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## Rethinking Rescission

Roger Bernhardt

*Golden Gate University School of Law*, [rbernhardt@ggu.edu](mailto:rbernhardt@ggu.edu)

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**September 2015**

## **Rethinking Rescission**

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*Wong v Stoler (2015) 237 CA4th 1375*, reported at p 133, is a fascinating decision to read and to draw predictions from.

The basic facts are that the purchasers of a hillside residence in San Carlos rescinded their completed contract because of misstatements made by the sellers to the effect that the property was served by a public sewer, when in fact the system was privately owned by the 13 residents of the area, who all had to share its maintenance costs. The trial court found that the sellers' statements were negligent misrepresentations, but it declined to order rescission because of the complications involved in unwinding the deal. Instead, it ordered the sellers to indemnify the purchasers for their sewer maintenance costs over the next decade.

The complications that deterred the trial court from granting recessionary relief included that this contract had been completed in 2008. In the seven years since then, the purchasers had spent \$300,000 on remodeling the property, including rebuilding the garage and the kitchen and removing much of the landscaping, before giving up attempting to get their neighbors to take the steps the city was requiring about the sewer. Meanwhile, the sellers had spent \$100,000 on improving their new house. Would you want to be the judge who had to untangle a mess like that?

But the court of appeal thought the trial court did not have discretion to refuse to unwind the transaction because a failure to do so would deny the purchasers the full relief that our statutes demand in the case of a successful rescission. Because the trial court had found the sellers to be guilty of negligent misrepresentation, and since that is a species of fraud, the purchasers were entitled to rescind and to be awarded "complete relief" under [CC §1692](#), which the trial court's substitute indemnity order did not provide.

### What Does This All Mean?

Defrauded purchasers (with whom I include for convenience those harmed by negligent misrepresentation as well as by lies) have always had a choice of two remedies: They could affirm the contract and sue for damages or they could rescind the contract and seek restitution. An action for damages is limited in most cases, by [CC §3343](#), to the difference between the price paid ("the actual value of that with which the defrauded person parted") and the value of the property purchased ("the actual value of that which he received)." This is not a very healthy measure. For

instance, if the seller says that the property has amenities that make it worth \$1 million—which would be correct if true—but it has no such amenities and is worth only \$750,000, the purchasers have no [§3343](#) damages if they only paid \$750,000 for the property (thinking they were getting a bargain). [Section 3343](#) explicitly asserts that a defrauded person *cannot* recover the difference between the “value of property as represented and the actual value thereof.” Although the statute sometimes permits a defrauded purchaser to recover lost profits, that protection does not extend to residential buyers who intended to live there. Thus, purchasers who were deceived but nevertheless got what they paid for (rather than what they misbelieved it was worth) have no recoverable damages and are generally forced to choose rescission instead of suing at law.

Rescission doesn't entitle a party to benefit-of-the-bargain damages either, but it does let swindled purchasers get their money back. If a national economic bubble has burst, so that the property they now own is worth a lot less than what they originally paid for it (the Wongs paid \$2.35 million for the property in 2008), rescission may be the smarter choice (although with prices now surging again, the Stolars may be the ones who make a profit in this particular case).

Rescission has its own requirements, so counsel for plaintiffs must first make sure that this remedy is available. [Civil Code §1689b](#) requires a showing of mistake, duress, menace, fraud, undue influence, failure of consideration, or illegality, but the fraud requirement is probably no different from the fraud needed in a damage action under [CC §3343](#). Fraud includes negligent misrepresentation, according to this case (and perhaps [CC §1710\[2\]](#))—although the opinion throws in for good measure that the sellers' statements were made with “reckless disregard.” The *Wong* decision treats the grounds of fraud or breach of contract as justifying either remedy (although I would expect a minor breach of contract to more readily support an action for damages than one based on rescission).

The two forms of relief do differ as to timing. Damage actions for fraud must be filed within 3 years of discovery ([CCP §338\(d\)](#)), whereas, although there is no formal statute of limitations for rescission, [CC §1691](#) requires plaintiffs to “promptly upon discovering the facts ... give notice of rescission.” (The section also requires (prompt?) restoration of what was purchased, except that an offer to restore is just as good. The section further provides that service of a pleading may substitute for the notice of rescission.) In this case, the Wongs purchased the property in May 2008, took possession of it in July, and then learned the truth about the sewer in November. Apparently, they never sent a preliminary notice of rescission, nor do we know when they filed suit. We are told that after they first learned about the problem, they tried to resolve it with their neighbors “without involving the Stolars” and that their offer to restore was made after their filing of a complaint. These latter facts incline me to believe that a delay in sending a rescission notice is forgivable if the interim time was spent attempting to solve the problem, not that the offer to restore must coincide with the filing of the lawsuit—except that a judge reluctant to wade into the nightmare of undoing a complex transaction might be tempted to find an escape by ruling that the notice of rescission or offer of restoration was not prompt enough. I would not rely too heavily on the generosity of the *Wong* decision in using it as an excuse to act tardily.

