Memorandum No. 4

Subject: Study No. 23 - Rescission of Contracts

Each of you has a copy of Professor Sullivan's study to determine whether the Civil Code should be amended so as to provide for a single method of procuring a rescission of a contract. Enclosed are (1) copies of the portions of the minutes of meetings of the Northern Committee held on May 4, July 26, and September 19, 1957, relating to this study; (2) a copy of a letter received from Professor Sullivan commenting on the matter discussed in the minutes of September 19.

As the minutes of September 19 show, the Committee reached something of an impasse the last time this matter was discussed. Now that the group has been augmented it may be possible to resolve the impasse. While I will endeavor to find time to draft the statutory provisions referred to on Page 5 of the September 19 minutes, I am not certain that I will be able to do so before the meeting. I believe, however, that even if I am unable to do so, we can profitably discuss the statute proposed by Professor Sullivan and the problem set forth in the minutes of September 19th.

Respectfully submitted,

John R. McDonough, Jr.
Executive Secretary

JRMJ:j

STUDY NO. 23 - RESCISSION OF CONTRACTS

The Committee gave further consideration to Professor Sullivan's study. The Committee discussed again whether a new single rescission action should include a requirement that the person desiring to rescind give prompt notice thereof to the other party and offer to restore what he has received.

In the course of this discussion Mr. Stanton stated that he has great doubt about the wisdom of Professor Sullivan's recommendation that the present provision in California law for out-of-court rescission be abolished. He stated that, in his opinion, the law should continue to make it possible for a party desiring to rescind a contract to do so without having to go to court to obtain a decree of rescission in the event that the other party is not willing to engage in a mutual rescission of the contract. He stated that parties act at the present time on the assumption that a unilateral out-of-court rescission does terminate a contract and that it is undesirable to create a situation in which a party must bring a lawsuit to rescind a contract. Mr. Stanton suggested that the law should either continue to provide for out-of-court rescission as an alternative to bringing suit to obtain a rescission or that, if there is to be but a single action, it should be an action to enforce an out-of-court rescission rather than an action to obtain a decree of rescission. He stated that as he sees the matter it is one of

eliminating the problems arising out of the duality of the existing legal and equitable actions and that this could be done under either of the alternatives which he suggested just as readily as by providing a single action to obtain a decree of rescission.

Messrs. Thurman and McDonough questioned whether there is any need to retain the out-of-court rescission, other than in the form of a mutual rescission by the parties. They took the following position:

> A "unilateral out-of-court rescission" is legally meaningless and will not preclude litigation except in the rare case where the other party is willing to acquiesce in the "rescinding" party's desires even though unwilling to state his acquiescence and thus effect a mutual rescission. A law suit is always necessary when the person seeking rescission desires to get back from the other party benefits conferred under the contract. A suit is also necessary even where no recovery is sought against the other party if the person desiring to rescind wishes to have his legal rights in the matter clearly settled. If the other party announces his disagreement with the rescinding party's assertion of his right to rescind, the rescinding party is exposed to the possibility of a suit for a breach of contract until the statute of limitations has run despite the fact that he has announced that he has rescinded the contract. If such a suit is brought, the defense will be those acts of the plaintiff which were the grounds for the "unilateral

out-of-court rescission"; nothing is added to this defense by virtue of the fact that the defendant undertook to effect an "out-of-court rescission". Even if "out-of-court rescission" is recognized, a rescinding party must, to avoid the over-hanging risk of a breach of contract action, bring an action to obtain rescission (if this is available as an alternative remedy) or bring a declaratory judgment action to put an end to his potential liability under the contract. In either case, the plaintiff's rights will depend, not on the fact that he has purportedly effected an "unilateral out-of-court rescission", but upon whether grounds for rescission of the contract in fact existed when he acted. Thus, the "out-of-court rescission" is legally meaningless and need not be retained as a part of our law.

Messrs. Thurman and McDonough were, therefore, of the opinion that Professor Sullivan's recommendation to abolish out-of-court rescission and have a single action to obtain a decree of rescission is the sound approach to ending the existing duality in rescission procedure.

