

# Chapter 6



## Law of Contracts

### Chapter 6 Goals:

- Understand what a contract is
- Recognize what makes an agreement a valid contract
- Understand the various types of contracts
- Learn the various provisions within a contract
- Recognize what would void a contract
- Understand the components of a counteroffer

# Chapter 6: Law of Contracts

*This chapter explores the essential components of a valid contract, general types of contracts, and how courts interpret contracts.*

## Key Terms

acceptance	emancipated contract	quasi contract
accord and satisfaction	emancipated minor	revocation
anticipatory breach	executory contract	rescission
assignee	express contract	right of first refusal
assignor	illusory contract	right of rescission
assignment of contract	implied agreement	seal
bilateral contact	judgment	statute of limitations
breach of contract	laches	substantial performance
commercial frustration	letter of intent	tender
competent parties	liquidated damages	time is of the essence
conditional acceptance	menace	unconscionability
consideration	mutual consent	unilateral contract
contract of adhesion	novation	valid contract
counteroffer	offer	void
divisible contract	operation of law	voidable contract
duress	parole evidence rule	waiver

## Contracts

### An Introduction



A **valid contract** is a written, expressed, or **implied agreement** that binds two or more parties to an agreed-upon set of terms. Any terms may be included, provided they are legal and just.

accurate, clear, and definitive.

A legally-binding contract does not have to be in formal legal language; however, its terms must be

### Statute of Frauds

The **statute of frauds** requires that certain agreements must be in writing in order to be enforceable. These include contracts involving:

- Marriage
- Settlements
- The sale of personal property over \$500
- The payment of debt
- One party guaranteeing another party's debt
- The transfer of real property
- The sale or lease of land for more than one year
- The administration of an estate
- Contracts that cannot be performed within a year of their execution

### **Case Review: *Arya Group, Inc. v. Cher* (2000)**

The case, *Arya Group, Inc. v. Cher* (2000) 77 Cal.4th 610., involved a dispute between a contractor and the famous musician, Cher.

A contractor (Arya Group) was hired for the construction and design of Cher's Malibu complex. Arya Group initially had an oral agreement with Cher. It later memorialized the terms in a written contract, but Cher never signed it. However, based on Cher's words, Arya Group assumed an implied contract and began work.

Cher initially paid installments to Arya Group. She also had Arya Group meet with Janet Bussel, an associate with whom Cher had previously completed residential projects. However, Cher ultimately terminated the contract. She claimed that because she had not signed a written contract, she was therefore not responsible for paying the remainder of Arya Group's fees. Arya Group sued Cher for a breach of contract.

The Superior Court contended that, on the basis of the statute of frauds, a oral contract was not enforceable. Therefore, it ruled in favor of Cher. Arya Group appealed.

Arya Group alleged that the purpose of the arranged meetings with Bussel was for her to get as much information about the project as possible so that Cher would reap all of the efforts of Arya Group and then terminate the contract. It claimed that Cher was unjustly enriched (whereby a person unfairly benefits from another's misfortune for which the one enriched has not paid).

The Court of Appeals agreed with Arya Group. It reasoned that although the written contract was not signed, Arya Group did not foreclose his right to enforce the oral agreement. Cher was a sophisticated businesswoman who had the help of professional legal counsel. Therefore, she was held liable for the

balance.

## Components of a Valid Contract

The components of a valid contract are:

- Offer
- Acceptance
- Consideration
- Competent parties
- Mutual consent
- Goals of contract are legal

A contract must have all of these components in order to be enforceable. If a component is missing, the contract is incomplete and therefore, void.

### **The Offer**

In order for a contract to be initiated, there must be an offer with a definitive course of action. Usually, this course of action is the exchange of money, goods, or services. An **offer** represents the terms to which one party is willing to agree, and includes all details related to the course of action. This includes the service or product in question, the price, the payment structure, and involved parties.

An offer's terms must be specific. For example, a valid contract cannot simply list a property's purchase price as "to be determined." If an exact price cannot yet be given, the contract must give a specific range or method for calculating price. An example would be a clause that states: "the purchase price will use the average price per square foot as the basis for the final sales price."

If the contract does not have a definitive closing date, a reasonable time period will apply.

An offer is not a legally-binding document until it is accepted.

### **Right of First Refusal**

The **right of first refusal** refers to a party's legal right to have priority in entering a contract ahead of another party. If a party with the right of first refusal matches, or exceeds, the price of a competing party, the party with the right of first refusal has the right to buy the product or service.

In the context of real estate, this means that a buyer with the right of first refusal has the opportunity to match a competing buyer's offer on a property before the seller accepts it.

### **Case Review: *Ellis v. Chevron U.S.A., Inc. (1998)***

The case, *Ellis v. Chevron U.S.A., Inc.* (1998) 201 Cal.3d 132., involved a dispute over the right of first referral.

A property owner (Ellis) was under a lease contract with Chevron which gave Chevron the right of first refusal. A company named Pep Boys submitted a purchase offer to Ellis, which included a \$3,000 monthly rent, the construction of a new building on the site, and the acquisition of an adjacent site. Ellis presented Chevron with Pep Boys proposal.

Chevron was willing to match the \$3,000 per month; however, it was not willing to pay the costs of construction for the new building or the acquisition of the adjacent property. Ellis proceeded to terminate his agreement with Chevron and accept the Pep Boys offer. Chevron sued Ellis for not accepting its offer.

The Superior Court argued that because Ellis had followed the correct procedures for tenants with a right of refusal, Ellis was free to accept Pep Boys offer.

### **Case Review: *Hartzheim v. Valley Land and Cattle Co. (2007)***

The case, *Hartzheim v. Valley Land and Cattle Co.* (2007) 153 Cal.4th 383., involved a dispute regarding a right of first refusal clause.

