1/15/60

Memorandum No. 5(1960)

Subject: Study No. 23 - Rescission of Contracts

The study submitted by the consultant has pointed out the many problems created by the existence of two methods of rescinding contracts in California. To solve these problems, the consultant has recommended the abolition of unilateral out of court rescission and the action to enforce such unilateral rescission. As a decision upon this basic issue will determine the direction of the Commission's study of the remaining problems, the questions involved in this basic issue are presented first.

1. Should unilateral out of court rescission be retained in California? Possible alternatives include: (1) Notice of rescission or an offer to rescind may be required as a condition precedent to the maintenance of an action to rescind. (2) Notice of rescission or an offer to rescind may be required as a condition precedent to the maintenance of an action to rescind, but failure to give such notice promptly will not defeat an action if no substantial prejudice has been occasioned the defendant. (3) The obligation to give notice of rescission or an offer to rescind may be required in actions to enforce rescission and abolished in actions to obtain rescission. (4) The obligation to give notice may be abolished altogether.

Comment: The problems involved are discussed in the Study at pp. 14-21. Another argument for the abolition of the out of court unilateral rescission may be found at page 2 (the indented material) of the minutes of the Northern Committee meeting held on September 19, 1957 (copy attached).

An argument for retention of the unilateral out of court rescission is contained in the Memorandum dated September 5, 1958, submitted by the Chairman.

Since these documents were written, Leeper v. Beltrami, 53 A.C. 196 (1959), has been decided. There a plaintiff was held to have lost his cause of action to obtain a judicial rescission because he failed to give prompt notice of rescission, even though there was no showing of laches (the matter was decided on demurrer), no prejudice apparent to the fraudulent defendant, and the statute of limitations had not run. Thus, it seems established that a notice of rescission is required even though an equitable action to obtain a rescission is brought. As the action involved is to obtain rescission, it is difficult to see what function the notice serves. Apparently, this case establishes -- alternative (1), above, (Notice as a condition precedent to suit) as the law in California in regard to actions to obtain rescission.

2. If it is decided to retain unilateral out of court rescission, or if it is decided to require any sort of out of court notice, when should the statute of limitations begin to run - on the date of the notice of rescission or on the date that the acts constituting the grounds for rescission were committed (or discovered in the case of fraud or mistake)?

Comment: This problem is discussed at pp. 22-26 of the Study. Of course, this problem will not exist if unilateral out of court rescission is abolished.

3. If it is decided to retain unilateral out of court rescission, should the action to obtain a rescission be abolished? If the action to obtain a rescission is not abolished, when should the statute of limitations commence?

4. For how long should the statute of limitations be- for an action to enforce rescission (if retained)? - for an action to obtain rescission (if retained)?

5. If both the legal and equitable actions are retained, should the grounds be uniform?

Comment: See Study, p.7. See also Civil Code §§ 1689, 3406.

6. Should there be a right to a jury trial - in actions to obtain a rescission? in actions to enforce rescission?

Comment: See Study, pp. 8-13. If it is concluded that unilateral out of court rescission is to be abolished, it seems to me the legal action to enforce rescission is gone. All rescission actions will be actions to have the court annul a contract. This is equitable relief. Equitable defenses, "clean hands," laches, etc. will be available. Under such circumstances, the constitutional right to a jury trial doesn't seem to be such an insurmountable problem. Accordingly, it is submitted that this question can be resolved upon the determination of the desirability of a jury rather than upon the basis of the Constitution.

7. Should the provisional remedy of attachment be available - in actions to enforce rescission? in actions to obtain rescission? under what circumstances?

Comment: See Study, pp. 26-27. The consultant has recommended that attachment be available in all rescission actions where a money judgment is prayed and the defendant is absent or the claimant has no security available to him.

8. Should a plaintiff be able to join unrelated contractual and

quasi-contractual causes of action with any type of rescission action?

Comment: See Study, p. 28.

9. Should justice courts have any jurisdiction over rescission actions?

Comment: See Study, pp. 28-29.

10. Should the common counts be an acceptable pleading in rescission actions?

Comment: See Study, p. 30.

11. In a case where a release has been rescinded, should the court have power in the substantive action to enter a judgment for the defendant in the amount of the consideration given for the release if this consideration has not been restored and the plaintiff does not prevail on his underlying claim?

Comment: See Study, pp. 19-21.

12. Should the parties be able to rescind a contract by out of court agreement, even though such agreement is unexecuted?

Comment: At page 31 of the Study the consultant recommends that the principle be approved that contracts may be rescinded out of court only by executed mutual agreement. This recommendation may stem from his desire to abolish actions to enforce out of court rescission entirely. It is submitted, though, that in enforcing the agreement to rescind, the court is merely enforcing a subsequent agreement of the parties. The problems here are those common to the enforcement of any contract and are different from those involved in unilateral rescission.

Respectfully submitted,

Joseph B. Harvey
Assistant Executive Secretary

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 acquiese in the "rescinding" party's desires even though unwilling to state his acquiesence 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 in 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

September 5, 1958

Memorandum re Rescission of Contracts (C)
Submitted by Mr. Thomas E. Stanton

Subject: Critique of Critique of Recommendations Agreed Upon at the June 1958 Meeting.

