

This contention had been rejected by the court of appeal on the ground that adequacy of consideration is measured at the time the agreement is made—not later. But the high court

decision should have less effect on standard real estate transactions, since most buyers do not spend the next year seeking permit entitlements on property they are thinking of purchasing. In terms of overall impact on the trade, most illusory purchase agreements could be expected to fail under the first leg of *Steiner* and not qualify for rehabilitation under its second.

But, again, there is a muddying footnote. Footnote 12 declares:

[W]e also note the agreement required Steiner to deposit \$1000 into escrow, which he did. The trial court concluded the payment did not constitute consideration because Steiner would recover the money if he terminated the agreement; thus, the money did not confer a benefit on Thexton. However, even assuming the trial court's interpretation of the agreement is accurate, it is not clear that its ultimate conclusion is correct... [B]y placing the money in escrow, Steiner gave up use of the money for as much as three years. This arguably constituted prejudice to Steiner even if he ultimately got the money back. In light of our conclusion regarding plaintiff's part performance, we need not resolve the effect of the escrow payment.

If it is unresolved whether escrow deposits may constitute sufficient consideration to make contracts binding despite their being refundable, then that is an issue for attorneys to note. If you represent a buyer who wants so much wiggle room as to make you fear that his obligation will be called illusory, then you should provide that his deposit constitutes consideration—indeed, perhaps even propose that it be made interest-bearing, with the interest it earns (and perhaps even part of the principal) going to the seller if the buyer withdraws. If the supreme court has signaled that it wants to find ways to uphold these deals, then lawyers should certainly cooperate in their document drafting and negotiating.

CAR's New Form in Vanilla Deals

The new CAR form's explicit requirement of good faith may satisfy the judicial concern as to whether an obligation is illusory or real, but I do not believe that it gives much comfort to counsel as to how weighty withdrawal rights really are. Can you tell a buyer that she may change her mind the day after she signed because she has now realized just how much extra she will have to pay each month on the new mortgage? Can you advise the seller that he can safely withdraw because his children have just learned what he did and rebuked him for giving up the home that they had grown up in? (See *Converse v Fong* (1984) 159 CA3d 86, 205 CR 242.) Is there "honesty in fact and the observance of reasonable commercial standards of fair dealing" (as Com C §1201 defines it)? Good faith appears to me more a comforting crutch for judges than a source of reliable guidance for parties in the real world who must face having to testify on the witness stand about their motives for repudiation, which too often may be psychologically persuasive but legally dubious.

Another feature I note in the new good faith provision is that it applies to sellers as well as buyers. The seller is given the right to cancel if the buyer fails to perform some of his duties in a timely way, but since the form now obliges the seller to first send a "Notice to Buyer to Perform," it is not clear in what other ways she is constrained by good faith. Many brokers believed (under the old form) that the seller was bound while the buyer was free to cancel during the 17-day period, but if the buyer's right made the deal illusory, then the seller was equally free to walk out, with or without good faith (as would have been true for Thexton had Steiner not already put in all that effort). Since the supreme court has explicitly held that the implied obligation of good faith cannot make an illusory promise into a binding obligation, it is doubtful

that an express statement of good faith can have a different effect (unless we all agree that *Steiner* does not apply to ordinary real estate deals).

Why Not Free Looks?

While the CAR form may mean that neither party can be too sure as to just how much either is bound to go through with the deal, it may be comforting to add that under the form, it may also be true that this twilight zone probably lasts only 17 days, after which time the parties can get down to business. But 17 days of uncertainty may be a high price for a buyer to pay just to have some time to cool off about his purchase. There may be more appealing alternatives, such as a true option, when the seller may be willing to hold her property off the market for a few days in return for a respectable nonrefundable cash payment, even if it is ultimately applied to the price.

Other jurisdictions employ what may be an even better choice. Elsewhere, real estate contracts often include attorney approval clauses, which make the obligations of the parties contingent on the approval of their attorneys. See, e.g., *Devine v Notter* (Wis 2008) 753 NW2d 557. The approval can be a condition precedent (see *Kellie Auto Sales v Rahbars & Ritters* (Ohio 2007) 876 NE2d 1014) or a condition subsequent (see *Patel v McGrath* (Ill 2007) 872 NE2d 537), but it gives the parties a cooling-off period in either case.

The reason I commend this provision as an attractive alternative on this issue is because of the decision by the New York Court of Appeals in *Moran v Erk* (2008) 11 NY3d 452, 901 NE2d 187, when it was considering a form contract that included the standard three-business-day attorney approval clause. According to the court (11 NY3d at 454):

After signing the contract, the Erks developed qualms about purchasing the Morans' house. They discussed their misgivings with their friends and family, and ultimately decided to buy a different residence. As a result, they instructed their attorney to disapprove the contract, and she did so on October 28, 1995, which was within the three-day period for invoking the attorney approval contingency.

When the seller then sued for damages on the ground that the covenant of good faith limited their attorney's ability to reject the contract, the court of appeal held (11 NY3d at 459): "An attorney for either party may timely disapprove the contract for any reason or for no stated reason" (lest she be made to testify as to confidential communications).

On balance, the New York practice may be better for both parties than we have in California. Here, for 17 days, a buyer may back out but must hope that he will be found to have done so in good faith, and we are quite unclear as to whether the seller can do the same. In New York, all either party has to do is to visit an attorney within three business days and pay her to write a letter (which should not cost that much, since it need give no reason). It seems to me that if we are going to keep seeing quasi-illusory arrangements, we might as well let the lawyers profit from them.

Steiner v Thexton (2010) 48 C4th 411, 226 P3d 359

Martin Steiner entered into an agreement to purchase 10 acres of Paul Thexton's 12.29-acre parcel for residential development for \$500,000. Thexton had rejected a prior offer of \$750,000 from a different party because that party wanted Thexton to obtain the required approvals and permits. The agreement between Steiner and Thexton provided that Steiner would obtain the

necessary approvals, including a parcel split, absorb the costs, and have absolute discretion to cancel the transaction at any time. After Steiner had spent substantial sums, Thexton reneged on the purchase agreement and canceled the escrow. Nevertheless, Steiner obtained approval for a tentative map and sued for specific performance. The trial court, following a bench trial, concluded that the agreement was merely an option unsupported by consideration. The court noted that the agreement was unilateral in that Steiner could cancel at any time and had provided Thexton with no payment or benefit in exchange for the option. The trial court also rejected Steiner's claim that promissory estoppel supported enforcement of the agreement. The court of appeal affirmed the trial court.

The supreme court concurred with the lower courts that the agreement constituted an option, but concluded that Steiner's efforts and expenditures in obtaining approval of the tentative map constituted sufficient consideration to render the option irrevocable. The supreme court pointed out that Steiner had provided bargained-for benefit to Thexton and had agreed to suffer prejudice by undertaking to obtain the necessary approvals. (The prior offeror had offered substantially more for the property, without such an undertaking.) Such consideration, unaffected by the power to cancel, cured the illusory nature of the initial promise.