Hartzheim was a lessee of the property owned by Valley Land and Cattle Company who had a right of first refusal clause in his contract. At some point, the owner of Valley Land and Cattle Company transferred the land to his children and grandchildren. This was done in an attempt to reduce taxes and begin estate planning. However, Hartzheim claimed that he had been deprived of his right of first refusal and sued.

The Superior Court ruled that an argument for the right of first refusal could not be applied in this scenario. Although Valley Land and Cattle Company's property was transferred, it was only transferred with the intent of managing the partnership's tax obligations and estate planning. As the transfer was not made to deliberately avoid their contractual obligation of offering the lessee the right

of first refusal, the court ruled in favor of Valley Land and Cattle Company.

### **Offer Expiration**

Most offers give the offered party a specific time period in which to respond. In the event that the deadline is reached without action, the offer expires and its terms are revoked.

Typically, a seller has three days to respond to a buyer's purchase offer. However, the buyer can extend or shorten the seller acceptance deadline, if necessary.

For example, a buyer agrees to keep an offer open for two weeks for the purchase of a seller's house. If the seller does not respond to the buyer's offer by the end of that two-week period, the offer automatically expires. Even if the seller ultimately decides to sell the property after the two-week period, the original offer is terminated. Therefore, the transaction will not occur unless the two parties agree to change the date or terms of the offer.

If an offer does not indicate an expiration date, the offer can be rescinded after a reasonable period of time based on the transaction and its terms.

### **Revocation**

An offer can be rescinded any time prior to the offering party's acceptance.

For example, suppose a buyer makes an offer on a seller's house, but the seller needs a few days to think it over. The buyer can legally revoke his or her offer prior to the seller's stated acceptance of the offer.

To revoke a contract, the offering party and offering party's agent must inform the offered party and offered party's agent. Revocation occurs when the offered party receives the revocation, not when the offering submits the revocation.

For example, say a buyer wishes to revoke an offer he made to a seller. He sends a revocation on the first of the month, but the seller doesn't receive it until the fifth. If the seller accepts the buyer's contract prior to the fifth, the offer is valid and legally enforceable.

### **Alterations to Contract's Subject**

An offer will also be terminated in the event that any alterations are made to the subject of the contract.

For example, if a buyer made an offer on a seller's property, but that property is subsequently destroyed in a fire, the buyer's offer is no longer valid.

### **Death / Incapacity**

If the original offering party in a transaction dies, his or her offer is no longer valid. This also applies to an offering party who becomes mentally incapacitated.

If, however, the offering party is a corporation and only one of the officers in the transaction dies, the offer remains enforceable.

### **Acceptance**

A contract becomes legally enforceable when the offered party notifies the offering party of his or her acceptance. Acceptance indicates a clear willingness by the offered party to be bound by the contract.

By law, acceptance takes place immediately upon receipt or confirmation by the offered party. In California, an offered party can accept an offer either verbally or in writing, although it is highly advisable to do so in writing.

Fax and email are considered reasonable methods for communicating acceptance. Offered parties can scan an email or sign a special electronic signature pad.

Civil Code Section 1583 states that mailing an acceptance offer is also acceptable. It is advisable for an offered party to retain a confirmation of mailing an acceptance offer, however, such as a postal receipt or a signature for a certified mailing transaction.

If a proposed contract contains a specific provision about how to indicate acceptance, this provision must be met in order for acceptance to be valid.

The offered party must clearly communicate his or her acceptance of an offer with no ambiguity. For example, statements such as "I love the deal, but let me look it over with my wife" or "I'll only do it if you reduce the price another \$2,000" do not communicate acceptance. Similarly, an offer cannot contain a silent acceptance clause (i.e. "if I don't hear from you within 10 days, the property is mine").

Only the offered party or the offered party's legal representative (i.e. power of attorney) may accept an agreement. The contract is not valid if a different person accepts the agreement. Similarly, acceptance can only be communicated to the offering party, the offering party's real estate agent, or the offering party's legal representative.

Contracts are enforceable only when the accepted offer is the original offer. If additional terms or amendments are introduced into the contract by the offered party,

the offering party has the right to reject acceptance of the contract.

Contracts have an implied “**time is of the essence**” clause. This specifies the date by which a party is required to fulfill a condition or finalize the transaction. Failure to do so constitutes an unacceptable breach of contract.

“Offers” made in real property advertisements – such as those found in the multiple listing services or the local newspaper – are simply a means to begin negotiations. They do not constitute a legal offer and therefore, a party cannot “accept” them as such.

### **Counteroffer**

A **counteroffer** is a form of negotiation in which the offered party responds to an original offer’s terms with additional changes or provisions. Essentially, the offered party rejects the offering party’s terms and submits a new offer with different terms.

In the event of a counteroffer, the acceptance period of the contract is terminated and there is no acceptance. Instead, there is a new offer and a reversal of roles between parties: the original offered party is now the offering party who is dictating the terms of the contract, and the original offering party is now the offered party in a position to either accept or reject those terms.

For example, assume a buyer puts in an offer to buy a seller’s property with a 45-day inspection period. However, the seller counters that provision with an offer for a 30-day inspection period. The seller now becomes the offering party, and the buyer becomes the offered party.

### **Conditional Acceptance**

A **conditional acceptance** is a form of acceptance that is subject to a certain action being performed, or a term of an offer being altered. Conditional acceptance is similar to a counteroffer in that the introduction of a new condition changes the original offer and initiates a new offer.

### **Rejection by the Offered Party**

Should the offered party reject the offering party’s offer, the option of acceptance is terminated.