Following is the long promised memorandum of the Chairman on rescission, which has taken the form suggested by the above subject. My "critical examination" of the points made in Memorandum (B) has led to the following comments:

1. I agree that it is the duty of the Executive Secretary to point out what seem to him to be shortcomings of any of the Commission's recommendations at any time, and personally I do not feel that he should be concerned as to how "respectfully" it is done. The important consideration is that each point be stated as forcefully and as persuasively as may be necessary to compete on equal terms with the points made by others in the course of formulating our recommendations.

2. The term "adjudged" did not originate with Professor Sullivan, but is found in Section 3406 of the Civil Code. This section is in a chapter entitled "Specific Relief", and its purpose seems to have been to provide for and preserve the specific relief afforded by courts of equity in rescission cases. For reasons given later, I feel that the versions presently recommended by the Commission should be fitted into the basic pattern of the Civil Code and that if this is done, some if not all of the problems suggested by the Executive Secretary will be solved.

3. After reading some only of the many California cases dealing with rescission I am more than ever convinced of the wisdom of preserving the concept of the out-of-court rescission. Since at this point the view I favor has prevailed, I will not labor the matter, but I am still concerned that such excellent minds as those of McDonough and Thurman remain unconvinced.

The case of M. F. Kemper Co. v. Los Angeles (1951) 37 Cal. (2d) 696, will furnish a good illustration of my point. There a contractor had submitted a bid to the city for the performance of public work which was in the nature of an irrevocable offer, since the contractor had also furnished a bond in a substantial amount guaranteeing that it would enter into a contract with the city for performance of the work if the contract was awarded to it. The contractor made an error in its bid under circumstances which entitled it to rescind the bid. Immediately upon discovering its error, the contractor gave the city notice of the error and of its election to rescind its bid. The city nevertheless attempted to hold the contractor to its bid, to forfeit its bid bond and to recover damages in the amount of the difference between the contractor's bid and that of the next lowest bidder.

The contractor sued the city for specific equitable relief, namely, the cancellation of its bid and the discharge of its bid bond. The court granted this relief upon the theory that the prompt notice of rescission was effective to rescind the bid and to prevent the happening of the contingency on which the city would have been entitled to forfeit the bid bond.

It seems apparent to me that if the law were changed to provide that a rescission could only be accomplished by mutual consent or by a court decree, the result of the Kemper case would either be changed or the courts would have to adopt a different rationale to reach the same result. In my opinion the Commission should not recommend legislation which would require either of these alternatives.

4. While, for the reasons given above, it is important to preserve the right to an out-of-court rescission, it is likewise important to preserve the right to specific equitable relief in rescission cases.

The proposed repeal of Section 3406 might be construed as abolishing this right.

Section 3274 of the Civil Code provides as follows:

> As a general rule, compensation if the relief or remedy provided by the law of this state for the violation of private rights, and the means of securing their observance; and specific and preventive relief may be given in no other cases than those specified in this part of the Civil Code.

Section 3406 is the section of the Civil Code which expressly confers authority upon the courts to "adjudge" the rescission of a contract, and in view of the provisions of Section 3274, it appears important to preserve this express authority.

Accordingly I propose:

a. That Section 3406 be retained and amended to read as follows:

> 3406. The rescission of a contract may be adjudged, on the application of a party aggrieved, in any of the cases mentioned in Section 1689.

b. That proposed Section 1692 be made Section 3407 and proposed Section 1692.5 be made Section 3408.

5. I question the accuracy of Professor Sullivan's statement on page 14 of his report that "it seems now to be settled in this State as it is elsewhere that a pre-action notice of rescission and an offer of restoration is not a condition to an action to obtain a rescission."

Professor Sullivan cites the case of Seeger v. Odell, 18 Cal. (2d) 409, in support of this statement.

In the Kemper case, however, the court said (37 C. (2d) 701-702):

> In addition, the party seeking relief must give prompt notice of his election to rescind and must restore or offer to restore to the other party everything of value which he has received under the contract. (Civ. Code #1691; see McCall v. Superior Court, 1 Cal.2d 527, 535-536 [36 P.2d 642, 95 A.L.R. 1019]; Seeger v. Odell, 18 Cal.2d 409, 417-418 [115 P.2d 977, 136 A.L.R. 1291].

See also the statement to the same effect in Carruth v. Fritch (1950) 36 C. (2) 426, 430, which likewise cites the Seeger case, and King v. Mortimer (1951) 37 C. (2d) 430, 435, which does not seem to me to be distinguishable on the basis stated in footnote 41 to Professor Sullivan's report.

I believe that an offer to restore benefits should be required in the usual case, and that such offer should be excused only in cases where it would be inequitable to deny relief for failure to make such an offer.

Accordingly, I propose that the following language from the decision in the Carruth case be inserted after the word

"contract" in the third line of subdivision 2 of proposed Section 1692:

> in any case where the court may by its judgment fully adjust the equities between the parties.

6. To meet the point behind the second conclusion stated in Memorandum (B), I propose the following:

a. That the first sentence of subdivision 3 of Section 337 C.C.P. be changed to read:

> 3. An action arising out of the rescission of a contract in writing or to have such rescission adjudged, whether such action would formerly have been denominated legal or equitable.

b. That a similar change be made in the proposed revisions of Sections 339, 427 and 537 of the C.C.P.

THOMAS E. STANTON, Jr.