

Memorandum No. 81(1960)

Subject: Study No. 23 - Rescission of Contracts

Attached is a draft recommendation together with the statute as revised by the Commission relating to Rescission of Contracts.

At the August meeting, the Commission deferred action on the question of whether the proposed Section 169⁴ relating to releases should be included in the rescission statute or not. The staff has considered the question and believes that it might be located more appropriately in the Code of Civil Procedure as Section 598. This places the section in the chapter on Issues, Mode of Trial, and Postponements. It immediately follows the section that provides for a separate preliminary trial on defenses that constitute a bar to the plaintiff's cause of action but do not involve the merits of the plaintiff's cause of action. As the section on releases, as revised by the Commission, refers to a determination of the validity of the release as well as to the question of rescission, the staff believes that it should be the subject of a separate bill with a different title. The attached draft incorporates this staff recommendation.

Respectfully submitted,

Joseph B. Harvey
Assistant Executive Secretary

(23)

CALIFORNIA LAW REVISION COMMISSION
School of Law
Stanford, California

T E N T A T I V E

RECOMMENDATION AND PROPOSED LEGISLATION

relating to

RESCISSION OF CONTRACTS

NOTE: This is a tentative recommendation and proposed statute prepared by the California Law Revision Commission. It is not a final recommendation and the Commission should not be considered as having made a recommendation on a particular subject until the final recommendation of the Commission on that subject has been submitted to the Legislature. This material is being distributed at this time for the purpose of obtaining suggestions and comments from the recipients and is not to be used for any other purpose.

September 21, 1960

RECOMMENDATION OF THE CALIFORNIA LAW REVISION COMMISSION

Relating to

Rescission of Contracts

The Civil Code provides two distinct methods by which a person who has the right to rescind a contract may obtain rescissory relief. Sections 1688 through 1691 provide for out of court rescission. These sections set forth the grounds and the method by which a person may rescind a contract by his own act. After an out of court rescission, either party may bring an action to enforce his rights arising out of the out of court rescission. Sections 3406 through 3408 provide for an action for rescission. These sections set forth the grounds and conditions upon which a person may obtain the specific judicial relief of rescission. Any further relief that is needed is usually given as a part of the judgment granting rescission.

An out of court rescission is accomplished by giving the other party to the contract notice of rescission and by offering to restore the consideration if any has been received. An action to enforce the out of court rescission and recover the consideration given is deemed to be an action at law upon the implied promise to restore the consideration that arose when the contract was rescinded. Because the action is to enforce the implied promise that arose by implication when the contract was rescinded, the statute of limitations begins to run on the date of the notice. Because the promise is implied and not written, the two-year

statute of limitations applicable to actions on unwritten contracts applies even though both the principal contract and the rescission notice are in writing. Because the action is deemed to be a "legal" contract action, there is a right to a jury trial, the action may be brought in a justice court, the common counts may be used in pleading, the cause of action may be joined with other unrelated contractual causes of action and the property of the defendant may be attached to secure the claim for relief. Despite the fact that an action to enforce an out of court rescission is deemed a "legal" action, incidental equitable relief, such as the cancellation of an instrument, is sometimes granted in such an action.

Unlike an action to enforce an out of court rescission, an action for judicial rescission is considered an action in "equity." The same grounds that the code provides for a unilateral out of court rescission are also grounds for the judicial relief of rescission; however a judicial decree of rescission may be obtained on two additional grounds -- where the contract is legal and the parties are not equally in fault, and where the continuance of the contract would prejudice the public interest. Because a decree of rescission is based upon the theory that specific relief is being given for the wrong that gave rise to the right of rescission, the statute of limitations begins to run from the date the act occurred that gave the plaintiff the right to rescind. The length of the limitation period depends upon the nature of the wrong. If rescission is sought for fraud or mistake, the three-year limitation (from discovery thereof) is applicable. If rescission is for material breach of a written contract, presumably the four-year statute applies. Because no implied

promise to restore consideration arises until a contract is actually rescinded, the action to obtain a rescission decree is not regarded as an action to enforce a promise and the provisional remedy of attachment may not be utilized. For the same reason, a cause of action for rescission may not be joined with other unrelated contract causes of action. Because the action is in "equity," there is no right to a jury trial, the justice court does not have jurisdiction and the common counts may not be used in pleading. Nevertheless, the action to obtain a decree of rescission may be used even though the only substantive relief a party wants is a return of the consideration given -- a money judgment.