Should the real estate transaction be an auction, the auctioneer, also known as the offered party, can reject any offer. In auction’s there are minimum bids that offering party’s must surpass in order to qualify for the purchase and therefore the acceptance of the offered party. Auctions without a reserve are a type of auction whereby the

auction will be granted to the highest bidder, assuming the bids surpass the minimum requirement. An offer to purchase real property in auction may not constitute a sale, even if the offer is the highest bid, unless the auction was without a reserve price.

### Case Review: *Roth v. Malson (1998)*

The case, *Roth v. Malson (1998)* 67 Cal.4th 552., featured a discrepancy over a counteroffer.

A buyer (Roth) and seller (Malson) were in negotiations over the purchase of an acre of land. Malson had listed the property for \$47,600. Roth made an all cash offer of \$41,650 with a 30-day closing period. Malson countered Roth's offer with an offer of \$44,000, and Roth accepted. Upon signing, however, Roth added new language to the contract.

Shortly thereafter, Malson notified Roth that he would no longer be selling the property. Roth brought a lawsuit against Malson for breaching the terms of their contract. He sought specific performance to require Malson to sell.

In court, the judge ruled that the original contract was not valid because Roth had added additional items to the agreement. This created a counteroffer, rather than acceptance. Because a counteroffer must be accepted by the opposing party – and it was not when Malson decided to no longer sell – the contract was not valid. Therefore, Malson was not required to perform the specific performance of selling the house.

## Consideration

The next component of a valid contract is consideration. **Consideration** is the exchanged value between parties in a contract, or the reason each party enters the contract. It legally defines the roles of each party contingent on performance.

The most common type of consideration is an agreement to act in return for the other party's act. This typically involves the exchange of one party's money for the other party's services, property, objects, ideas, or future acts.

For example, let's say Roger offers to pay Mary \$3,000 to design his home. If Mary accepts Roger's proposal, there is consideration. Mary is receiving \$3,000, while Roger gets a newly designed home.

Another type of consideration is a party agreeing not to act in some way, even when the party has the legal right to do so.

For example, assume Driver X rear-ends Driver Y's car, incurring damages of \$900. To avoid having to claim the accident on his insurance, Driver X pays Driver Y the \$900 to get his car repaired. In this example, Driver Y's consideration is getting his car repaired (via the \$900), whereas Driver X's consideration is Driver Y not reporting the damages to the insurance company.

Although consideration must be clearly defined in a legally-binding contract, the legal system rarely enforces such clauses unless one of the parties brings a lawsuit. Should the consideration of a contract be unfair, unlawful, or otherwise immoral, the courts may allow the injured party to terminate the contract.

## Competent Parties

An enforceable contract requires all parties entering into a contract to be competent and have the legal capacity to do so. Contracts are enforceable unless a party can prove that he or she was incompetent at the time of the contract's execution.

With few exceptions, adults are considered competent parties. This includes:

- Currently incarcerated individuals
- Formerly incarcerated individuals
- Alien citizens

Currently and formerly incarcerated individuals maintain real property rights. Those who are incarcerated can even acquire or convey property while in jail.

Examples of legally incompetent parties include:

- Minors
- Mentally incapacitated
- Under the influence

California law assumes that a minor does not have the legal capacity or experience to engage in real estate transactions. In the event that a minor does enter into such a contract, his or her minor status make it unenforceable.

The exception to this rule is an emancipated minor. An **emancipated minor** is an individual under the age of eighteen who is no longer a dependent of a parent or legal guardian, and thus, has the legal authority to make decisions for themselves. An **emancipated contract** is a contract a minor can enter. To enter into the contract, the minor must fulfill specific conditions that allow them legally execute the contract while being under the age of 18.

In the event that a mentally incapacitated person needs to refinance their mortgage or

buy or sell property, he or she must do so under the discretion of the courts. A person who executes a contract while under the influence of substances can void that contract.

## Mutual Consent

All parties involved in a contract must consent to entering into a contract.

Consent is achieved by a mutual understanding of the terms of an agreement. All involved parties must be aware of their responsibilities and obligations, and they must express their desire to enter into a contract of their own volition.

A contract must also be consented through actions. This is most commonly done through signing the contract, oftentimes with a seal. A **seal** is a mark used to authenticate a signature on a contract.

Conversely, a **letter of intent** – or illusionary contract – only expresses a buyer's intent to purchase property, rather than his or her commitment. Such a letter does not verify mutual consent or legally bind parties.

## Goals of Contract Are Legal

If any contract provision violates the law, or unfairly prevents someone from engaging in legal activity, the contract is unenforceable.

Civil Code Section 1644 states that the “words of a contract are to be understood in their ordinary and popular sense.” This means that courts and other legal bodies must be able to easily understand a contract’s provisions. If a contract may be interpreted with multiple meanings, only the legally enforceable interpretation will be used. Parties may also have the right to terminate the contract.

For example, assume Mary sells a bakery to Susie. In the purchase contract, Susie may require a non-competing clause that prevents Mary from starting a different bakery that sells the same items or is on the same block. However, Susie cannot include a provision that denies Mary the right to ever open up another bakery.

If a law changes and makes the activity within an executed contract illegal, the contract is no longer valid.

If there are multiple contracts that are intended to supplement each other, and a portion of one contract is illegal, only the enforceable provisions will remain.

For example, say Bradley employs Cupertino Drywall to develop his subdivided land. Cupertino Drywall begins the process of installing drywall. Then Bradley discovers that he does not have the proper permits from the city to continue the project. Therefore,

the project itself is illegal, but Cupertino Drywall is still entitled to retain payment for services provided. Their contract with Bradley is legal, and therefore, they should not be held liable for Bradley's failure to obtain the proper permitting.

