



FOR YOUR CONSIDERATION BUYER'S PART PERFORMANCE DEEMED SUFFICIENT TO ENFORCE CONTRACT: STEINER VS. THEXTON REVERSED

On March 18, 2010, the California Supreme Court issued one of its most significant rulings in recent years impacting commercial real estate transactions. The Supreme Court reversed the holding in *Steiner v. Thexton*¹, which previously held that a contract giving a buyer the right to terminate for any reason in its sole discretion was an unenforceable option agreement that lacked consideration.

The Contract

In 2003, Steiner (Buyer) entered into a purchase and sale agreement titled "Real Estate Purchase Contract" with Thexton (Seller) for the sale of 10 acres of land for \$500,000. The agreement required Buyer to pay a \$1,000 refundable deposit into escrow once the agreement was executed, which deposit would be applied toward the purchase price at the closing of the sale. The agreement contained a three-year escrow period to allow Buyer at its sole cost to obtain various county approvals and permits necessary to develop the property into several residences. The parties agreed that if Buyer could not obtain the necessary approvals, Buyer could terminate the agreement. The agreement, however, contained a much broader "Contingencies" section that included a provision that stated in part, "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." The agreement did not provide that Buyer could only terminate if Buyer failed to obtain the necessary approvals.

The Lawsuit

A year after Buyer spent \$60,000 to obtain approvals, Seller advised Buyer it would no longer sell the property. Buyer filed suit seeking specific performance. Seller argued the agreement was not enforceable because it constituted an option agreement that lacked consideration. Specifically, Seller claimed that because the agreement allowed Buyer to terminate at anytime, for any reason in Buyer's sole and absolute discretion, the agreement was an option. The trial court agreed and stated, "The unilateral nature of this agreement is the classic feature of an option."² Further, since the Seller did not receive any money or other benefit for the "option," the trial court held that the agreement was unenforceable. The trial court rejected Buyer's argument that the work Buyer did and money it spent on the approvals constituted consideration. The trial court reasoned that the adequacy of consideration is measured at the time the contract is entered into. Because Buyer was not obligated to do anything at the time it signed the contract, Buyer's later decision to seek approvals could not satisfy the consideration requirement. Notably, the trial court also concluded that the \$1,000 deposit did not constitute consideration. The Court of Appeals affirmed for the same reasons given by the trial court. The Supreme Court, however, rejected the lower courts' holdings. Although the Supreme Court agreed with the lower courts that the purchase and sale agreement was in fact an option agreement, it held that there was sufficient consideration to make it enforceable. In reaching its decision, the Supreme Court laid out several important real estate legal principals.

Purchase and Sale Agreements vs. Option Agreements

First, the Supreme Court noted that the label of the document is not dispositive; "Rather, we look through the agreement's form to its substance."³ Because the Buyer had no obligation to do anything,

while the Seller had the obligation to sell the property if the Buyer opted to pay the purchase price, the Supreme Court concurred the agreement was an actual option despite the fact it was titled "Real Estate Purchase Contract."

Second, and perhaps the most critical for real estate practitioners, the Supreme Court explained that because Buyer could terminate for any reason, even if all contingencies had been satisfied (including as the Supreme Court pointed out, if Buyer found a better deal), the Supreme Court rejected Buyer's assertion that the agreement should be construed as a bilateral contract subject to a contingency (i.e., an agreement that is enforceable because the buyer's obligation to purchase satisfies the consideration requirement). The Supreme Court explained that if an agreement allows a buyer to terminate because of a failure of a contingency, such as a loan or inspection contingency, termination is permitted "only" if the contingency fails. These types of agreements do not require separate consideration since the buyer is obligated to perform from the outset. The Supreme Court concluded, "Thus, bilateral contracts subject to a contingency, which are widely used in real estate transactions, are not affected by our holding."⁴

Third, the Supreme Court rejected Buyer's argument that Buyer was subject to the implied covenant of good faith and fair dealing, thereby, giving Buyer only a limited right to terminate based on good faith reasons. The Supreme Court stated, "...the implied covenant does not trump an agreement's express language."⁵ The Supreme Court commented that provisions granting a party broad rights to act in its sole and absolute discretion will not be subject to the covenant of good faith and fair dealing.

Consideration

After establishing that the contract was an option agreement, the Supreme Court next tackled the issue of consideration. The Supreme Court cited the definition of consideration in California Civil Code section 1605⁶, and explained, "Thus, there are two requirements in order to find consideration. The promise must confer (or agree to confer) a benefit or must suffer (or agree to suffer) prejudice. We emphasize either alone is sufficient to constitute consideration..."⁷ Further, "As we held in *Bard v. Kent*, the second requirement is that the benefit or prejudice must actually be bargained for as the exchange for the promise."⁸ In other words, it is not enough for a party to suffer a burden, rather the burden must be one which the other side bargained for.⁹

For consideration purposes, the lower courts concluded it was immaterial that Buyer had begun to seek the parcel split since the Buyer had no obligation to do so. But the Supreme Court rejected these conclusions holding, "To the contrary, we conclude as a matter of law that [Buyer's] part performance of the bargained-for promise to seek a parcel split created sufficient consideration to render the option irrevocable."¹⁰