It was decided that all concerned would give the matter further consideration and that the Executive Secretary should attempt to draft statutory provisions embodying both of the alternatives suggested by Mr. Stanton in order to see whether it would be feasible to enact either or both of them if the Commission were to decide upon them.

The study was continued on the agenda of the Committee for further consideration at its next meeting.

Respectfully submitted,

John R. McDonough, Jr.
Executive Secretary

STUDY NO. 23 - RESCISSION OF CONTRACTS

The Committee began but did not have time to complete its consideration of Professor Sullivan's study.

The Committee tentatively agreed to recommend to the Commission that it recommend (1) that a single rescission action be established; (2) that a right to jury trial be provided; (3) that attachment be made available and (4) that such an action be joinable with unrelated contract actions.

The Committee was unable to agree whether the new procedure should include a requirement that the person desiring to rescind promptly give notice thereof and offer to restore what he has received. Mr. Stanton favors such a requirement; Mr. Thurman would make failure to give notice and offer to restore a defense only when the other party has been prejudiced thereby.

No decision was reached with respect to what statute of limitations should apply to the single rescission action or as to whether the justice court should be given jurisdiction of rescission actions.

The statute proposed by Professor Sullivan was not discussed in detail.

Respectfully submitted,

John R. McDonough, Jr.
Executive Secretary

STUDY NO. 23 - RESCISSION OF CONTRACTS

At the beginning of the discussion Professor Lawrence Sullivan distributed copies of a lengthy outline of his proposed study on this subject. He then outlined orally a number of the points covered in the outline. Several of these points were discussed at some length. It was agreed that the members of the Committee and the Executive Secretary would read and discuss Mr. Sullivan's outline and that the Executive Secretary would then communicate to him any suggestion which we might have concerning the study. Mr. Sullivan expressed his intention of completing the study at a relatively early date.

1/6/58

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Dear John:

Thank you for your recent letter bringing me up to date on the action thus far taken in connection with my rescission study. I read with great interest the minutes of the September 19 meeting of the Northern Committee but delayed responding until I had time to comment at length.

As I view the problems involved in this topic, they are essentially procedural. Except for the minor (and inexplicable) differences in the grounds for rescission predicated by Section 1689 on the one hand and 3406 on the other, the same substantive requirements for rescission prevail whether the relief is sought by way of an out-of-court rescission and an action ("at law") to enforce the out-of-court rescission, or by way of a proceeding ("in equity") to obtain rescission. With minor exceptions, the same basic facts - for example, facts constituting fraud - would provide a basis for either mode of redress. Under either procedure, undue delay by the injured party will preclude relief. Under either procedure, the effect of the relief is to restore the status quo, the injured party giving back what he has received and recovering back that with which he parted or its value.

The only differences between the two modes of redress entail conditions upon obtaining relief - whether the aggrieved party must give notice of rescission and offer with precision to restore precisely what the other party is entitled to before commencing his action - and ancillary matters of a procedural character such as whether jury trial is available, whether attachment is available, what statute of limitations applies, and the like.

The principal conclusion of my study was that under a unified civil procedure in which law and equity are merged, there is neither a logical nor a pragmatic reason for retaining two separate modes for

obtaining rescissionary relief. The existing duality is nothing more than an anachronism resting entirely on the outmoded historical distinction between law and equity. Moreover, the existing duality is not merely a quaint but harmless reminder of the old English law tradition - it is productive of vast confusion, it results in like cases being decided differently depending upon which procedure is utilized, and it poses a constant threat that unjust results may be reached in individual cases merely because a lawyer or a judge was unable to make his way successfully through the procedural maze.

The primary question, therefore, - and one which it seems to me the Commission must first decide - is whether the dual procedures are to be retained, or whether a unified procedure is to be adopted. And in my view, this question admits only of one answer - that sound judicial administration necessitates an end to the existing duality.