The California courts have frequently failed to distinguish clearly between the action to enforce an out of court rescission and the action to obtain the specific relief of rescission. Although there is no statutory requirement that a notice of rescission be sent as a condition precedent to the action for rescission, the courts have implied such a requirement from the fact that such a notice is necessary to accomplish an out of court rescission. Despite the fact that the action for rescission is in equity and the doctrine of laches should be applicable, the courts have denied relief for failure to send the notice of rescission promptly regardless of whether such failure has caused any prejudice to the other party.

The existence of these two procedures for obtaining the same type of relief permits a plaintiff to affect seriously the rights of the parties merely by the way he drafts his complaint. The period of the statute of limitations, the date of its commencement, the forum of the trial and the right to a jury may all be changed by the form of the complaint. At times,

relief may be denied a plaintiff with a meritorious cause of action merely because the wrong form of action is pleaded.

The Law Revision Commission believes that the rights of the parties should not be dependent on the form of the complaint. These rights should be dependent upon the substantive relief requested and the nature of the wrong complained of. As it is the existence of the duality in the procedures for obtaining rescissionary relief that has given rise to this situation, the Commission believes the problems may be solved by the elimination of this duality.

Accordingly the Law Revision Commission recommends:

1. The provisions in the Civil Code providing for rescission by judicial decree should be repealed. The Commission has concluded that the judicial rescission procedure should be repealed rather than the out of court rescission procedure, for in many instances the time of giving the notice which effects the out of court rescission has a substantial effect on the rights of the parties. Under the Sales Act, the notice operates at times to shift the title to property, thus shifting the risk of loss in some cases and determining whether a seller is an unsecured creditor of a bankrupt buyer in others. Because it is important to retain these aspects of rescission procedure, the Commission concluded that judicial rescission should be abolished.

2. The code provisions setting forth the out of court rescission procedure should be amended to include the two additional grounds for rescission that presently appear only in the sections providing for judicial rescission.

3. The notice requirement that is contained in the existing statutes on out of court rescission should be amended to provide that the service of a pleading requesting rescissory relief shall be deemed to be the required notice if none has been given previously. In addition, the notice requirement should be amended to provide that relief may not be denied for failure to give the required notice promptly unless such failure has substantially prejudiced the other party. Thus, a party with a meritorious claim will not be denied relief for failure to comply with a technical requirement when the failure has not amounted to a waiver of the right to rescind and has not caused any prejudice to the other party. The Commission does not believe that an innocent party's right to rescissory relief against a fraudulent defendant should be lost by a bare failure to promptly notify the defendant.

4. The rescission statutes should make plain that, after rescinding a contract, a party may seek any form of relief warranted under the circumstances, whether legal or equitable. As all such actions will be to enforce a rescission, the right of the parties to a jury and the court in which the action must be brought will be determined by the nature of the substantive relief requested and not by the form of the complaint. If a bare money judgment is sought, a justice court will have jurisdiction, and the action may not be converted into an equity action merely by a prayer for rescission. Of course, if it develops at the trial that the plaintiff has mistaken his remedy and the purported rescission has been ineffective, the statute should also make plain that the court may grant any other relief that is appropriate under the circumstances.

5. To dispel any doubt concerning the scope of relief that may be given in the action to enforce rescission, the statute should also indicate that the court may award consequential damages as well as a restoration of any consideration that has been given. The court should also be given the specific authority to render a conditional judgment in appropriate cases or otherwise adjust the equities between the parties.

6. The statutes limiting the time within which actions must be brought should be amended to provide a four-year limitation on actions to enforce the rescission of a written contract and a two-year limitation on actions to enforce the rescission of an unwritten contract. The period of limitation should begin when the cause for rescission occurs -- or, in the case of fraud or mistake, when it is discovered -- and not when the notice of rescission is given; for a party should not be able to control the commencement of the limitation period by his own act or failure to act. The limitation periods for enforcing rescission should correspond to the limitation periods for enforcing the contracts themselves so that a person's right to rescind will not be lost before the other party loses his right to enforce the contract.