In the event that both parties are guilty of an illegal violation, the less guilty party will typically have the right to recover for damages.

### **Case Review: *Sterling v. Taylor (2007)***

The case, *Sterling v. Taylor (2007)* 40 Cal.4th 757., involved a legal dispute over the definiteness of a sales contract.

A buyer (Sterling) bought a property from a seller (Taylor). The transfer of property did not include a formal purchase agreement. Rather, the transaction was documented with a handwritten memorandum entitled "Contract for Sale of Real Property". The memorandum listed the property's sales price as \$16,750,000, and the rental income as \$1,600,000 a year. Using those figures, it indicated that the return on the property was approximately 10.468%.

The memorandum included signature lines for both Sterling and Taylor. Sterling signed his name, Taylor did not. Ultimately, Taylor signed the agreement indicating that it was agreed, accepted, and approved.

However, prior to the close of the sale, Sterling discovered that the property's actual rental income was \$1,375,404 a year (not \$1,600,000). To compensate for this difference, Sterling countered Taylor's asking price with an offer of \$14,404,841. Taylor rejected the offer. Sterling sued, alleging a breach of contract.

The Superior Court contended that the terms of the agreement were ambiguous. The original signed contract indicated a purchase price of \$16,750,000. This was separate from Sterling's proposed changes based on the discovery of the property's actual rental income. The court ruled in favor of Taylor.

## **Types of Contracts**

If all of the aforementioned components are met, a contract is considered valid. An **executed contract** means that all parties have met their obligations and the terms of the agreement have been ratified.

Various situations produce different types of contracts.

## Express Contract

An **express contract** – sometimes known as a special contract – is an agreement that explicitly sets out an exchange of terms between parties. Such contracts may be verbal in nature, although they are typically done in writing in order to clarify the roles and duties of each party. An express contract requires mutual intent on behalf of both parties prior to the execution of a contract.

## Implied Contract

An **implied contract** is an agreement whereby the actions of involved parties bind them to a contract. Civil Code Section 1621 defines such a contract as “the existence and terms of which are manifested by conduct”.

For example, if a homeowner hires the services of an appraiser for the purpose of obtaining a loan, it is implied that a contract exists between them, even if the homeowner and appraiser never agreed to a specific price or agreement.

A **quasi contract** is an implied contract created by the courts in the event that a formal contract was not originally set forth between parties. It is a legally enforceable contract that is implemented to avoid jeopardizing a party’s legal equity.

The **parole evidence rule** is a law that oversees the extent that parties can bring new evidence into court with the purpose of modifying an issue. One might site that a contract was implied using this rule.

## Bilateral Contract

A **bilateral contract** is an agreement whereby one party is entitled to receive money or a service in exchange for another party providing money or a service. The party that promises to provide or do something is called the **promisor**. The party that receives something, or to whom a promise is made, is called the **promisee**.

A real estate purchase contract is considered a bilateral contract as a buyer puts forth money in exchange for the title to a seller’s property.

## Unilateral Contract

A **unilateral contract** is an agreement in which one party performs a specific act, typically in exchange for money. Unlike a bilateral contract, a unilateral contract only contains a promisor.

For example, in a nonexclusive real estate listing, an agent does not enter into an

agreement with a seller unless he or she finds an appropriate buyer first. In this case, the agent must first perform a specific act in order to receive a commission.

## Executory Contract

An **executory contract** – or **illusory contract** – describes an agreement in which one or both parties have yet to perform their contractual obligations. More simply, it is an unexecuted contract.

An example of an executory contract in real estate is when a buyer and seller are in escrow, and one or both parties still have obligations they must perform.

### Case Review: *Gibbs v. American Savings & Loan Association (1990)*

The case, *Gibbs v. American Savings & Loan Association* (1990) 217 Cal.3d 1372., involved a dispute regarding the timing of a counteroffer.

The buyer (Gibbs) submitted an offer of \$180,000 to purchase a foreclosed house from the seller (American Savings & Loan Association). He received a counteroffer from American Savings that contained some additional terms and conditions. However, the counteroffer did not mention the purchase price. Gibbs signed the counteroffer and sent it back through the mail.

However, before receiving Gibbs's acceptance of the counteroffer, American Savings revoked the counteroffer. It claimed that it had been made in error, as it wished to increase the sales price to \$198,000. Gibbs sued for damages, specific performance, breach of contract, and declaratory relief.

In court, Gibbs insisted that he had accepted the counteroffer before it was revoked and thus, a contract existed. However, the Superior Court contended that Gibbs' acceptance of the counteroffer had to have been received prior to American Savings' cancellation of the contract in order for it to be valid. It ruled in favor of American Savings.

Gibbs appealed, but the appellate court upheld the lower court's ruling.

## Divisible Contract

A **divisible contract** is an agreement that possesses multiple parts in which each party's obligations are performed independent of the other party's obligations. Each party has

the right to demand performance by the other party. However, a violation of one part of the contract does not excuse a refusal to complete the other parts. In other words, a divisible contract is a contract whereby parties roles are divided into various phases or portions independent of one another meaning that a failure to perform one element of the contract does not make the violating party in breach of the whole of the contract.

For example, assume Aaron Mendez hires Ludwick Contracting to develop his large estate. Aaron wishes to develop three properties on his land. Ludwick Contracting finishes the first property however have massive delays on the second property. The delays on the second property do not forfeit Mendez' duty to pay for the construction of the second and third property and also does not terminate Ludwick's requirement to finish all three properties.

### **Contract of Adhesion**

A **contract of adhesion** is a standard contract where terms are indicated by one party with very little to no negotiation room for the weaker party.

