

## Memorandum 81-40

Subject: Study H-403 - Marketable Title (Unexercised Options)

An option agreement that affects real property may be recorded. In most cases the recorded option will include an expiration date. If the option is not exercised of record before the expiration date, the option nonetheless continues to cloud title. A title insurer or bona fide purchaser or encumbrancer cannot rely on the fact that the option has expired because there may have been an off-record extension or its exercise may have been prevented by acts of the property owner. See, e.g., discussion in 1 A. Bowman, Ogden's Revised California Real Property Law § 11.10 (1974).

In 1965 California enacted Civil Code Section 1213.5 to deal with the cloud created by an unexercised option by providing that the option ceases to be a cloud one year after its expiration date unless an extension of time is recorded:

1213.5. When a recorded instrument has created, or shall hereafter create, an option to purchase real property, which, according to its terms, or by operation of law, has expired, and one year has elapsed since such time of expiration, and no conveyance, contract or other instrument has been recorded showing that such option has been exercised or extended, then the written instrument whereby such option was created shall cease to be notice to any person or put any person on inquiry, with respect to the exercise or existence of such option or of any contract, conveyance or other writing which may have been executed pursuant thereto.

This statute is drawn from the Model Act Concerning Option Contracts as Notice prepared by Simes & Taylor. It was sponsored by the California Land Title Association. See Review of Selected 1965 Code Legislation (Cal. CEB 1965).

While Civil Code Section 1213.5 is a generally effective means of clearing the cloud on title of an unexercised option, it has several defects. It specifies that the option remains a cloud on title for one year after its expiration date. In order to clear the option of the cloud within the one-year period the property owner must obtain a quit-claim deed from the option holder or bring a quiet title action.

On occasion the parties will seek to avoid this problem by adding to the option a provision that purports by its terms to shorten the one-year cloud period--upon expiration "this document shall be of no effect against persons who would otherwise be affected by it under Civil Code Sections 1213-1220 as those sections may now or hereafter be amended or construed with subsequent legislation." Many title companies will insure title immediately based on this type of provision, although some may require an additional premium; other title companies, however, still require a quitclaim by the option holder. See discussion in Moore & Sturhahn, Options, California Real Estate Sales Transactions § 7.42 (Cal. CEB 1967).

The staff believes that the one-year cloud on title of the expired option serves no useful purpose other than to permit recording of an exercise or extension of the option at the end of its term. For this purpose, 30 days after expiration of the term should be sufficient; this is the approach New York takes. N.Y., McKinney's Real Prop. L. § 294; cf. Uniform Simplification of Land Transfers Act (1977) § 3-206 (6 months). Section 1213.5 should be revised to provide that the cloud created by the recorded option terminates 30 days, rather than one year, after expiration of the option if notice of its exercise or extension is not recorded by that time.

Section 1213.5 also fails to deal with the situation where the option specifies no expiration date. In such a situation, the option holder has a reasonable time under the circumstances of the case within which to exercise the option. See 1 B. Witkin, Summary of California Law, Contracts § 129 (8th ed. 1973). Obviously under this rule, a bona fide purchaser can never be assured that the recorded option has expired without having been exercised. At least two jurisdictions provide that if no performance date for an option is specified, the option expires within a short time after its execution. Conn. G.S.A. § 47-33a (18 months); Ala. Code 1975 § 35-4-76 (2 years); see also Uniform Simplification of Land Transfers Act (1977) § 3-206 (6 months). The staff believes such a rule is desirable; Section 1213.5 should provide for expiration of an unexercised option 6 months after it is recorded if no expiration date is provided in the option.

Concern has also been expressed about long-term options that can tie up marketability of property for long periods of time. See Simes & Taylor, *The Improvement of Conveyancing by Legislation* 232-234 (1960). In those states that have the common law Rule Against Perpetuities, the Rule destroys options having an indefinite term or a term greater than 21 years unless the option is to renew a lease or purchase the property at the expiration of the lease. For those states that do not have the common law Rule Against Perpetuities, Simes & Taylor propose a Model Act Limiting the Duration of Options to a 20-year period. This act is milder than the Rule Against Perpetuities in that it limits the term of the option rather than destroying an offending option altogether.