Only after it has been determined that it is necessary to substitute a unified procedure for the existing dual procedure does it become pertinent to inquire how the particular procedural differences now prevailing should be resolved, i.e. whether, for example, to elect for the new procedure the statute of limitations now governing the "action at law" to enforce a rescission or the statute now governing the "proceeding in equity" to obtain a decree of rescission. And I would suggest that each of these subsidiary questions, including that upon which Mr. Stanton was focused - respecting whether a pre-trial notice and an offer to return what has been received should be a condition to relief - should be considered and passed upon separately, each upon its own merits.

In this connection, I would like to suggest that the "right" of an aggrieved party, which Mr. Stanton suggests should be preserved, to effect a unilateral out-of-court rescission is, realistically viewed, hardly a right at all, but merely an obligation to take a specified formal step - the sending of a formal notice of intent to rescind and a formal offer to return what has been received - as a prerequisite to bringing an "action at law" as distinguished from a "bill in equity" to procure rescissionary relief.

I agree entirely that the statute should not be changed so as to necessitate litigation where litigation is not now necessary. Thus, if the aggrieved party could persuade the other to participate in a mutual rescission, out of court, he should be free to do so. And under the changes I have recommended, he would continue to be free to attempt to do this, and to accomplish such a resolution if possible.

However, if the party in default does not agree to rescind, litigation is inevitably necessary if the aggrieved party is to have relief. His right to rescind, then, is but a right to sue - the same right he would have under the procedure which I have suggested. Indeed, his present right is a more humble one than that which the new procedure would afford since presently the right is conditioned upon his giving notice and offering before suit to restore the status quo. The concept of an "out-of-court rescission" developed initially as a fiction which

facilitated rescissionary relief in courts of law which felt incapable of entering conditional judgments. The plaintiff was afforded relief at law only if he first made an out-of-court tender; and the tender requirement was developed solely because the law courts felt incapable of entering an order in the action conditioning relief upon such a tender. Where, as under a unified civil action, any court may enter a conditional judgment, the distinction between the two types of actions is nothing but a relic.

Now it may be that there is an independent justification for requiring a notice and offer before an action is commenced, and, accordingly, that the new unified procedure should retain this requirement, making it applicable to all rescission actions. It has been argued, for example, that such a requirement reduces the likelihood that litigation will be necessary, inasmuch as the prospective defendant, seeing that the injured party is in earnest, may accept the offer, thus accomplishing a mutual out-of-court rescission.

This contention, I am personally persuaded, is little more than a specious rationalization. I think we may depend on self-interest to assure that rescinding plaintiffs will not resort to suit when their objectives could be accomplished without suit, just as we depend upon plaintiffs asserting all other kinds of claims to pursue settlement prospects on their own initiative. I don't see how we can assume the rescinding plaintiff is any more likely to sue without first exploring settlement prospects than is, for example, the plaintiff seeking compensatory damages for breach of contract.

In my view, therefore, little or no good is derived from the requirement of a formal notice and offer. On the other hand, justice may at times be frustrated by it, inasmuch as a party having a substantive claim to relief may artlessly fail adequately to comply with the requirement, and then, if he sues "at law", may be precluded from recovering by the technical defense.

It does not advance the argument, or serve to resolve the problem, to say that parties presently proceed on the assumption that they may rescind out of court. We would deprive an aggrieved party (and his attorney) of nothing other than a certain amount of confusion and anxiety if we told him he could procure judicial relief in a unified procedure without first giving a formal out-of-court notice of rescission and offer to restore. He can accomplish this now, if he is careful to frame his pleading in equitable terms and is willing to forego the procedural advantages of the "legal" mode of redress. Similarly, the change would work no hardship on the party defendant. In all likelihood he will be approached by the aggrieved party before suit, and will be afforded an opportunity to effect a mutual rescission. Indeed, the likelihood of settlement might be enhanced if the prospective defendant were approached informally, as he could be were formal notice not a prerequisite to relief, rather than by being greeted with the presently requisite formal notice of rescission and offer to restore which typically has all the earmarks of the initial step in a lawsuit and which may thus serve to render the prospective defendant's position more rigid. And even if under the new

procedure I have recommended the defendant were not approached before suit, he would still be free, after suit began, to tender back all that he had received (exactly as he would have to do were he willing to accept the formal notice of rescission which is now a prerequisite to suit) and thus to terminate the litigation at its inception.