The Supreme Court explained that the evidence showed that Buyer's parcel split was a bargained-for-benefit to the Seller because the Seller rejected a prior offer to a third party for \$750,000 (50% higher) that required the Seller to bear the expense and burden of seeking



the parcel split. The Seller accepted the lower offer instead because the Seller stood to benefit from Buyer's agreement to obtain the parcel split. But even without this bargained-for benefit, the Buyer clearly suffered a bargained-for-prejudice by undertaking the parcel split, in itself sufficient to meet the consideration test. "It is true that [Buyer's] promise to undertake the burden and expense of seeking a parcel split may have been illusory at the time the agreement was entered into, given the language of the escape clause. However, there can be no dispute that [Buyer] subsequently undertook substantial steps toward obtaining the parcel split and incurred significant expenses doing so....On this record, the only possible conclusion is that [Buyer] both conferred a bargained-for benefit on [Seller] and suffered bargained-for prejudice unaffected by his power to cancel, making up for the initially illusory nature of his promise."¹¹

Having established that consideration existed, the Court added a meaningful opinion as dicta, stating, "Although our conclusion is based upon [Buyer's] part performance of the promise to obtain a parcel split, we also note the agreement required [Buyer] to deposit \$1,000 into escrow, which he did. The trial court concluded the payment did not constitute consideration because [Buyer] would recover the money if he terminated the agreement; thus, the money did not confer a benefit on [Seller]. However, even assuming the trial court's interpretation of the agreement is accurate, it is not clear its ultimate conclusion is correct. As previously discussed, for consideration to exist it is sufficient that a promisee suffers bargained-for prejudice. By placing money in escrow, [Buyer] gave up use of the money for as much as three years. This arguably constituted prejudice to [Buyer] even if he ultimately got the money back. In light of our conclusion regarding [Buyer's] part performance, we need not resolve the effect of the escrow payment."¹²

Practice Pointers

1. When drafting purchase and sale agreements, the parties should tie the buyer's right to terminate to specific contingencies such as title, environmental, physical inspection, permits, financing (rare in commercial transactions), etc. The question remains, however, whether it makes a difference if the buyer's right to terminate for a specific contingency is based on a buyer's reasonable discretion or sole and absolute discretion. It is safe to say that an agreement with a contingency tied to reasonable discretion will be enforceable as a bilateral contract but it remains unclear whether a contingency tied to absolute discretion would be analyzed more closely with a bilateral contract or an option agreement.

2. Most buyers expect to have a "free look" due diligence period where they can back out for any reason. Practically, most sellers do not force a buyer to justify its basis for termination by providing hard evidence that a contingency failed. Typically, sellers accept a buyer termination letter without requiring more. But it is certainly possible for a seller to reject a buyer's attempt to terminate based on a specific contingency. To protect against this possibility, buyers should include many contingencies and establish easy to satisfy reasonable grounds to terminate if the property does not meet the buyer's expectations.

3. To avoid any question over whether an agreement is a bilateral contract or whether it is an option agreement, buyers may desire to pay some nominal amount of consideration. As the court suggested, it may be enough for a buyer to pay into escrow (not even to the seller) a \$1,000 refundable deposit.

4. While a refundable deposit to escrow *may* be sufficient consideration, it is well established that buyer payments of non-

refundable deposits to sellers (which still could be applied to the purchase price if the deal closes) would satisfy the consideration test. While this may be the safest route, it is not necessary and most buyers would rather not come out of pocket unless they have to. In light of the above recommendations, it is unnecessary to structure transactions this way *unless* the buyer wants to retain the right to terminate in its sole and absolute discretion. Beware, however, of agreements in which buyers agree to pay a nominal amount to sellers without actually following through and paying the amount.

5. If you are a buyer who already entered into an agreement that gives you the unilateral right to terminate in your sole discretion, start performing now! Of course, you may still have to show that the seller bargained for your performance.

6. An alarming lesson from this case is that both the trial court *and* the Appellate Court got it wrong. Most real estate experts were very surprised by the lower courts' rulings which questioned the enforceability of many real estate contracts. The irony is that the Buyer may have achieved a Pyrrhic victory given the current state of the real estate market.

¹ *Steiner v. Thexton*, 77 Cal.Rptr.3d 632 (2008), *rev'd*, No. S164928, 2010 WL 960418 (Cal. March 18, 2010).

² *Steiner*, 2010 WL 960418, at *1.

³ *Id.* at *2.

⁴ *Id.* at *3 n.8.

⁵ *Id.* at *3 (emphasis in the original) (citations omitted).

⁶ Civil Code section 1605 states, "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."

⁷ *Steiner*, 2010 WL 960418, at *4.

⁸ *Id.* (citation omitted).

⁹ In *Bard v. Kent*, 19 Cal.2d 449 (1942), a lease option was held unenforceable for lack of consideration. Although the tenant "suffered" the burden of paying for an architect to draw plans, the landlord did not bargain for this burden, but rather for the construction of \$10,000 of improvements to the property, a requirement that had not been met before the agreement was terminated.

¹⁰ *Steiner*, 2010 WL 960418, at *5.

¹¹ *Id.*

¹² *Id.* at *5 n.12.



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