California has the common law Rule Against Perpetuities (Civil Code § 715.2), but the Rule is modified by Civil Code Section 715.6, which saves any interest in real property that vests within 60 years after it is created. Thus an option created for any period up to 60 years is not invalid under the California Rule Against Perpetuities. Although 60 years seems rather long to tie up marketability of property, the staff does not believe the period should be shortened. Where the parties have bargained for this period, the bargain should be honored; where the parties have not specified a term, the 6-month statutory term proposed above is preferable.

The staff has drafted the attached tentative recommendation to implement the suggestions made in this memorandum. If the draft appears sound, we will distribute the tentative recommendation to interested persons for comment.

Respectfully submitted,

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STAFF DRAFT

## TENTATIVE RECOMMENDATION

relating to

## UNEXERCISED OPTIONS

Civil Code Section 1213.5 provides that an unexercised option to purchase real property that has been recorded remains a cloud on the title to the property for one year after the option expires according to its terms or by operation of law.<sup>1</sup> An unexercised option that provides no expiration date according to its terms expires by operation of law within a reasonable time after it is executed.<sup>2</sup>

The one-year cloud on title after expiration of an unexercised option unduly impairs the marketability of real property. The property owner may seek to minimize the effect of the cloud on title in a number of ways, none of which is satisfactory. Title may be cleared by obtaining a quitclaim deed from the option holder; however, this is not always possible. A quiet title action is available within the one-year period; but such an action is time-consuming and costly. An effort to shorten or eliminate the one-year cloud by the terms of the option itself is problematical.<sup>3</sup>

The apparent function of the one-year cloud after expiration of an option is to allow the option holder sufficient time to record an exercise or extension of the option that occurs at the end of the term of the option.<sup>4</sup> For this purpose one year is excessive; 30 days should be sufficient.<sup>5</sup> Civil Code Section 1213.5 should be revised to provide

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1. See discussion in Review of Selected 1965 Code Legislation 53-54 (Cal. CEB 1965).
  2. See 1 B. Witkin, Summary of California Law, Contracts § 129 (8th ed. 1973).
  3. See discussion in Moore & Sturhahn, Options, California Real Estate Sales Transactions § 7.42 (Cal. CEB 1967).
  4. Civil Code Section 1213.5 is drawn from the Model Act Concerning Option Contracts as Notice, L. Simes & C. Taylor, The Improvement of Conveyancing by Legislation 197. Simes and Taylor in their discussion of the Model Act do not justify the one-year cloud.
  5. New York has adopted this rule. See N.Y., McKinney's Real Prop. L. § 294.

that the cloud on title of an unexercised option to purchase real property lasts for 30 days after the option expires according to its terms.

The provision of Civil Code Section 1213.5 for a cloud on title for one year after an option expires by operation of law creates uncertainty that requires a court determination of the date of expiration to resolve. If the option does not by its terms provide an expiration date, the option should expire for purposes of notice to third parties 6 months after it is recorded.<sup>6</sup> This provision will enable the option holder to be aware of the exact time when notice of exercise or extension of the option must be recorded. The provision will enhance the marketability of property if notice of exercise or extension is not recorded within the statutory period by removing the cloud on title simply by the passage of time without need for resort to judicial proceedings.

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6. The Uniform Simplification of Land Transfers Act (1977) has adopted this rule Section 3-206. See also Conn. G.S.A. § 47-33a (18 months); Ala. Code 1975 § 35-4-76 (2 years).

The Commission's recommendations would be effectuated by enactment of the following measure:

An act to add Title 5 (commencing with Section 884.010) to Part 2 of Division 2 of, and to repeal Section 1213.5 of, the Civil Code, relating to options to purchase real property.