The only thing of value of which the defendant would be deprived by the new procedure is something which, in justice, he ought not to have: that is, the opportunity to win his law suit, though substantively he is in the wrong, should the plaintiff's attorney stub his toe on the highly technical requirements respecting notice and offer to restore which now prevail.

My conclusion, then, is that the notice and offer to restore which are requisites for an "out-of-court rescission" and an action to enforce, are not conditions which ought to be carried over to the new procedure. I would re-emphasize, however, that a contrary conclusion would not vitiate the need for a new unified procedure. Even if it were to be concluded that the requirement of a pre-trial notice and offer to restore is a desirable one, this conclusion does not militate against the adoption of a single procedure. If it makes sense to require a formal notice of rescission and an offer to restore the status quo as a condition to rescissionary relief "at law", then it makes sense to require the same as a condition to rescissionary relief wholly regardless of the procedure chosen to obtain relief. Under present law, distinctions are drawn not on the basis of the nature of the underlying claim, but entirely upon the basis of the historic classification of the particular procedure chosen as a vehicle for asserting the claim. This is an anachronism which, to my mind, is utterly incapable of justification. Its sole consequence is confusion and differing results on like facts depending upon whether the claim for relief is cast in "equitable" or "legal" form.

Mr. Stanton also raises the question whether there would be a conflict between the amendments I have proposed and the Uniform Sales Act. I do not believe that there would be.

Section 69(d) of the Sales Act authorizes a buyer, upon a breach of warranty, among other remedies, to:

> "rescind the contract to sell or the sale and refuse to receive the goods or, if the goods have already been received, return them or offer to return them to the seller and recover the price or any part thereof which has been paid."

The thrust of this provision is substantive, not procedural. At common law there were conflicting decisions concerning whether a breach of warranty was a sufficiently material breach to warrant rescission as an alternative to an action for compensatory damages for breach (see Williston, Sales, Sec. 608a (Rev. Ed., 1958)). Section 69(d) makes it clear that rescission is available upon a breach of warranty.

Section 69(d) also has substantive implications in that it speaks of refusing to accept the goods or of offering to return them. This necessity - restoration of the status quo - has always been a substantive requisite to rescission whether at law or in equity. Section 69(d) simply reiterates this substantive requirement. It does not purport to suggest the procedural implementation - whether an offer to return must be made before suit, or whether it is sufficient that the judgment be made conditional on return or an offer to return.

The question I have been concerned with in my study is not the substantive question: whether rescission shall be conditioned on re-establishment of the status quo. I don't think it has ever been suggested by anyone that the aggrieved party ought to recover what he has given without returning or offering to return what he has received. The question upon which I have focused is whether the aggrieved party must make his offer, in formal and precise terms, before bringing his action, or whether it is sufficient that he make his offer as a concomitant of his law suit, and that the decree or judgment in his favor be conditioned upon a tender of whatever the court determines to be due.

Section 69(d), although not specifically, may also imply that the buyer must proceed in timely fashion. This, of course, is also part of the substantive law applicable to rescission, whether achieved in an action at law or in equity.

In sum, the legislative changes recommended in my study would not alter or conflict with the provisions of Section 69(d) of the Sales Act, but would simply make it clear that the offer necessitated by that section to return the goods would not be a procedural condition to the right to bring an action for rescission but only a substantive condition to the right, conferred by the section, to "recover the price or any part thereof which has been paid".

Section 65 of the Sales Act presents a somewhat more serious question. That section, dealing with the seller's remedy for breach of the sales contract, states that:

> "Where the goods have not been delivered to the buyer, and the buyer has repudiated the contract to sell or sale, or has manifested his inability to perform his obligations thereunder, or has committed a material breach thereof, the seller may totally rescind the contract or sale by giving notice of his election so to do to the buyer."