7. The provisions of the Code of Civil Procedure relating to joinder and attachment should be amended so that it is certain that an action to enforce rescission will be considered like any other contract action.

8. A statute should be enacted to deal with the problems created by the rescission of a release. The California courts have permitted a plaintiff who has been fraudulently induced to execute a release to rescind the release even though the plaintiff does not restore the consideration he received for executing the release. The courts have

permitted such a plaintiff to sue on the underlying cause of action and have the consideration received for the release offset against the judgment recovered against the defendant. This procedure may be quite unfair to a defendant if the plaintiff does not recover a judgment as large as the consideration he received or if the plaintiff fails to establish any cause of action. In such cases, the defendant has been deprived of the benefit of his bargain without a restoration of the payment made. Therefore, the Commission believes that a statute should be enacted providing that, if a release is pleaded and the plaintiff asserts that it is invalid or subject to rescission for any reason, the court shall first determine the validity of the release; and if the release is found to be invalid or to have been rescinded, the court shall set off the consideration received by the plaintiff for the release against any judgment that he may recover, and if the consideration received by the plaintiff exceeds any judgment recovered, the court shall enter judgment against him for the excess.

The Commissions' recommendations would be effectuated by the enactment of the following measures:

I.

An act to amend Sections 1689 and 1691 of the Civil Code, to add Sections 1692 and 1693 to the Civil Code, to amend Sections 337, 339, 427 and 537 of the Code of Civil Procedure, and to repeal Article 5 (beginning with Section 3406) of Chapter 2 of Title 3 of Part 1 of Division Fourth of the Civil Code, relating to rescission of contracts.

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

SECTION 1. Section 1689 of the Civil Code is amended to read:

1689. A [~~party-to-a~~] contract may be rescinded [~~may-rescind-the-same~~] in the following cases if the party against whom rescission is sought can be restored to substantially the same position as if the contract had not been made [~~only~~]:

1. If the consent of the party rescinding, or of any party jointly contracting with him, was given by mistake, or obtained through duress, menace, fraud, or undue influence, exercised by or with the connivance of the party as to whom he rescinds, or of any party to the contract jointly interested with such party [~~+~~] .

2. If [~~,-through-the-fault-of-the-party-as-to-whom-he-rescinds,~~] the consideration for [~~his~~] the obligation of the rescinding party fails, in whole or in part, through the fault of the party as to whom he rescinds [~~+~~].

3. If [~~such~~] the consideration for the obligation of the rescinding party becomes entirely void from any cause [~~+~~].

4. If ~~[such]~~ the consideration for the obligation of the rescinding party, before it is rendered to him, fails in a material respect [;] from any cause [;].

5. ~~[By-econsent-of-all-the-other-parties;-or]~~ If all the parties thereto consent.

6. If the contract is unlawful for causes which do not appear in its terms or conditions, and the parties are not equally in fault.

7. If the public interest will be prejudiced by permitting the contract to stand.

8. Under the circumstances provided for in Sections 39, 1785 [and], 1789, 1930 and 2314 of this code, Section 2470 of the Corporations Code, Sections 331, 338, 359, 447, 1904 and 2030 of the Insurance Code or any other statute providing for rescission.

SEC. 2. Section 1691 of the Civil Code is amended to read:

1691. ~~[Rescission, when not effected by consent, can be accomplished only by the use, on the part of the party rescinding, of reasonable diligence to comply with the following rules:]~~ (1) Subject to Section 1693, to effect a rescission a party to the contract must, [i.e.--He must rescind] promptly upon discovering the facts which entitle him to rescind if he is free from duress, menace, undue influence or disability and is aware of his right to rescind:

(a) Give notice of rescission to the party as to whom he rescinds; and

(b) Restore to the other party everything of value which he has received from him under the contract [;] or [must] offer to restore the same upon condition that [such] the other party [shall] do likewise, unless the latter is unable or positively refuses to do so.

(2) When notice of rescission has not otherwise been given and an offer to restore the benefits received under the contract has not otherwise been made, the service of a pleading in an action or proceeding that seeks relief based on rescission shall be deemed to be such notice and offer.