In the context of real estate, the buyer is typically the weaker party, as the seller holds the property that the buyer wishes to purchase.

### **Termination of a Contract**

When one of the components of a contract is missing, or a contract is found to be illegal, the contract is not valid and can become **void**. Some of the circumstances under which a contract can be terminated will be explored below. A **voidable contract** is one that violates a law or includes a party that is a minor.

### **Operation of Law**

In terms of the termination of a contract, **operation of law** refers to situations where a contract terminates automatically and/or without legal action being taken. A contract may terminate by operation of law when it reaches its agreed-upon end date, or when all parties involved have satisfied their required obligations.

Additionally, parties may agree to voluntarily terminate a contract without taking legal action if its provisions are found to be impractical, impossible, or unlawful to perform.

### **Rescission**

**Rescission** refers to the legal concept of removing or “un-making” a contract. It brings

both parties back the original state they were in prior to the contract's execution.

Either party may rescind a contract; however, a contract cannot be rescinded simply because one party does not want to perform his or her required duties. Either both parties must agree to rescind the contract, or one party must demonstrate how a provision within the contract makes it worthy of rescission.

Mutual rescission is when both parties agree to rescind a contract. In this case, both parties are discharged of all duties and obligations.

Court-ordered rescission is used when one party wishes to rescind a contract and the other party refuses to do so. In this case, the court determines whether there are grounds for the contract to be rescinded. If there are, it orders rescission to take place.

### **Right of Rescission**

Standard real estate mortgages possess a **right of rescission** clause that gives borrowers the ability to rescind a home loan within three days of the loan's closing. The right is provided on a no-questions-asked basis. Its purpose is to protect and empower consumers. A lender must return its claim to the property and all fees within 20 days.

The amount of time a buyer or a borrower has to employ a right of rescission clause differs in various real estate transactions:

- **Truth in Lending Act:** Buyers have the right to rescind a mortgage within three days of the mortgage's closing.
- **Interstate Land Full Disclosure Sales Act:** Buyers have the right to rescind an undeveloped land purchase within seven days of closing.
- **Timeshares:** Buyers have three days to rescind a timeshare purchase.
- **Subdivision Maps Act:** Buyers of wrongfully divided land have up to one year to rescind their property purchase. (The Act allows a substantial rescission period due to the financial ramifications of purchasing the wrong property.)
- **Home Equity Sales:** If a lender forecloses using illegal means, or violates any foreclosure statutes, the owner of a foreclosed property that contains 1 to 4 units may have up to two years to rescind the foreclosure.
- **Undivided Interest Subdivision:** Buyers have the right to rescind the purchase of undivided interest subdivision within three days of closing.

### **Unconscionability**

Unconscionability is a legal concept that bars the enforcement of a contract that is grossly one-sided, unfair, or immoral. For a contract to be deemed unconscionable, it must contain language that places a great strain on one party and/or create a situation

whereby the violated party's legal equity is jeopardized.

Unconscionable acts include fraud and intentional misrepresentation. Contract fraud occurs when one party intentionally misleads, acts, or lies with the intent of cheating or confusing the other party. It involves the concealment of facts, the failure to disclose full and accurate knowledge, and/or providing false information with the intent of creating confusion.

Examples include:

- falsely inflating the price for goods or services, including real property
- using overly technical language in an attempt to confuse the other party
- using overly complex or drawn-out legal contracts in an attempt to confuse or deter the other party

If there is proof that an unconscionable act has been committed, a contract may be terminated.

For example, say that a Chinese citizen, Mr. Ho, moves to the United States and decides to purchase a property. His real estate agent, Marisa, realizes that Mr. Ho knows nothing about American real estate. She purposely sells Mr. Ho a property at 60% above market value in order to boost her commission. This is an unconscionable act. If Mr. Ho discovers that Marisa took advantage of him in this manner, he can terminate the contract – even if he has already expressed acceptance. In the event that Mr. Ho discovers Marisa's unconscionable act after the close of the sale, he may sue for damages.

### **Case Review: *Higgins vs. Superior Court (Disney/ABC) (2006)***

The case, *Higgins v. Superior Court (Disney/ABC) (2006)* 140 Cal.4th 1238., involved five siblings who sued a television studio for unconscionability.

The Higgins siblings were five orphans who were approached about being featured in an episode of a reality television series called *Extreme Makeover: Home Edition*. Disney/ABC presented the Higgins siblings with a long and drawn-out contract. The siblings signed.

However, during the filming of the episode, Disney/ABC failed to provide the Higgins siblings with a home. The siblings also felt that Disney/ABC was exploiting them and portraying them inaccurately. It was at this point that they discovered that their contract possessed an all-but-hidden clause rescinding their rights to arbitration. The Higgins siblings subsequently sued Disney/ABC for what they claimed to be unconscionable provisions.

The siblings argued that they were young and unsophisticated, and had signed the contract without proper understanding of its dense contents. However, they claimed the contract's language and its provisions – such as the arbitration clause – were added to intentionally take advantage of them.

The Superior Court agreed. It concluded that due to the relatively young age of the siblings and the fact that their parents had recently passed away, the difficult to understand provisions within the contract were unconscionable.

## Accord and Satisfaction

**Accord and satisfaction** occurs when one party involved in a contract agrees to release the other party from the contract in return for a settlement. Typically, the settlement amount is for a reduced payment amount in exchange of releasing the party from all other liability. In this type of agreement, both parties waive their legal right to sue for damages in the future.

For example, say Rebecca offers Bob's Contracting Services \$30,000 to remodel and add additional square footage to her home. The contract calls for three payments over the course of construction: an initial deposit of \$15,000, a payment of \$10,000 at the project's midpoint, and an additional \$5,000 upon completion.