This section, on its face, may seem to make notice a substantive prerequisite to rescission by the seller for the buyer's breach, and, hence, to be affected by the amendments suggested by my study. In fact, however, the section is largely surplusage and is itself in conflict with other settled principles of the law of contract and sales. It does not make the substantive right of the seller to be free of his obligations under the contract dependent upon the giving of notice.

Section 65, it should be noted, is permissive in terms. It states that the seller, in given circumstances, "may" rescind upon giving notice. By implication, it would seem, a seller could not rescind in the designated situations without giving notice. However, the section deals only with cases "where the goods have not been delivered to the buyer" - that is, with situations where the injured party - the seller - if he wishes to treat the contract as being at an end, has no need to recover anything from the party in default - the buyer - because the status quo has not as yet been disturbed by a delivery of the goods to the buyer.

In situations to which Section 65 might be applicable, therefore, the seller, in addition to the "right to rescind", by giving notice, conferred by Section 65, has two alternatives, one of which is the equivalent of rescission and which is not conditioned upon notice.

First, the seller may stand on the contract, treating the buyer in default since the buyer has already "repudiated" or committed a "material breach", or "manifested his inability to perform". On this choice, the seller may sue for compensatory damages.

Secondly, and of significance here, if the seller does not think that he can prove compensatory damages, he may simply refuse to perform the contract without giving the buyer any notice whatsoever. If the buyer should then sue for breach, the seller has a complete defense in that the buyer -having "repudiated", or "manifested his inability to perform", or "committed a material breach" - has not fulfilled the implied conditions to his right to recover on the contract. See, Williston, Sales, §§467, et seq. (Rev. Ed., 1948); Williston, Contracts, §§814, et seq., Restatement, Contracts §§267, 274, 280, 395, 397 et seq. In substance, therefore, the seller's right, conferred by Section 65, to "rescind" by giving notice, is the precise equivalent of his right to refuse to proceed, even without giving notice, because of the buyer's failure to fulfill conditions to the seller's obligation. If the seller is sued, he still must defend. And if he can show "repudiation", or "material breach" by the buyer or that the buyer has manifested his "inability to perform", the defense is a complete one whether or not notice of rescission has been given.

I recognize that were the changes in the rescission provisions, which I recommended, to be adopted there would be a lack of synthesis between these provisions and Section 65, inasmuch as Section 65 does contemplate an out-of-court rescission accomplished by notice. Accordingly, should the changes I have recommended be accepted, the ideal solution might be to amend Section 65 by striking the phrase, "by giving notice of his election so to do to the buyer". I did not recommend this in my study, however, because I viewed Section 65 as an anomolous provision having no significant substantive effect even as the law now stands, and because I do not feel that the Sales Act - which is replete with anomolies and internal inconsistencies such as that implicit in Section 65 - should be dealt with piecemeal, particularly inasmuch as it has been the subject of extensive study in connection with the proposed Uniform Commercial Code recently adopted in Pennsylvania and Massachusetts.

I hope that these observations may be of aid to you and to the Commission, and I will be most interested to learn what action is finally taken. Should it seem expedient, I would be pleased, of course, to make the minor revisions in my study which you suggested earlier. Quite frankly, however, I feel that there is little further than I can do, either to clarify the issues, or by way of expressing my own views upon them, which would be of material aid to the Commission in considering and passing upon the study topic involved.

The most important question, as I have indicated, would seem to be whether the present dual rescission procedure is useful or meaningful. It seems quite clear to me that it is not, and that a single rescission procedure should be substituted.

The subsidiary questions involve separate determinations, with respect to each of the procedural distinctions now prevailing, as to which alternative - that now governing actions to enforce a rescission, or that now governing actions to obtain a rescission - should be carried over to the new unitary rescission procedure. In my study, I have expressed my view with respect to each of these subsidiary questions, and the reasons for the views I have taken.

I look forward to hearing from you about whether there is anything further that I can do.

Sincerely,

/s/ Larry

Lawrence A. Sullivan

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