The people of the State of California do enact as follows:

SECTION 1. Title 5 (commencing with Section 884.010) is added to Part 2 of Division 2 of the Civil Code, to read:

TITLE 5. MARKETABLE RECORD TITLE

[CHAPTER 1. GENERAL PROVISIONS]

[CHAPTER 2. ANCIENT MORTGAGES AND DEEDS OF TRUST]

[CHAPTER 3. DORMANT MINERAL RIGHTS]

CHAPTER 4. UNEXERCISED OPTIONS

§ 884.010. Expiration of record

884.010. A recorded instrument that creates an option to purchase real property expires of record if no conveyance, contract, or other instrument that exercises or extends the option is recorded within the following times:

(a) Thirty days after the option expires according to its terms.

(b) If the option provides no expiration date, 6 months after the date the instrument that creates the option is recorded.

Comment. Subdivision (a) of Section 884.010 reduces the period of former Section 1213.5 for expiration of record of an option from one year to 30 days after expiration by its terms.

Under subdivision (b) an option with no prescribed term expires of record 6 months after its recordation rather than one year after its expiration by operation of law as provided under former Section 1213.5. This modifies the rule that if an option provides no expiration date it may be exercised within a reasonable time after it is executed. See, e.g., 1 B. Witkin, Summary of California Law, Contract § 129 (8th ed. 1973). Subdivision (b) does not prescribe the time within which such an option must be exercised; it only limits the effect of the option on third persons. See Section 884.020 (effect of expiration).

Nothing in Section 884.010 affects the application of the Rule Against Perpetuities to an option that expires within a fixed or indefinite period in accordance with its terms or that expires by operation of law within a reasonable time after it is executed. See, e.g., 3 B. Witkin, Summary of California Law, Real Property § 304 (8th ed. 1973).

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§ 884.020. Effect of expiration

884.020. Upon its expiration of record a recorded interest that creates an option to purchase real property ceases to be notice to any person or to put any person on inquiry with respect to the exercise or existence of the option or of any contract, conveyance, or other writing that may have been executed pursuant to the option.

Comment. Section 884.020 continues the substance of a portion of former Section 1213.5. An option that has expired of record does not affect third persons but may still affect the parties to the option. See Section 884.010 (expiration of record) and Comment thereto.

§ 884.030. Transitional provisions

884.030. (a) Except as otherwise provided in this section, this chapter applies on the operative date to all recorded instruments that create options to purchase real property, whether executed or recorded before, on, or after the operative date. This chapter does not apply to an option that, according to its terms or by operation of law, has expired more than one year before the operative date.

(b) This chapter shall not cause an option that expires according to its terms within one year before, on, or within one after the operative date of this chapter to expire of record until one year after the operative date.

(c) This chapter shall not cause an option that provides no expiration date to expire of record until one year after the operative date of this chapter.

Comment. Subdivision (a) of Section 884.030 continues the effect of former Section 1213.5 to govern all options now in existence or hereafter created. Subdivision (b) is intended to protect fixed term option holders who may have relied on the one-year expiration period formerly provided in Section 1213.5. Subdivision (c) is intended to protect indefinite term option holders before the operative date of this statute from expiration until an adequate time after the operative date, during which time an exercise or extension of the option may be recorded.

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SEC. 2. Section 1213.5 of the Civil Code is repealed.

~~1213.5. When a recorded instrument has created, or shall hereafter create, an option to purchase real property, which, according to its terms, or by operation of law, has expired, and one year has elapsed since such time of expiration, and no conveyance, contract or other instrument has been recorded showing that such option has been exercised or extended, then the written instrument whereby such option was created shall cease to be notice to any person or put any person on inquiry, with respect to the exercise or existence of such option or of any contract, conveyance or other writing which may have been executed pursuant thereto.~~

Comment. Former Section 1213.5 is superseded by Sections 884.010 (expiration of record), 884.020 (effect of expiration), and 884.030 (transitional provisions).