Construction takes much longer than promised, and once the project is complete, Rebecca discovers that the renovations are not up to the agreed-upon standards. She tells Bob's Contracting Services that she is not going to pay the last scheduled payment of \$5,000. Bob says he will sue Rebecca for damages and seek a mechanic's lien on her property. Rebecca and Bob agree to compromise using accord and satisfaction, whereby Rebecca pays Bob \$2,500 and Bob releases Rebecca from the contract.

## Assignment of Contract

An **assignment of contract** is when one party transfers his or her contractual obligations to a third party. The party transferring the rights is called the **assignor**, while the party receiving them is called the **assignee**. The other party in the original contract must be informed of the assignment.

After implementing an assignment of contract, the assignee takes on primary responsibility and liability of the contract provisions, essentially becoming the assignor. The assignor holds secondary liability.

Some contracts may prevent an assignment of a contract. Parties cannot assign a contract if that assignment will:

- adversely affect the performance of a service
- increases the risk for the other party
- decrease the expected return

Some professional fields involve specific skills. A professional who is hired on the basis of his or her specific skill cannot assign a contract to a third party who does not possess the same skill.

For example, say Jane hires Najera Engineering for its skills and experience. Najera Engineering cannot then assign the contract to a third party engineering firm who may or may not have a comparable level of expertise unless Jane agrees.

## **Novation**

**Novation** refers to the replacement of an original contract with a new contract, or the modification/substitution of a particular provision in the original contract. Novation requires that there was acceptance by both parties in the original contract.

For example, suppose that there is an accepted contract stating that Dan will sell his property to Alex. Suppose there is a separate accepted contract in which Alex has agreed to subsequently sell the property to Becky. It is possible to novate both accepted contracts and replace them with a single contract in which Dan agrees to sell his property directly to Becky.

## **Tender**

A **tender** is an offer made by a party to perform a specific act in return for removing a claim on that party. Typically, tender is money or the rendering of services.

For example, if one party owes another party money, but does not have the full amount to pay them, the violating party may offer to perform a specific act in lieu of payment.

## **Mistakes**

A mistake is defined as an erroneous belief that certain facts are true. These misunderstandings can be in regards to essential facts within a contract, or the law.

### **Unilateral Mistakes**

A unilateral mistake is the most common type of mistake. It occurs when just one party in a contract misunderstands its terms or provisions. Most times, a unilateral mistake does not void a contract, unless the mistake led to a positive one-sided result for the

mistaken party.

### **Mutual Mistake**

A mutual mistake occurs when both parties enter into a contract under the same erroneous assumption about the material facts surrounding the contract. They are at cross-purposes (unintentionally contrary to each other's purposes) and consequently, the contract is unenforceable.

### **Common Mistake**

A common mistake is when both parties misunderstand the same facts. If both parties misunderstand the vital facts of the agreement, the contract is likely not enforceable.

If a common mistake results in damages, liability will be determined based on whether the erroneous belief was purposeful or ignorant. If one party recognizes that the other party misunderstands the agreement, but proceeds with the agreement anyway, the party may be held liable.

## **Impossibility of Performance**

A party may be excused from performing a certain provision within a contract if the provision is deemed impossible, or otherwise dangerous, to perform.

For example, suppose Jenny employs Donald's Construction for renovations on her coastal beach house. The contract states that the construction must be completed by May 15th. If a hurricane occurs and prevents Donald's Construction from performing work on Jenny's property, Donald is excused from the contract's original completion date.

**Commercial frustration** refers to a situation in which an unforeseen, uncontrollable circumstance makes the fulfillment of a contract by one party impossible, or nearly impossible. Commercial frustration allows the party who suffered the unforeseen circumstance to be excused from a contract's legal obligations and/or to rescind the contract entirely. This provision does not apply to situations that could have been reasonably predicted.

For example, assume a property owner contracts Mendoza Construction Services to remodel the property. If a wildfire breaks out in the area and burns down the property, the property owner would be excused for not meeting his or her portion of the contract.

## Substantial Performance

Substantial performance refers to the situation where the actions of a contract's violating party may be deemed complete, even if a nonessential component of the contract is missing. This doctrine assumes that the violating party has put a good faith effort into completing the project.

The purpose of substantial performance is to protect parties from being wrongfully sued for a small violation. Courts however do not have a set practice in place that is used when determining the outcome of substantial performance cases.

Substantial performance typically occurs with construction projects. For example, it is common practice for contractors to use different methods than those originally promised in order to reduce the cost of a project or the time it takes to complete the project. If the methods or products used are nearly identical to those promised and the changes are negligible, the property owner can sue however will likely lose in court. If a contractors performance is only slightly deficient the property owner would be required to pay the agreed upon payment even if the deficiency is slightly different than what was agreed upon.

### Case Review: *Levy v. Wolf* (1956)

The case, *Levy v. Wolf* (1956) 46 Cal.2d 367., involved a buyer seeking damages from a seller over a mistake regarding the property's rental income.

A buyer (Levy) purchased a property from a seller (Wolf). The purchase contract indicated that the land currently had a tenant who was renting a unit. After the sale, the tenant stated that his lease – which had been made with Wolf – was not binding, and therefore, he was not responsible to pay Levy rent. Levy purchased the land under the assumption that he could collect rental income from the tenant. He sued Wolf for damages resulting from the diminution in the property's value due to the inability to collect that income.

The Superior Court ruled in favor of Levy, indicating that he was entitled to recover the requested damages as a result of the mistake.

## Breach of Contract

A **breach of contract** occurs when one party fails to perform his or her obligations in a contract, or engages in activity that prevents the other party from fulfilling his or her obligations. The violated party has the right to recover for damages resulting from a breach of contract. A **menace** is a party that will likely cause harm to another party and

can be a reason that a contract is breached.