Too Hard to Unscramble?

The chief error committed by the trial court, according to the court of appeal, was in declining to effectuate the purchasers' rescission because of the prejudice that would cause to the sellers. I gather that this "prejudice" encompassed several features, including:

- The sellers had since improved their new property at a cost of \$100,000; and
- The purchasers had altered their property by changing the kitchen and garage and removing some of the landscaping.

How do you correct for those facts?

The sellers' improvements were easy to dispose of: Harm to the sellers was an "improper consideration" not to be factored into the judgment. (Anyway, since rescission would merely make the sellers take back their old house, but not give up their new one, what they spent on it really wouldn't matter.) On the other hand, the improvements made by purchasers did get considered, but their largeness was offset by the fact that

- They were made before the purchasers discovered the truth; and
- Improvements are made recoverable by [CC §1692](#).

The purchasers waived their claim for the value of their improvements, as opposed to their cost, but I do not know how much good that did them, since neither cost nor value is used in the statute. (I imagine that our innocent-improver statutes might come into play on that question.) The economic effects of the lost landscaping were not discussed, but I imagine that they might serve as a sort of offset against what the sellers have to give back, unless their innocence trumps that consideration.

Overall, I think that rescinding purchasers will not only get their money back, but also more than that for value-increasing improvements they have made and for unavoidable expenditures they have incurred, and without deductions for value-decreasing activities, if those were shown to have occurred before the discovery of the fraud. That would probably include broker commissions, title expenses, moving costs, purchase price payments, and interest on them. Defrauded purchasers who rescind will also benefit from a lower market value (during a recession) because they get their entire price back when they return the property, whereas a damage action measured by "the actual value of that which he received" is probably based on the value as of the date the sale closed without regard for subsequent depreciation; they may recover some damages, but not for subsequently reduced value.

Of course, rescinding purchasers will have to pay rental value for the time of their occupancy, although only if they actually took possession, which would not be owed if they sued for damages instead. Whether they can recover from their vendor the mortgage payments they made in the interim is more complicated. I know of no law on this issue, so the rest of this paragraph is simply speculative wondering by me. Should vendors be required to subtract from what they recover for rental value what the purchasers paid on the mortgage? Those payments were actual expenditures by the buyers and—like taxes—saved the property from being foreclosed, making it perhaps unnecessary to ask whether they did the seller any good. If the purchasers get some kind of credit for their mortgage

payments, should it be for the entire payments or just the interest components, or just the principal reductions? Should it matter whether the mortgage was paid off as part of returning the property to the sellers (with the inclusion of a prepayment because of the due-on-sale clause), or whether the sellers took the property back subject to the mortgage, and whether this mortgage was larger or smaller than the original mortgage owed by the sellers, and whether the mortgage was itself a seller carry-back? Accountings for these issues will probably be nightmarish and unpredictable. (I don't even want to think about the consequences of the purchasers prevailing but then having to deal with sellers who lack the funds to restore the purchase price to them.)

The statutory mandate is to give the rescinder “complete relief, including restitution of benefits ... conferred by him ... and any consequential damages to which he is entitled”—which seems broader than giving the other party “any compensation ... which justice may require ... and otherwise ... adjust(ing) the equities.” Although legal damages are not allowed to plaintiffs in rescission actions, the measure of recovery is certainly richer than what damages actions permit.

A party does not have to make an early choice between damages and rescission because [CC §1692](#) declares those claims “not inconsistent,” so there is no reason to not seek both. Damages are always a fallback if restitutionary relief is denied (or some other form of equitable relief is granted, as was the case here). Defendants cannot compel a victorious plaintiff to select the remedy least harmful to them, so plaintiffs have nothing to lose by asking for both at the start.

#### Attorney Fees

Finally, there was the question of attorney fees. The appellate court observed that no such fees were authorized under [CC §1717](#) because the contract had been rescinded, but that fees might be available to the Wongs as part of the complete relief due to them under [CC §1692](#). While I am skeptical about such fees being unavailable under [CC §1717](#) (if the contract had an attorney fees provision and the sellers had prevailed, such fees might have been awarded to them), nevertheless, the use of [CC §1692](#) as a back door to the same result, when rescission has defeated the original clause or there was none in the contract to begin with, adds even more luster to the new glamour of rescission.

Go for it!