SEC. 3. Section 1692 is added to the Civil Code, to read:

1692. (1) When a contract has been rescinded in whole or in part, any party to the contract may (a) bring an action to recover any money or thing owing to him by any other party to the contract as a consequence of such rescission or for any other relief to which he may be entitled under the circumstances or (b) assert such rescission by way of defense, counter-claim or cross-complaint.

(2) If in an action or proceeding a party seeks relief based upon rescission and the court determines that the contract is not subject to rescission, the court may grant any party to the action any other relief to which he may be entitled under the circumstances.

(3) A claim for damages shall not be deemed inconsistent with a claim for relief based upon rescission. The aggrieved party shall be awarded complete relief, including restitution of benefits, if any, conferred by him as a result of the transaction, and any consequential damages to which he is entitled; but such relief shall not include duplicate or inconsistent items of recovery.

SEC. 4. Section 1693 is added to the Civil Code, to read:

1693. (1) When relief based upon rescission is claimed in an action or proceeding, such relief shall not be denied because of delay in giving

notice of rescission unless such delay has been substantially prejudicial to the other party.

(2) A party who has received benefits by reason of a contract that is subject to rescission and who, in an action or proceeding or by way of defense, counterclaim or cross-complaint, seeks relief based upon rescission shall not be denied relief because of a delay in restoring or in tendering restoration of such benefits before judgment unless such delay has been substantially prejudicial to the other party; but the court may make a tender of restoration a condition of its judgment and may otherwise in its judgment adjust the equities between the parties.

SEC. 5. Article 5 (commencing with Section 3406) of Chapter 2 of Title 3 of Part 1 of Division Fourth of the Civil Code is hereby repealed.

SEC. 6. Section 337 of the Code of Civil Procedure is amended to read:

337. Within four years: 1. An action upon any contract, obligation or liability founded upon an instrument in writing, except as provided in Section 336a of this code; provided, that the time within which any action for a money judgment for the balance due upon an obligation for the payment of which a deed of trust or mortgage with power of sale upon real property or any interest therein was given as security, following the exercise of the power of sale in such deed of trust or mortgage, may be brought shall not extend beyond three months after the time of sale under such deed of trust or mortgage.

2. An action to recover (1) upon a book account whether consisting of one or more entries; (2) upon an account stated based upon an account

in writing, but the acknowledgment of the account stated need not be in writing; (3) a balance due upon a mutual, open and current account, the items of which are in writing; provided, however, that where an account stated is based upon an account of one item, the time shall begin to run from the date of said item, and where an account stated is based upon an account of more than one item, the time shall begin to run from the date of the last item.

3. An action based upon the rescission of a contract in writing.

The time begins to run from the date upon which the facts that entitle the aggrieved party to rescind occurred. Where the ground for rescission is fraud or mistake, the time does not begin to run until the discovery by the aggrieved party of the facts constituting the fraud or mistake.

SEC. 7. Section 339 of the Code of Civil Procedure is amended to read:

339. Within two years. 1. An action upon a contract, obligation or liability not founded upon an instrument of writing, other than that mentioned in subdivision two of section three hundred thirty-seven of this code; or an action founded upon a contract, obligation or liability, evidenced by a certificate, or abstract or guaranty of title of real property, or by a policy of title insurance; provided, that the cause of action upon a contract, obligation or liability evidenced by a certificate, or abstract or guaranty of title of real property or policy of title insurance shall not be deemed to have accrued until the discovery of the loss or damage suffered by the aggrieved party thereunder.

2. An action against a sheriff, coroner, or constable upon a liability incurred by the doing of an act in his official capacity and in virtue of

his office, or by the omission of an official duty including the nonpayment of money collected upon an execution. But this subdivision does not apply to an action for an escape.

3. An action based upon the rescission of a contract not in writing.

The time begins to run from the date upon which the facts that entitle the aggrieved party to rescind occurred. Where the ground for rescission is fraud or mistake, the time does not begin to run until the discovery by the aggrieved party of the facts constituting the fraud or mistake.

SEC. 8. Section 427 of the Code of Civil Procedure is amended to read:

427. The plaintiff may unite several causes of action in the same complaint, where they all arise out of:

1. Contracts, express or implied [;]. An action brought pursuant to Section 1692 of the Civil Code shall be deemed to be an action upon an implied contract within the meaning of that term as used in this section.