**Anticipatory repudiation** occurs if one party brings legal action against the other party if it is obvious that the other party cannot fulfill his or her contractual obligations. An **anticipatory breach** is the act that makes it impossible for a party to perform his or her duties. This may include the violating party indicating that he or she will not fulfill his or her obligations.

## Threats

A contract may be voided if one party engages in threatening behavior against the other party.

**Menacing** involves one party intentionally putting another party in fear of physical injury or death. Typically, this involves the display of a weapon or an action that suggests imminent danger.

**Duress** involves one party threatening to harm another party – or putting them under duress – for the purpose of making them do something against his or her will.

### Case Review: *Jaramillo v. JH Real Estate Partners, Inc. (2003)*

The case, *Jaramillo v. JH Real Estate Partners, Inc. (2003)* 3 Cal.Rptr.3d 525., involved a tenant who sued his landlord over an unconscionable lease.

A tenant (Jaramillo) signed a lease with a landlord (JH Real Estate Partners). Unbeknownst to him, the lease agreement contained a fine print arbitration clause. It stipulated that any legal claims by tenants had to be made 180 days before arbitration, and that tenants had to pay for all the administrative fees associated with arbitration.

Jaramillo originally brought a lawsuit against JH Real Estate Partners for negligent inspections and maintenance. Jaramillo claimed this led to water incursion and moisture in the building. However, when he discovered the arbitration clause, he sued on the ground that the lease was unconscionable.

The court ruled that the arbitration clause in the lease agreement was unconscionable, as it was an undue burden on the tenant. Because the lease agreement did not provide tenants an alternative to the arbitration clause, the court of appeal did not allow the clause to be unconscionable clause to be implemented.

### Case Review: *U.S. v. Cloud* (1989)

The case, *U.S. v. Cloud* (1989) 872 F.2d 846., involved a real estate seller who was accused of bank fraud.

An experienced real estate entrepreneur (Cloud) put his hotel and casino on the market for \$18 million. A potential buyer (Perroton) presented falsified documents to the bank – including a forged sales agreement – in order to obtain the \$20 million loan. Cloud had knowledge of this fraudulent behavior, but did not report it. Instead, he manipulated the escrow instructions to inflate hotel and casino's sales price in order to cash out on the property. After the sale's execution, the loaning bank lost in excess of \$24 million.

The U.S. Government sued Cloud for conspiracy to commit bank fraud, and aiding and abetting bank fraud. The Superior Court and appellate court found Cloud guilty.

## Contracts in a Court of Law

### Interpretation



Civil Code 1641 states: "The whole of a contract is to be taken together, so as to give effect to every part, if reasonably practical, each clause helping to interpret the other."

This means that singular provisions of a contract must be interpreted within the context of the contract as a whole. If a contract has conflicting terms, or one or more of its provisions are inaccurate, the contract is not enforceable.

The Civil Code also stated that contracts are supposed to be "interpreted as to give effect to the mutual intention of the parties as it existed at the time of contracting". As with the creation of a contract, intent is important in its interpretation. If there is any ambiguity or conflicting information within a contract, "it must be interpreted in the sense in which the promisor believed at the time of making it, that the promisee understood it" (Civil Code Section 1649).

If there are multiple agreements that make up the whole of a contract, they must be used together – and in sequence – to form the basis for understanding.

Courts interpret contracts 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 was made.”

For example, assume Lisa agrees to rent a unit to Sherwin for \$3,000 a month. When drafting the lease, Lisa accidentally writes the rent as “\$300 a month”. If all competing units in Lisa’s building are \$3,000, Lisa may be able to terminate the lease as her intended meaning was \$3,000 a month, not \$300.

Similarly, if one party in a contract puts an inaccurate price on a contract, the courts will typically interpret the written figure, rather than the numerical number. In terms of a check, this would be the written-out portion of the amount due, not the number portion.

## **Waiver of Damages**

A **waiver** is the surrender of a party’s rights and privileges. An example is a disclaimer statement.

Contract clauses that waive a party’s right to damages are illegal, and therefore, not enforceable. Civil Code Section 1668 states: “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.”

## **Judgment**

A **judgment** is a court-ordered legal action against a violating party in a contract. It determines the rights and liabilities of each party in a legal action. The court will usually provide an explanation as to how and why it determined its particular judgment.

One common judgment in real estate cases is a lien. A lien is a granted interest in a property that secures a lender’s debt. Liens will be explored further in Chapter 11.

## **Declaratory Judgment**

As discussed in Chapter 1, declaratory judgment – or declaratory relief – is a court-ordered legal remedy that clarifies a contract’s terms and provisions. This form of judgment is used to clarify the legal rights and obligations of each party in a contract and to help disputing parties avoid a lawsuit.

### Case Review: *Salton Bay Marina v. Imperial Iss Dist. (1985)*

The case, *Salton Bay Marina v. Imperial Iss Dist. (1985)* 172 Cal. App. 3d 926., involved a property owner who was forced to sign a contract with illegal language.

A property owner (Salton Bay Marina) had a marina that bordered the Salton Sea. The Water District had required Salton Bay Marina to sign an agreement discharging the district of any liability resulting from negligence. However, when the property was damaged by the Salton Sea's rising water levels, Salton Bay Marina brought legal suit against the Water District for damages.

The Superior Court concluded that it was against the law for a contract to possess language that discharges a party's liability. It rewarded the Salton Bay Marina for damages and all costs including court and attorney fees.

### Specific Performance

Also introduced in Chapter 1, specific performance requires the violating party in a contract to perform a specific action that the contract obligated him or her to perform.

The **parol evidence rule** is a legal concept that indicates the extent to which parties can bring forward evidence of a prior arrangement that were not included in the contract. The rule prevents the use of previous oral agreements to alter the terms of an executed contract if the contract already is legally-binding. Parol evidence can be used, however, to clarify a portion of the contract if parties do not fully understand the contract.

### Case Review: *Seck v. Foulkes (1972)*

The case, *Seck v. Foulkes (1972)* 25 Cal.3d 556., involved a case that used the parol evidence rule.

A seller (Foulkes) employed the services of a broker (Seck) to sell his property. Foulkes wanted Seck's commission to be paid in installments, rather than a lump sum at the closing. Seck denied this request. The terms of Seck's commission were then written on Seck's business card (which Foulkes initialed). Soon after, Foulkes' property was sold. However, Foulkes refused to pay the commission. Seck sued, claiming that he should be compensated for his actions which led to

the close of the transaction.

The court concluded that Seck was entitled to commission based on a written memorandum on Seck's business card. It reasoned that these written words were a valid form of parol evidence and provided enough evidence that a valid and enforceable contract existed.

## Injunction

An injunction is a temporary or permanent court order that mandates a violating party to perform – or suspend – a specific act.

For example, a court may issue an injunction against a trespasser who has repeatedly violated a property owner's property. It orders the trespasser to cease trespassing.

## Damages

### Compensatory Damages

As discussed in Chapter 1, compensatory damages are financial compensations recovered on behalf of a plaintiff in civil court cases. They are awarded for damages resulting from the unlawful and/or negligent actions of the defendant. Compensatory damages may cover actual injuries sustained by the plaintiff, and/or the economic losses incurred, such as the cost of hiring an attorney and filing a lawsuit.

### Case Review: *Erlich v. Menezes* (1999)

The case, *Erlich v. Menezes* (1999) 21 Cal.4th 543., involved a husband and wife who sued their general contractor for damages.

A husband and wife (Erlich) hired a contractor (Menezes) to complete construction on their property. However, faulty construction techniques caused severe leaking which led to three inches of water in the Erlichs' living room. Additionally, the roof that became so inundated with water that a portion of the garage roof collapsed. Upon inspections, structural engineers determined that there was significant structural damage. As a result, the property became uninhabitable. The Erlichs brought suit against Menezes for damages and emotional distress.

The Superior Court ruled in favor of the Erlichs, awarding them \$406,700 in

damages and emotional distress. Menezes appealed. The Court of Appeals affirmed the lower court's ruling. However, it ruled that the Erlichs' claims of emotional distress were invalid and did not require those damages to be paid.

### Liquidated Damages

Liquidated damages are agreed-upon financial compensations within a contract that are awarded in the event that one party violates the contract terms. Most real estate contracts contain a provision that requires a down payment. The purpose of this clause is to have money set aside that can be used to reimburse a violated party in the event that liquidated damages are demanded.

For example, if a buyer and a seller enter into a sales contract for a property and the buyer ultimately decides not to buy the property, the seller will be entitled to the contract's agreed-upon liquidated damages.

Typically, the cost of liquidated damages does not exceed three percent, or the cost of the down payment.

### Case Review: *BD Inns v. Pooley (1990)*

The case, *BD Inns v. Pooley (1990) 218 Cal.3d 289.*, involved a buyer who cancelled a purchase agreement after the terms had been accepted.

A seller of a motel (BD Inns) entered into an agreement to sell the motel to a buyer (Pooley). BD Inns sued Pooley for specific performance and breach of contract on the grounds that Pooley cancelled the sale after a contract had been agreed upon.

The Superior Court sides with BD Inns and ordered Pooley to perform the contract as previously agreed. However, as Pooley was no longer willing to purchase the property, he was ordered to pay the difference between the purchase price that had been agreed to in the contract and the property's future sales price.

### Reformation

Reformation refers to a court's ability to alter the contents of a legally-binding contract in order to clarify conflicting or unclear terms. There must be a valid reason to "reform" a contract, such as the presence of an error, mistake, or inadvertent misrepresentation.

Reformation can only be utilized by parties who have acted in good faith in the original execution of the contract.

Examples of legally-binding agreements that are commonly reformed are deeds, mortgages, and trusts.

## Statute of Limitations

A **statute of limitations** refers to the legal period of time in which a violated party may bring forth a lawsuit. Upon the expiration of a statute of limitations, the violated party may no longer claim legal judgments or damages. Any claim filed after the claim period is not valid, and will not be rewarded in court.

The amount of time a party has to initiate a lawsuit differs based on the type of violation:

- **Property Damage:** within three years of the date the damage occurred
- **Personal Injury Claims:** within two years of the date of the injury
- **Written Contract:** four years from the date the contract was violated
- **Government Claims:** within 6 months of a violation
- **Tenants:** 90 days
- **Oral Contract Claims:** within two years
- **Real Estate Licensee Fraud:** within three years
- **Real Property:** within five years
- **Mortgages:** four years

## Laches

**Laches** is a type of estoppel. It describes a situation in which one individual employs a deliberate and unreasonable delay in bringing forth legal action so as to disadvantage an adversary. Failure of a party to assert his or her rights in a timely manner may result in a legal claim being barred.

For example, say Mary moves in next door to Pam and they immediately dislike each other. Pam has lived in the same neighborhood for over 20 years and is aware of all property lines. Mary is not. Knowing where property lines begin and end, Pam allows Mary to develop her land over property lines and into Pam's property. Pam purposely waits for Mary to finish development before informing Mary that she has violated the property lines and must now take down the house. Because Pam deliberately waited for Mary to spend money and develop the property, knowing that she was in violation of property lines, she is guilty of laches.