2. Claims to recover specific real property, with or without damages for the withholding thereof, or for waste committed thereon, and the rents and profits of the same [;].

3. Claims to recover specific personal property, with or without damages for the withholding thereof [;].

4. Claims against a trustee by virtue of a contract or by operation of law [;].

5. Injuries to character [;].

6. Injuries to person [;].

7. Injuries to property [;].

8. Claims arising out of the same transaction, or transactions connected with the same subject of action, and not included within one of the foregoing subdivisions of this section.

9. Any and all claims for injuries arising out of a conspiracy, whether of the same or of different character, or done at the same or different times.

The causes of action so united must all belong to one only of these classes except as provided in cases of conspiracy, and must affect all the parties to the action, and not require different places of trial, and must be separately stated; but an action for malicious arrest and prosecution, or either of them, may be united with an action for either an injury to character or to the person; provided, however, that in any action brought by the husband and wife, to recover damages caused by any injury to the wife, all consequential damages suffered or sustained by the husband alone, including loss of the services of his said wife, moneys expended and indebtedness incurred by reason of such injury to his said wife, may be alleged and recovered without separately stating such cause of action arising out of such consequential damages suffered or sustained by the husband; provided, further, that causes of action for injuries to person and injuries to property, growing out of the same tort, may be joined in the same complaint, and it is not required that they be stated separately.

SEC. 9. Section 537 of the Code of Civil Procedure is amended to read:

537. The plaintiff, at the time of issuing the summons, or at any time afterward, may have the property of the defendant attached, as security for the satisfaction of any judgment that may be recovered, unless the

defendant gives security to pay such judgment, as in this chapter provided, in the following cases:

1. In an action upon a contract, express or implied, for the direct payment of money, where the contract is made or is payable in this State, and is not secured by any mortgage, deed of trust or lien upon real or personal property, or any pledge of personal property, or, if originally so secured, such security has, without any act of the plaintiff, or the person to whom the security was given, become valueless. ~~[; provided, that~~ ~~an]~~ An action upon any liability, existing under the laws of this State, of a spouse, relative or kindred, for the support, maintenance, care or necessities furnished to the other spouse, or other relatives or kindred, shall be deemed to be an action upon an implied contract within the term as used throughout all subdivisions of this section. An action brought pursuant to Section 1692 of the Civil Code shall be deemed to be an action upon an implied contract within the meaning of that term as used in this section.

2. In an action upon a contract, express or implied, against a defendant not residing in this State, or who has departed from the State, or who cannot after due diligence be found within the State, or who conceals himself to avoid service of summons.

3. In an action against a defendant, not residing in this State, or who has departed from the State, or who cannot after due diligence be found within the State, or who conceals himself to avoid service of summons, to recover a sum of money as damages, arising from an injury to person or property in this State, in consequence of negligence, fraud, or other wrongful act.

4. In an action in unlawful detainer where it appears from the verified complaint on file therein that rent is actually due and payable from the defendant to the plaintiff for the premises sought to be recovered in said action; provided, the payment of such rent is not secured by any mortgage or lien upon real or personal property, or pledge of personal property, or, if originally so secured, such security has, without any act of the plaintiff or the person to whom the security was given, become valueless.

5. In an action by the State of California or any political subdivision thereof, for the collection of taxes due said State or political subdivision, or for the collection of any moneys due upon any obligation or penalty imposed by law.

II

An act to add Section 598 to the Code of Civil Procedure, relating to
trial procedure when a release is pleaded as a defense.

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

SECTION 1. Section 598 is added to the Code of Civil Procedure, to read:

598. Where a release is pleaded as a defense to a cause of action, the court shall first determine whether the release is valid and constitutes a defense to the cause of action or has been rescinded. If the release is held to be valid and not rescinded, it shall be accorded the effect to which it is entitled as a defense to the cause of action. If the release is found to be invalid or to have been rescinded, the release shall be accorded no effect as a defense to the cause of action; but the court shall set off against any judgment rendered in favor of the party asserting the cause of action the amount or value of any benefits that were conferred upon such party in exchange for the release by the party who pleaded the release except to the extent that such benefits may have been restored, and if such amount exceeds any judgment rendered in favor of the party asserting the cause of action, the court shall enter judgment in favor of the party who pleaded the release in the amount of such excess.